Investing Under Uncertain Inflation

SAGE CAPITAL

Sean Fenton
Chief Investment Officer

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After a couple of decades of falling and low inflation, expectations from policy makers have been that this state will continue for the foreseeable future. However, the Covid-19 pandemic has thrown the cat amongst the pigeons by causing massive disruptions to supply chains and shifting spending patterns. The result has been a spike in inflation that hasn't been witnessed in many years. The official line has been that this spike will be transitory, but as pressures continue to build these claims are wearing thin. This raises some very important questions for investors. How long will higher inflation persist, how do you protect your portfolio from it and what do you do if central banks do a U-turn and try to control it?

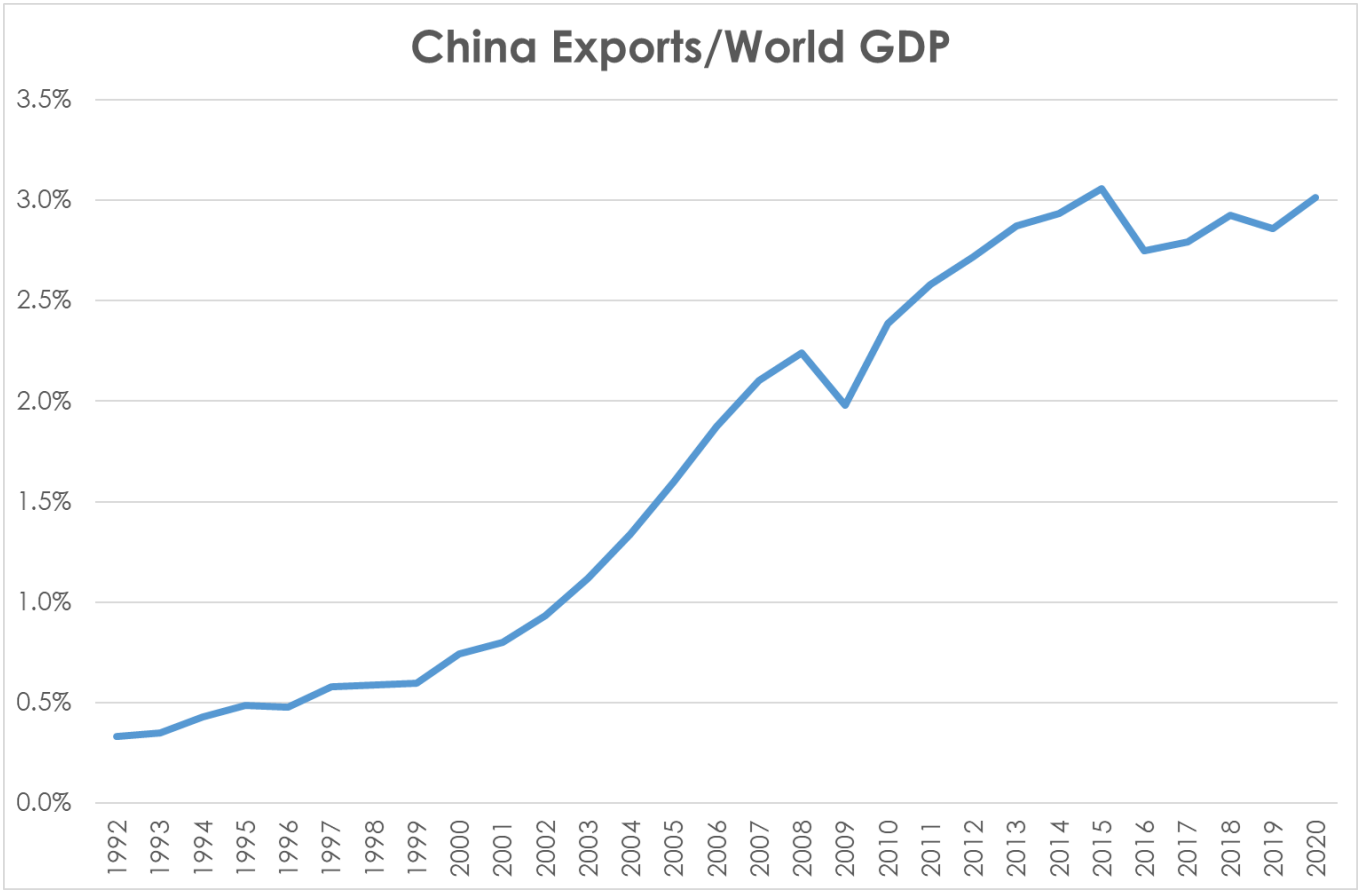
The great disinflation drivers

It is worth trying to understand what drove the low inflation environment of the past 20 to 30 years to get an appreciation for whether it can be maintained. Various theories have been put forward to explain the disinflation, with the main ones being the impact of technological change, ageing demographics and globalisation.

Technology is undoubtedly deflationary, but has been with us for a long time. Ever since we invented the wheel, we've been developing machines to do work for us and replace labour. This is a key driver of productivity and economic growth and has been responsible for the material lift in real income and standards of living we've seen. It's difficult to measure, and there is some conjecture as to whether technological progress is accelerating or decelerating, but there doesn't appear to be much evidence that this dynamic has been more deflationary than usual in recent decades.

The ageing demographic is also pointed at as exerting a deflationary force. The most dramatic evidence is from Japan with one of the most rapidly ageing populations and an inflation rate that has barely shifted from zero for 30 years. Of course, the collapse of a massive housing bubble, an impaired banking system and an ongoing debt deleveraging cycle also acted to stymie the price level, so it is difficult to attribute all of this low inflation to demographics. Europe also has an ageing population and a lower inflation rate, but has also had more problems with the structure of the EU and the recovery of the banking system from the financial crisis. Certainly, spending habits change with age and consumption drops materially in retirement, but leaving the workforce also impacts supply in the labour market which should boost real wages and inflationary pressures for the remaining workers. Demographics may exert a disinflationary impulse, but the significance remains unclear.

