

# Inflation: Keep calm and carry on

✓ **Inflation is picking up, but there's no need to panic. Economic growth is expected to remain strong, and investments in cyclical and quality business should do well**

The monetary and fiscal largesse deployed to fight the Covid-19 pandemic had to come at a price – inflation. We're now starting to see the effects, which have sent shockwaves through financial markets and unnerved investors the world over. I firmly believe, however, that there is no need to panic.

True, we will see a significant rise in inflation with the reopening of economies and a recognition that supply channels were empty, inventories were low and that these conditions will take some time to normalise. In the US, for example, core inflation jumped to 3.8 per cent in May, its highest in nearly three decades.

But a deeper analysis suggests that most of the rise in inflation so far has come from Covid-sensitive areas of the economy such as lodging away from home, used cars, car rentals, airline fares, televisions, toys and personal computers. These accounted for 1.7 percentage points of the headline US number, while base effects added a further 0.5 ppts. Strip those out, and price growth has remained stable. If that continues, it should give investors some comfort.

Secondly, since the 1980s, whenever we've seen significant monetary or fiscal stimulus, markets have persistently adjusted to price in higher inflation than was actually eventually realised. This time, too, the market has discounted a significant rise in inflation that's been priced in pretty immediately. So, arguably, if you are worried about inflation over the next 12-18 months, it's too late to panic. The market has already priced that in.

Thirdly, even when price pressures have picked up in the past three decades,

those peaks have been relatively low. Annual US CPI inflation peaked at 13.5 per cent in 1980, for example, but hasn't been above 4 per cent since 1991. Pictet Asset Management's economists see US inflation at 3.4 per cent this year, and averaging 2.6 per cent over the next half a decade.

In the longer term, however, the outlook is less clear. Politically, there is a strong push towards higher employment and towards better wages for the low-paid parts of the workforce (through higher minimum wages or even the introduction of a universal basic income). If governments in the US, the UK and beyond succeed in their ambitions to redistribute income, that could lead to more significant, structural inflationary pressures. However, it will be a slow burn problem, that will probably only become apparent five to 10 years from now.

## Going for growth

For now, though, we maintain that there is no need to panic. For a start, even if prices rise faster than expected, many liability-driven investors have an inflation cap on their liabilities. For defined benefit pensions schemes in the UK that has, in my experience, been around 3 per cent.

And, crucially, aside from pandemic-related, short-term supply worries, any longer-term pressure on inflation will come from demand, from stronger economic growth – factors which also tend to drive strong asset returns.

In this environment, we favour exposure to economic growth. Being exposed to corporate profits through equities is part of that. Real assets, such as industrial commodities, gold and real

estate could also have potential.

Quality companies should also do well, particularly in areas of strong structural growth, such as tech and communication services. Active asset allocation will become increasingly crucial in order to generate more alpha from within that growth pool.

Bonds, meanwhile, look less attractive. We are in a period of financial repression, where the prospective return on bonds is negative in real terms. Investors requiring a positive real return will have to accept higher risk, on average, than they've experienced over the last two decades. Even yields on US junk bonds have fallen below inflation – for the first time ever.

Inflation-linked bonds are, arguably, an obvious choice to protect against rising prices, but the recent surge in demand means they are looking quite expensive. Structurally, the regulatory backdrop and risk preferences – particularly for DB pension schemes – have pushed investors towards immunising inflation risks almost at any cost. At the same time, supply of inflation-linked bonds is very limited, coming almost exclusively from sovereign governments. As a result we now see extraordinary negative real yields across much of the maturity spectrum.

My guess is that the inflation debate is going to persist for the rest of this year and into early 2022. Our working assumption is that inflationary pressures will then start to subside and that the inflation risk premium will slowly come back down again. Until then, allocation to growth-focused, quality companies and real assets should help cushion investor returns.



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