

Investing whatever the (inflation) weather

✓ **Inflation concerns are on the rise, with everyone scrambling to forecast its path. We believe a better approach is to position for the risks. Here's how**

Let's talk about inflation. The steady removal of lockdown restrictions, tremendous amounts of public spending and highly accommodative central bank policy are creating a lot of anxiety about a possible overheating of the economy. There are grounds for concern – inflation has a major bearing on asset prices but it can be tough to gauge; many economists have made big forecasting errors in trying to predict it.

Which is why we take a risk management approach: rather than trying to predict exactly how inflation might evolve in the next few years, we focus on where the greatest risks lie and hedge against them.

Most of the anxiety about inflation stems from a surge in government spending – public expenditure in most developed economies is now running above 4 per cent of GDP. And there is more largesse to come, particularly in the US. Traditional economic theory, as espoused by John Maynard Keynes, suggests that stimulus on such a scale would transform what is currently a very large output gap into a very large output surplus, giving rise to unusually high levels of inflation.

However, this time the trigger for the stimulus was an extremely deep and violent shock to growth. Government spending has just managed to keep the economy afloat but output is yet to catch up with pre-pandemic levels. Moreover fiscal spending is set to decrease dramatically from 2022. At most, thus, the output surplus is likely to reach 3

per cent, which is unlikely to de-anchor long-term inflation expectations beyond current levels.

The second source of inflation anxiety is money supply. Growth in M1 and M2 has dwarfed pretty much any period since the Second World War. However, that's no reason to panic. The correlation between money supply and inflation has been extremely low for 40 years. Furthermore, money velocity has collapsed, with the pandemic prompting businesses and consumers to hoard large sums of cash, which we believe are unlikely to be fully put to use in the economy.

Thirdly, commodity and goods prices are surging. These were key sources of inflation in the 1980s and early 1990s. Since then, the correlation between producer and consumer prices for goods has broken down as the importance of goods prices in consumer inflation in general has declined in favour of services.

Whatever 'should' happen to growth and inflation, Covid remains a major uncertainty that could yet derail it all. Another unknown are US tax hikes, which could potentially dampen some of the inflationary pressures.

All told, that makes accurate forecasts very difficult. Broadly, there are three main scenarios:

1) **Same old, same old scenario** – Consumer price rises average 0.1-0.14 per cent a month, as for most of the last decade. US inflation would still be below the Federal Reserve's 2 per cent target in two years' time. In this scenario, long-end Treasuries, developed market high grade credit and emerging market local

currency debt should outperform.

2) **Fed scenario** – Inflation averages 0.2 per cent per month, reaching 2 per cent by July 2023, with a possible overshoot to around 2.5 per cent thereafter. This scenario is pretty much in-line with current market positioning. High yield credit and EM hard currency debt should continue to do well, followed by EM credit.

3) **Inflation scare** – Inflation averages 0.25 per cent per month and starts to move beyond the Fed's comfort zone. Around 3 per cent, the Fed may feel the need to slam on the breaks and hike rates aggressively. The last thing the Fed wants is to de-anchor inflation expectations – they have enough credibility to afford a small overshoot, but only a small one and for a limited period of time.

Our base case lies somewhere between one and two, with the third scenario representing a not-insignificant tail risk.

This is where we are taking some hedging positions. Chinese renminbi bonds are a particularly interesting option, as China wants to establish the renminbi as a stable alternative to the dollar. Commodity currencies and medium-maturity TIPS should also hold up well.

Whatever happens to inflation, we believe there are enough dislocations in global bond markets to generate attractive real returns over the coming years.

Uncertainty brought by the pandemic and unorthodox fiscal and monetary policies is here to stay. The key is to identify the risks and the opportunities and balance your portfolio between the scenarios.



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