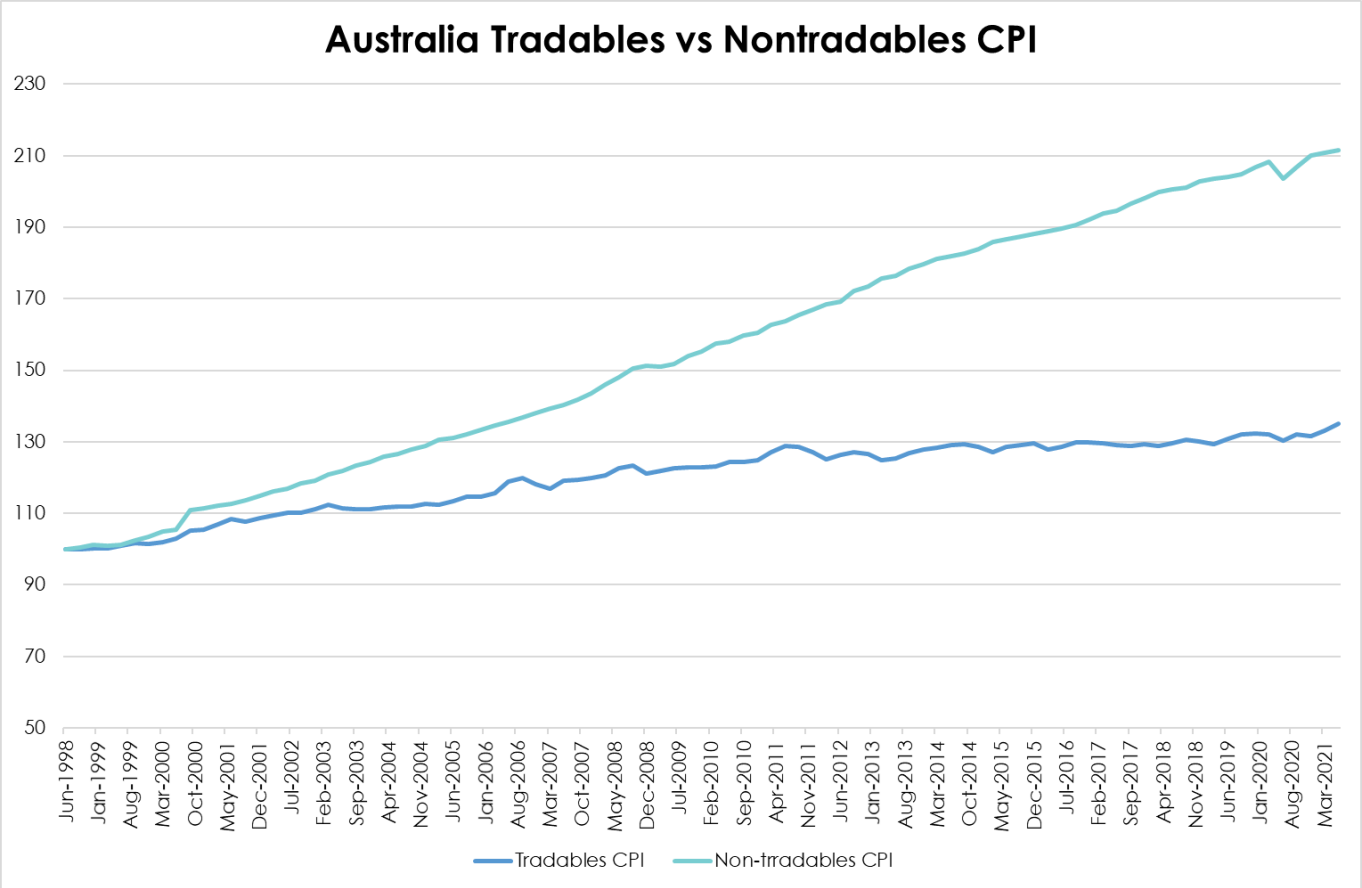
What should be clear is that China's rise as a manufacturing powerhouse, flooding the world with cheap labour and capital has been a massive deflationary driver. The Chinese economy has been growing strongly since the "opening up" reforms of Deng Xiaoping in 1978, but really accelerated with its inclusion in the World Trade Organisation in 2001. This is highlighted by the following chart which shows the ratio of the value of China's exports to total World GDP, and the clear acceleration in that trend since 2001.



