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Markets

# Inflation is coming

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By: Guest writers

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*This is a guest post by Teun Draaisma and Ben Funnell, co-portfolio managers on Man Group's DNA team, arguing that inflation is about to make an unexpected comeback in a big way.*

We think it is possible that financial markets are on the cusp of a once-in-a-generation regime change that could create havoc for savers and investors.

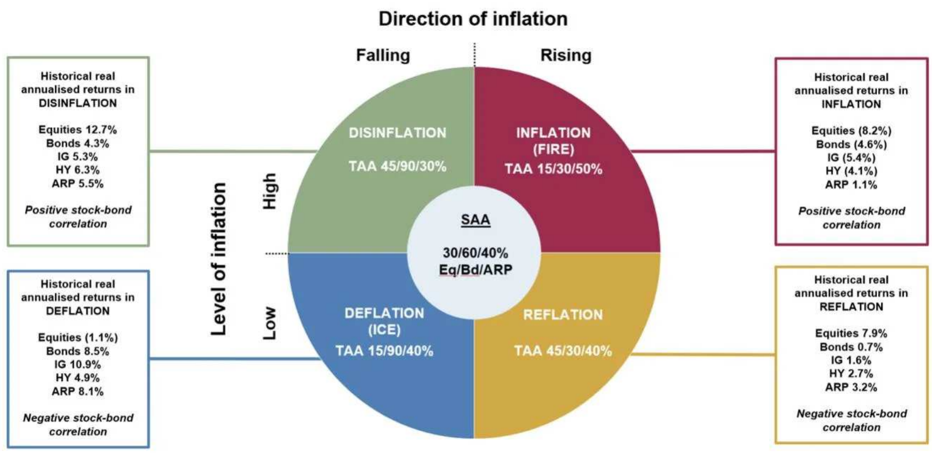
For the first time in 40 years, we believe we may now have to face up to the corrosive power of inflation.

It is high time to prepare for this change and figure out what to look out for and how one might go about immunising investment portfolios against such an outcome.

# A song of fire and ice

Man Group's DNA team likes to think about inflation and deflation using a paradigm we call Fire and Ice, with ice being deflation and fire hyper-inflation.

Neither are good news for asset prices and we believe that investors are unprepared for the coming storm. The chart below sets out the inflationary/deflationary cycle with an indication of what each scenario means for returns.



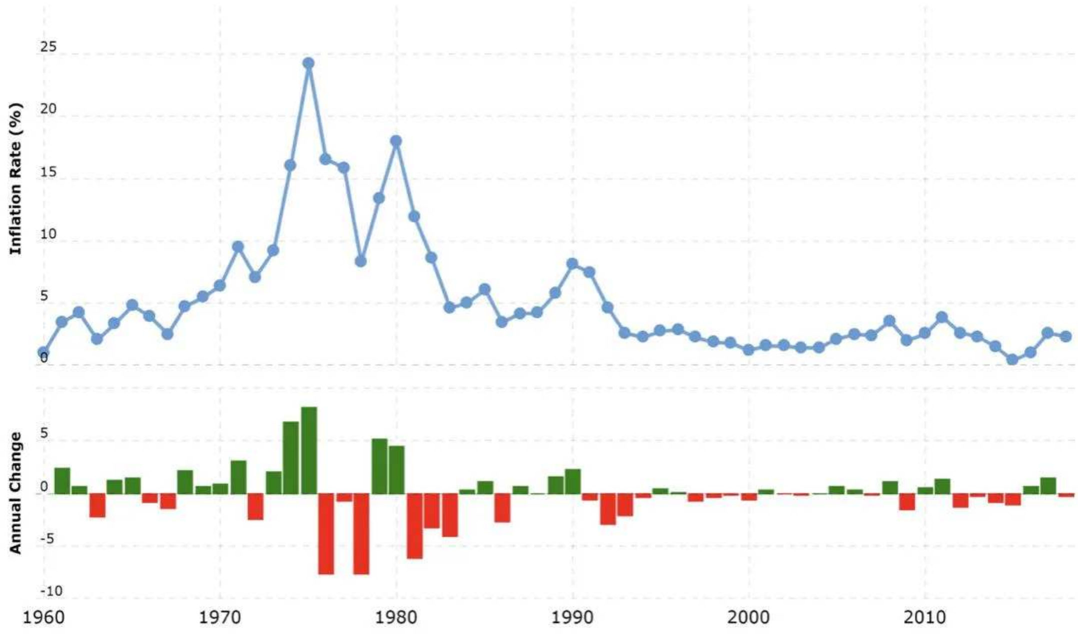

Source: Man DNA team using data from Professor Shiller, Fama-French and Morgan Stanley. Equities refer to the S&P 500, Bonds refer to 7-10 year US Treasuries, IG refers to corporate issuance with BBB rating or higher, HY corporate issuance below BBB, ARP is equal risk contribution long/short portfolios of Value, Size, Momentum, Quality and Low Beta

The current disinflationary/deflationary regime started in 1982 and was caused by a catalogue of factors, notably a building debt load, rising income inequality, offshoring of manufacturing, just-in-time supply chains and ageing populations.