Source: World Bank, OECD

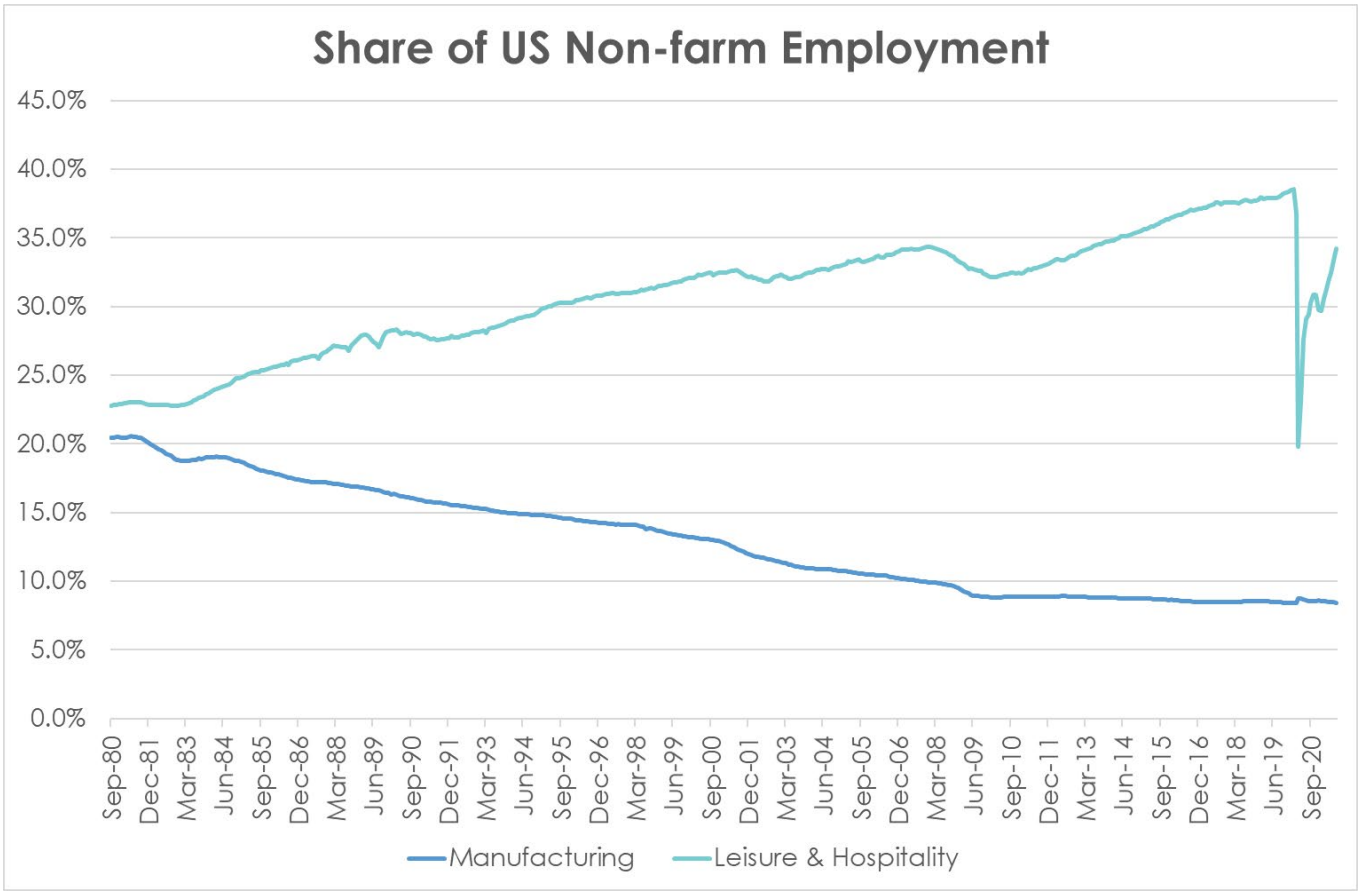
The emergence of China onto the world market had a two-pronged deflationary impact. By utilising a billion low-cost workers and a centralised economic model with access to cheap capital and production incentives not necessarily aligned with profit, it was able to manufacture goods far more cheaply than competing countries and grab a sizeable share of the global market in tradable goods. As an increasing number of firms directly sourced their goods from China and integrated their supply chains there, the price of many manufactured goods declined.

The following chart shows the price levels of tradables versus non-tradables over time in Australia. The significant impact of globalisation on the price of tradable goods and services is readily apparent.



Source: Australian Bureau of Statistics

This directly impacted consumer price indices all around the world, but also drove structural changes across developed markets. The manufacturing sector shrank in importance and there was a general shift in employment to other sectors. As can be seen in the following chart, this shift out of manufacturing has been a long term trend, but accelerated post 2001 and has largely stabilised since the financial crisis. There has been a significant increase in the proportion of workers employed within leisure and hospitality as the economy has transitioned towards services.

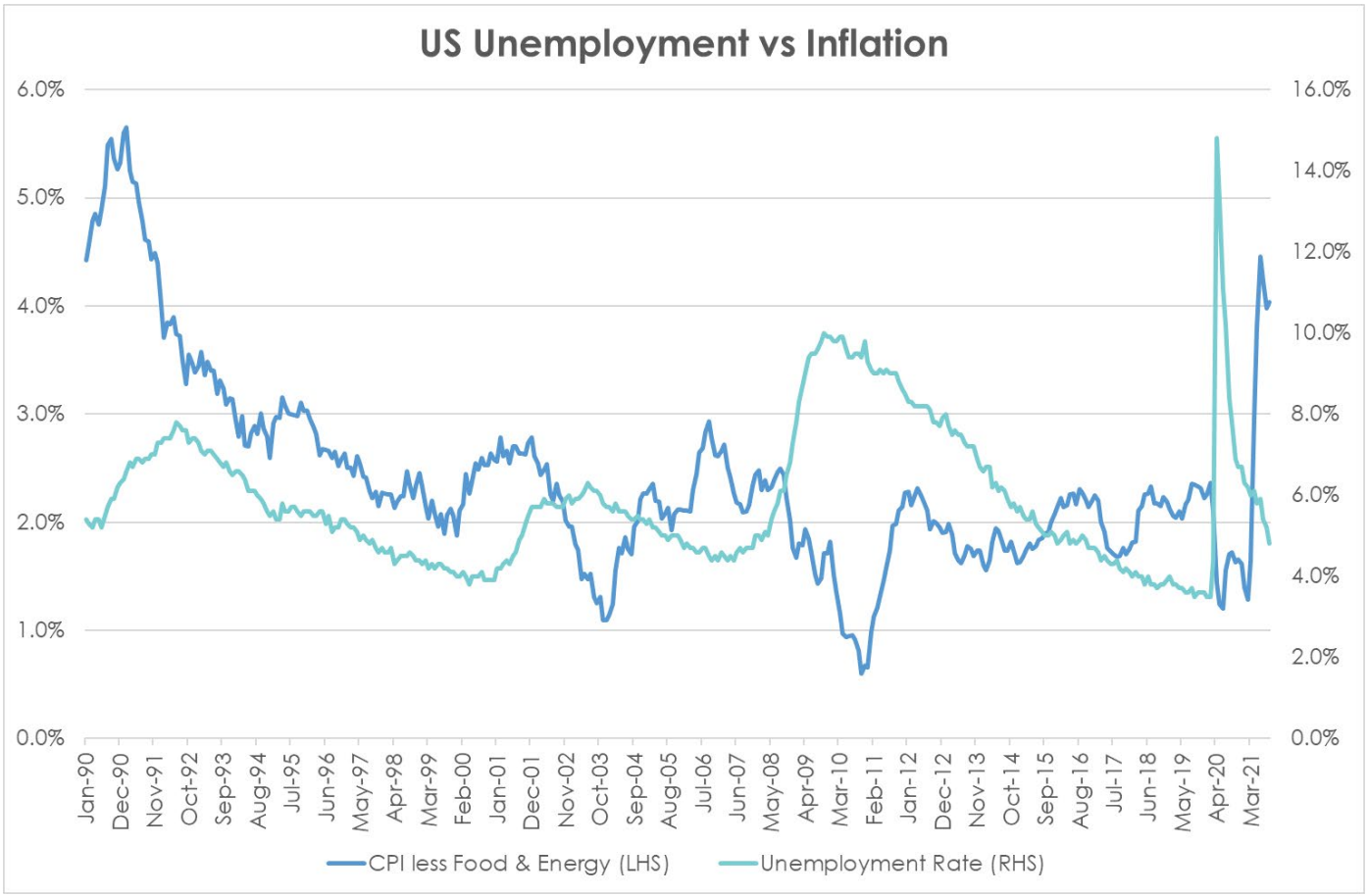


Source: US Bureau of Labor Statistics

This transition in developed economies has made the job of central banks difficult. Supply constraints evaporated with globalisation allowing economies to grow at a much faster rate without generating inflation.

> *"In essence, NAIRU (the non-accelerating rate of inflation) continued to fall allowing policy makers to run with looser monetary conditions. This policy response had its consequences though as low interest rates and lax regulation created a leveraged house price boom on a global scale."*

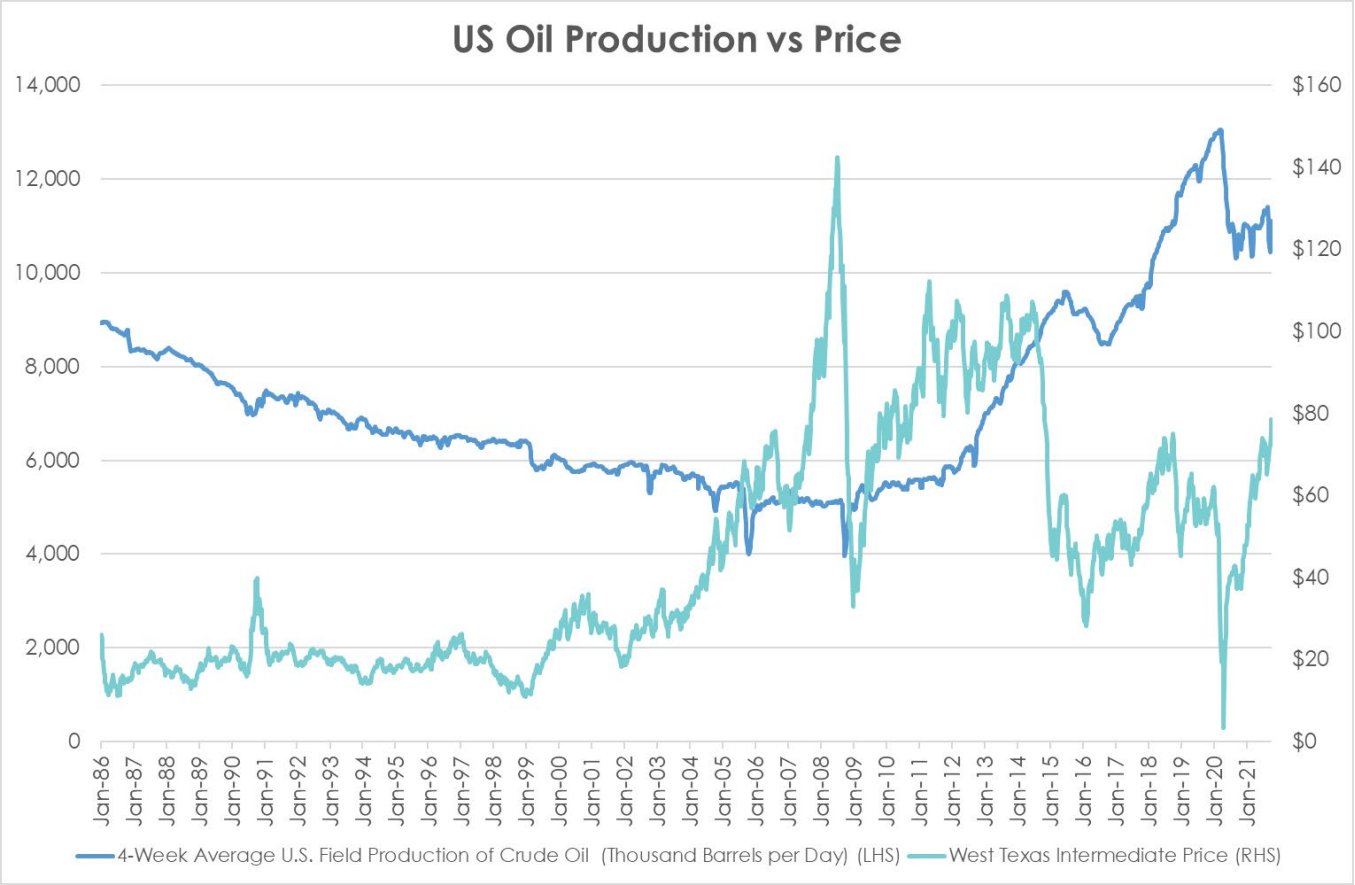
The eventual bursting of this bubble culminated in the global financial crisis which was in itself a significant deflationary shock. The following chart shows the impact of the crisis on the inflation rate in the US as demand sagged.



Source: Federal Reserve Bank of St. Louis

Inflation rebounded towards trend as the economy recovered, but has remained well anchored even as unemployment hit record lows. One reason for this is another side effect of low interest rates. The shale oil boom in the US, fuelled by high oil prices and cheap financing, propelled the US to become the world's largest oil producer. At the end of 2014 Saudi Arabia and OPEC tried to put a stop to this by flooding the market with oil and causing prices to plunge. While oil doesn't feed directly into core CPI this significant and prolonged drop does eventually feed through the economy as lower inflation.

The trade-off between inflation and unemployment



Source: US Energy Information Administration

What has been perplexing economists and policymakers though is the breakdown in the so-called Phillips curve. This curve is intended to show a somewhat linear trade-off between inflation and unemployment. However, in recent times multi-decadal lows in unemployment haven't seen a sustained lift in inflation. The most obvious way to explain this is that the Phillips curve isn't a great descriptor of the real world and that the relationship between employment, wages and inflation is far more complex.

There is a lot of circularity between wages and inflation, higher wages may cause firms to lift prices, while higher inflation may cause workers to demand higher wages. There are also many other factors driving inflation such as labour productivity and pricing across other factors of production. There is also some reasonably strong empirical evidence that households factor in recent inflation experiences when setting wage expectations.

The following chart shows the relationship between real wage growth, defined as average hourly earnings of production and nonsupervisory employees less a two year moving average of core CPI, with unemployment.

Source: Federal Reserve Bank of St. Louis, Sage Capital

We can see a strong relationship between real wage growth and unemployment. Wage growth failed to keep up with inflation during the stagflation of the 70's and the recession of the early 80's. Once excess labour slack was absorbed following the 90's recession real wages once again returned to growth. The relationship breaks down through the global financial crisis where real wages actually held to positive territory. This is likely due to a zero low bound on nominal wages, there's likely a great reluctance to either give or receive a pay cut or change jobs for less money. Real wage growth was also slow to pick up as the labour market tightened. This may be because they didn't fall enough through the recession or that inflation, while picking up, was below a threshold that households paid attention to.

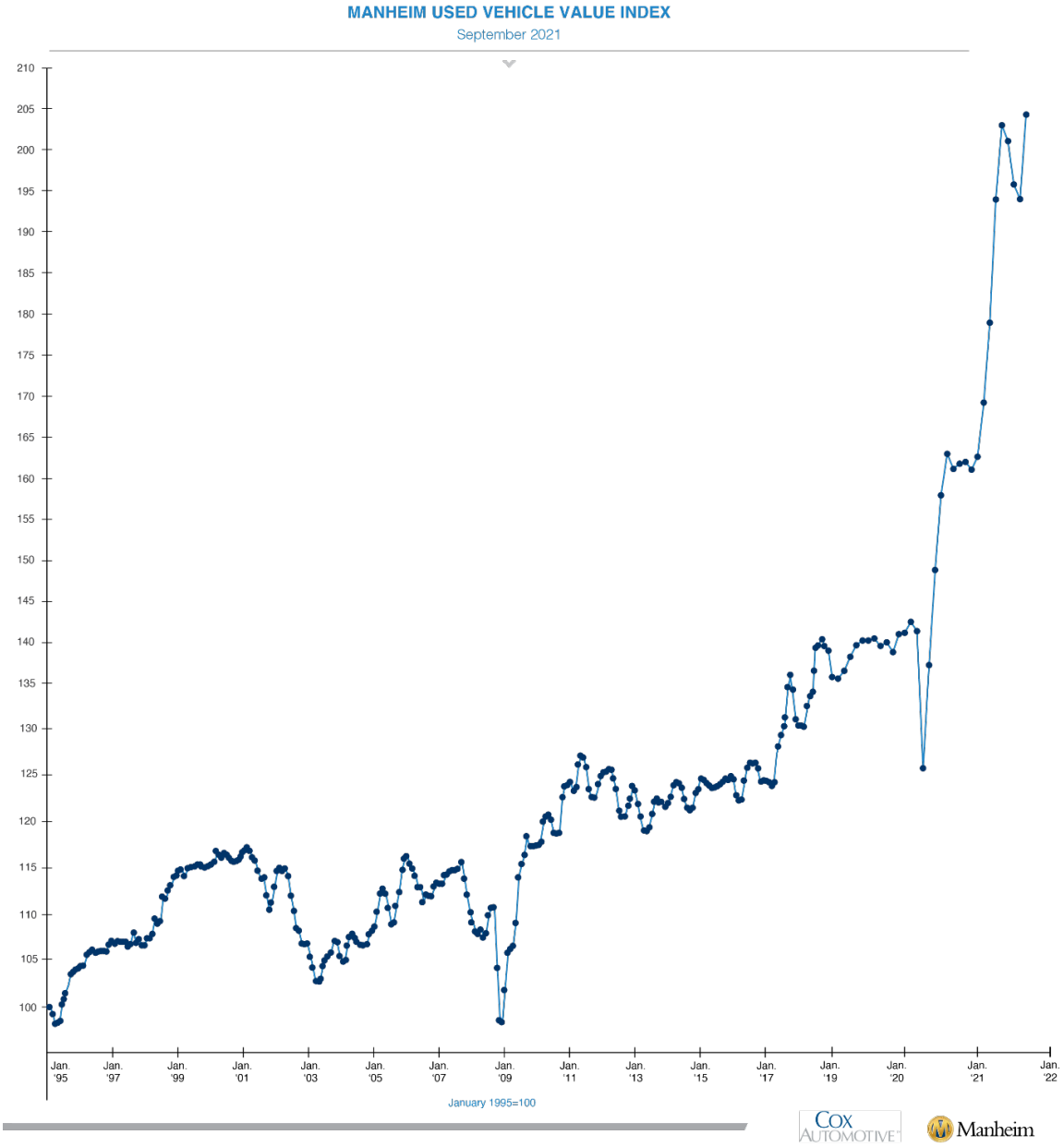
Inflation might well keep rising − but what happens after that?

Where does this leave us now? On a global basis we've experienced three decades of falling and then sustained low inflation across developed economies, driven by globalisation, probably some demographics and a series of financial shocks and crises. However, the most recent coronavirus pandemic has turned the tables. While unemployment spiked initially, a combination of government support and plenty of liquidity prevented a cataclysmic recession.

The advent of vaccines and economic reopening has seen unemployment levels revert quite quickly towards their pre-pandemic levels. The major change has been a surge in inflation which is contrary to the experience of recent crises.

"As opposed to the GFC where there was a massive hit to demand while the supply side of the economy was well supported with low interest rates, the current pandemic has seen fiscal and monetary support for demand while the supply side has been significantly disrupted by the restrictions on the movement of people. This has seen inflation surge to levels not seen since the 1970's and 80's."

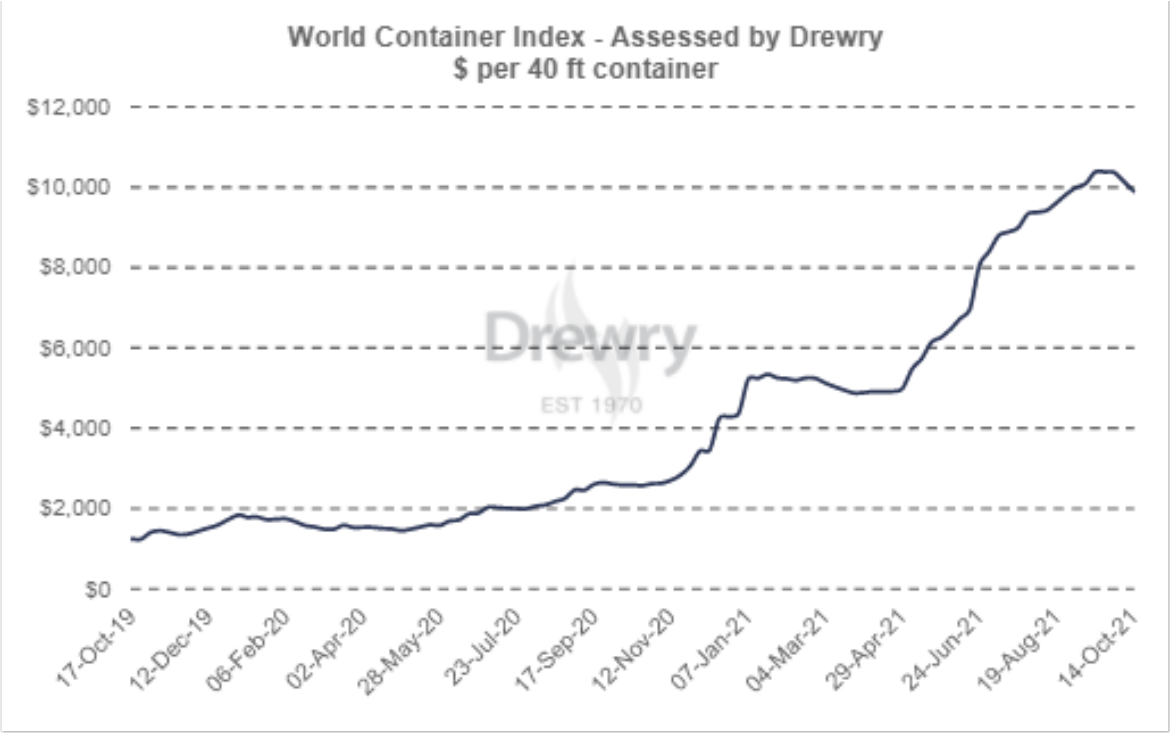
The causes of this inflation surge are many and varied, but a key one impacting headline CPI is shortages in semiconductor chips for the auto industry. This has, along with increased demand for personal mobility, seen new and used car prices surge. The following chart highlights this surge in the US.



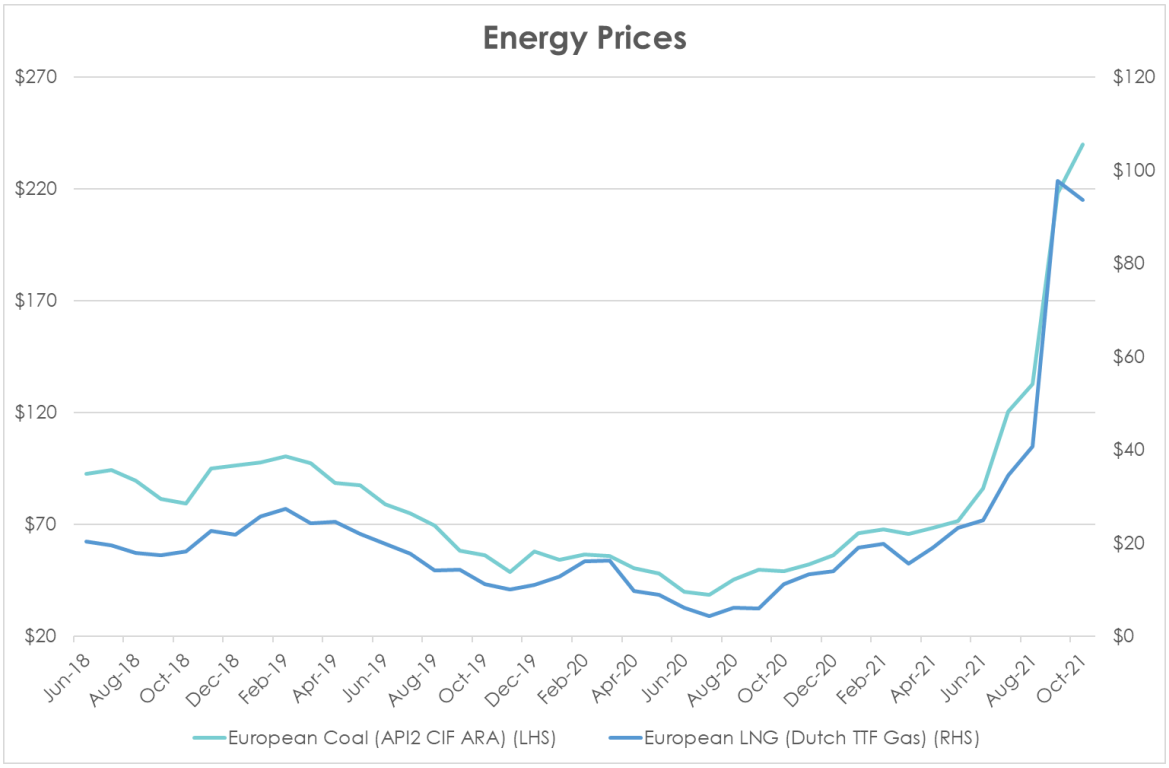
Source: Manheim

More recently these inflationary pressures have continued to broaden with global shipping and energy prices surging. The deflationary force of globalisation that was embodied in lean manufacturing and just in time inventory management has now swung into reverse. Supplier delivery times are blowing out and businesses are seeking to hold more inventory at all levels of the supply chain.

Higher commodity prices, increased transportation costs and higher inventory levels are all driving price rises across a broad range of manufactured goods.



Source: Drewry



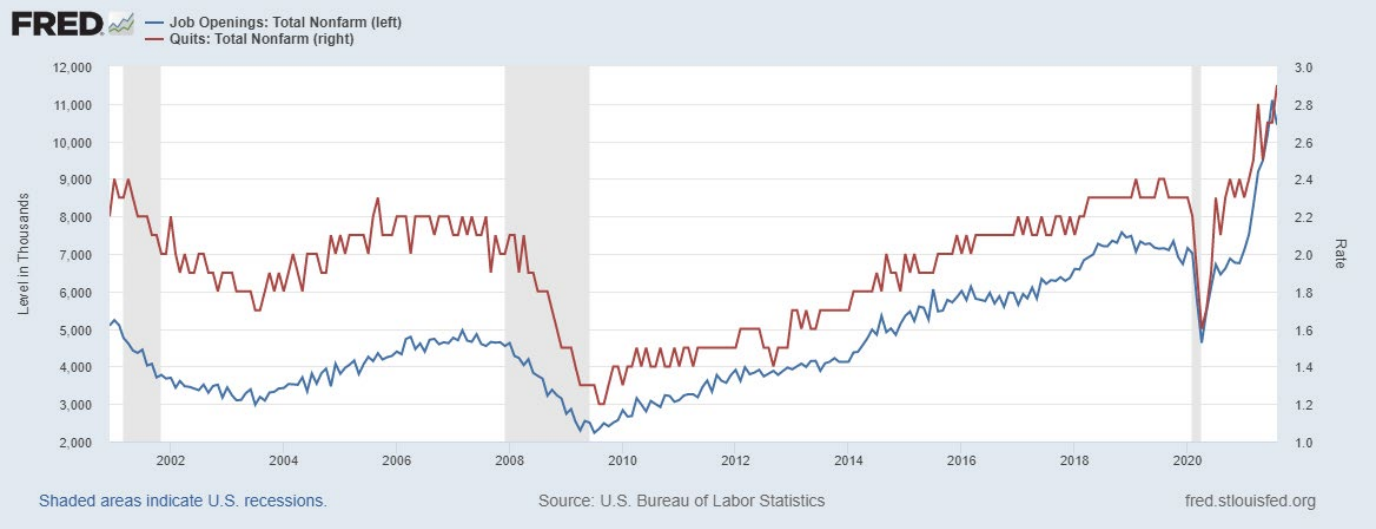
Source: New York Mercantile Exchange

Both charts above highlight the material surge that has occurred in transportation and energy costs. There are a variety of reasons for this with many related to Covid-19, such as restrictions on shipping crews moving through ports or truck drivers transporting coal and fuel. They are both very material costs that will filter through the economy to broader goods inflation. There is also the possibility that energy shortages have been exacerbated by the transition away from fossil fuels and a commensurate lack of investment.

The official position of policy makers has been that these inflationary pressures are transitory and that once economies reopen from Covid-19 lockdowns and restrictions, inflation will revert back to its well anchored level. However, as disruptions roll on and inflationary pressures continue to build, the time before these transitory effects fade is extending further out.

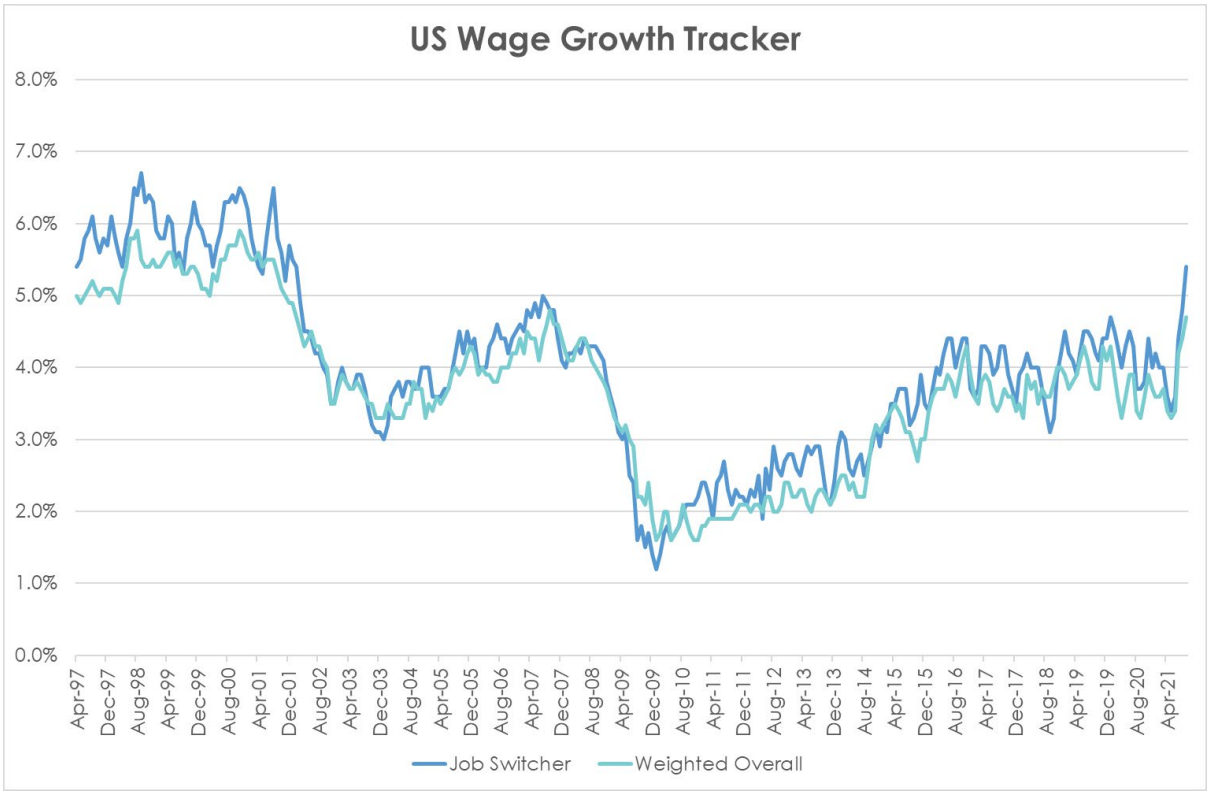
The risk for inflation is that, as opposed to previous crises, this is occurring in an environment where labour markets have rebounded rapidly and economies are closer to full employment.

The following chart is just one measure of labour tightness in the US and highlights that job openings are at a record level and people who are voluntarily quitting their jobs (likely to seek higher wages) is also at a record.



Source: Federal Reserve Bank of St Louis

This is further emphasised by the Federal Reserve Bank of Atlanta's Wage Growth Tracker for the US. The overall level of wages growth has rebounded quickly to a cycle high while the level of wages growth for job switchers has accelerated even further. It is this dynamic of low unemployment and high demand for workers, where workers are actively seeking higher wages against a backdrop of much higher observed inflation − that presents a real risk for policymakers and hence markets.



Source: Federal Reserve Bank of Atlanta

How should investors position themselves for such an uncertain economic and policy outlook?

While many of the current inflationary pressures are indeed likely to be transitory, if wages and inflation have found a new higher equilibrium in the meantime then inflation may not decline back to its pre-crisis levels. The self-reinforcing feedback between wages and prices may see inflation form an equilibrium at a new higher level. This represents a major risk for policymakers because it would be hard to justify interest rates at or near zero in such an environment. Sending real interest rates further into negative territory would likely compound the risks of excess leverage, asset bubbles and increase the fragility of economies.

How should investors position themselves for such an uncertain economic and policy outlook?
We consider three main scenarios.

1. Inflation increases, but policy makers do nothing
2. Inflation increases, and policy makers decide to fight it
3. inflation reverts back to low levels by itself.

1. Inflation increases, but policy makers do nothing

In the first scenario economic growth is likely strong along with corporate profits. Bond yields may be moving higher, but not materially if central banks are still anchoring cash rates. This is a situation where investors would want some equities exposure as an inflation hedge. Companies with pricing power are likely to perform best, such as Resources and Cyclicals. Growth stocks and Gold should be OK as inflation is increasing faster than interest rates. Increasingly negative real rates would support the valuations of both. Stocks with more stable earnings or which are reliant on higher interest rates to make money are likely to be left behind in this scenario.

2. Inflation increases, and policy makers decide to fight it

In the second scenario things are likely to get messy. An incredible amount of leverage has built up around the world in recent years on the assumption that interest rates will stay low and that if anything goes wrong central banks will cut rates further and inject liquidity to save the day. The moral hazard arising from previous efforts to solve crises has made the global economy very fragile to an inflation shock. If policy makers decide that inflation is a genuine problem, it will be very difficult to avoid a deleveraging event and a recession. In this case, equities in general will be under pressure as real interest rates move up. The most vulnerable sectors would be Growth and Gold as higher rates pressure valuations. Short duration style value stocks should be more insulated, but in the event of a recession they have earnings leverage that would be vulnerable. The relative safe areas would be cheaper Defensives, REITs and Yield that benefitted from higher real rates.

3. Inflation reverts back to low levels by itself

The final scenario is a bit of a goldilocks case where inflation really is transitory and quickly subsides. Any policy tightening would be quite minimal, allowing economies to continue to expand. Those stocks delivering strong growth will perform well. By implication, if inflation has subsided then Resources and Cyclicals may have seen their pricing power peak and earnings revert. Nominal bond yields staying low is also likely to be a drag on earnings for Yield stocks dependent on investment income. This scenario most favours the performance trends of recent decades, but also seems the least likely.

Positioning portfolios from unexpected macro risks

The conundrum for investors is that these outcomes require radically different portfolio positioning, and the direction relies on the policy decisions of a few key players. At Sage Capital, we deal with this problem by keeping our portfolios relatively neutral to these risks. By limiting our exposure to these broad groups of stocks our returns aren't overly influenced by policy actions. We can use our ability to go long and short across a broad range of stocks to generate returns from more stock specific company differences as opposed to relying on a single macro call. We are still interested in what is happening to the broad state of the market, not just in controlling risk − but how the earnings of different stocks will be impacted. We are controlling our overall portfolio exposure to any material shifts. This approach gives us the best opportunity to add value for our clients while protecting capital and controlling risk.

Contact Information

For more information, contact our investment manager partner Channel Capital or visit our website.

Phone 1800 940 599
Email distribution@channelcapital.com.au
www.sagecap.com.au