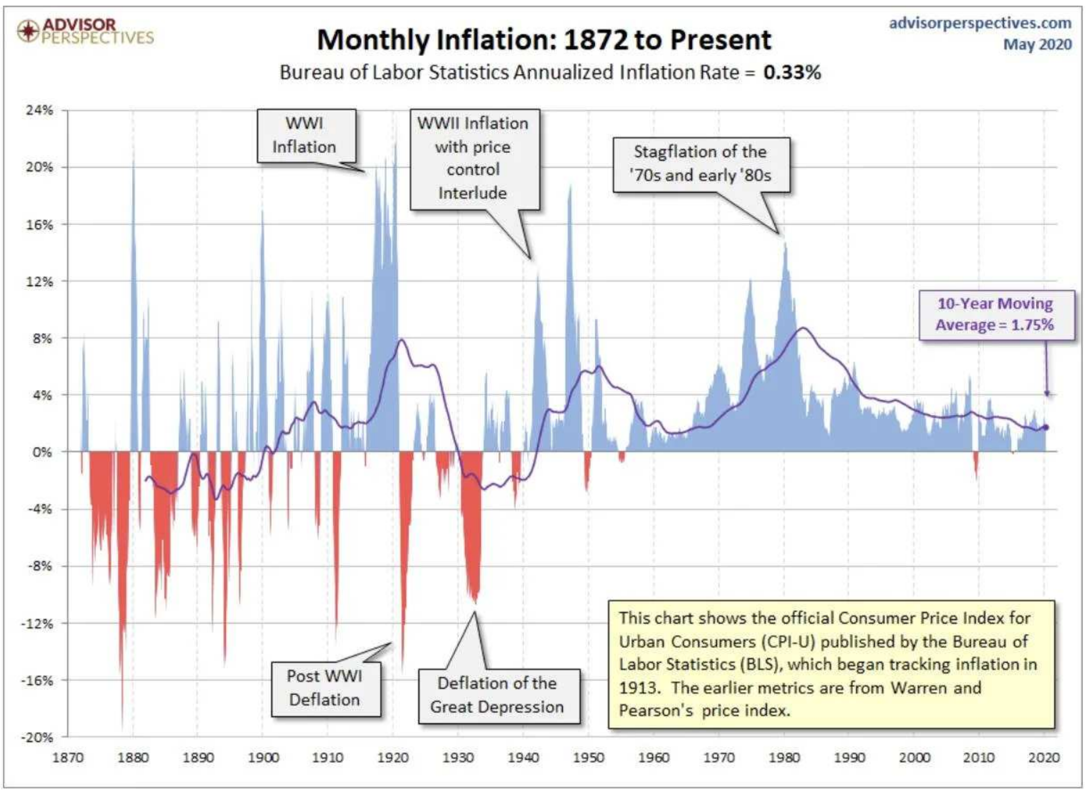
It was sustained by the policies put in place by central banks to support the financial system in the wake of the Great Financial Crash of 2008, which inflated asset prices but did not break the developed economies' slumber, or instigate any pick-up in broader measures of inflation.

This has meant a whole generation has grown up without ever really experiencing inflation. The last time inflation in the UK was above 5 per cent, Right Said Fred were high in the charts with 'Deeply Dippy', the Renault Twingo was big news at the world's motor shows, and the average price of a pint in a London pub was £1.25.

Only those closing in on retirement age will remember what it was like to trade in a truly inflationary environment, when the inflationary shocks of the 1970s led to social unrest and turbulent markets. A look at the chart below illustrates how benign inflation has been for the past 30 years:




But as this chart from Advisor Perspectives illustrates this has not historically been the case:




There have been five broad investment regimes in the past 100 years, each of which has forced investors to radically rethink their approach to asset allocation, with the key focus being how to position their portfolios to respond to inflation or deflation. These episodes were 1) Roosevelt's New Deal, 2) the Fed-Treasury Accord of 1951, 3) the 1970s inflation shocks, 4) the Volcker assault on inflation and 5) the deflationary bust of 2008.

The shift from disinflation to inflation that we now anticipate is not a direct result of the coronavirus crisis – many reflationary policy changes were already being put in place – but the scale of the central bank response to coronavirus, combined with a huge fiscal stimulus and "helicopter money", will, we believe, accelerate and accentuate these pressures. The numbers attached to coronavirus bailouts are clearly astronomical, and it is clear that governments have decided on a 'whatever it takes' approach to spending their way out of the slowdown in the short term.

But thereafter will they be able to wean themselves off deficit spending financed by central bank balance sheets? We suggest not – after all, which Finance Minister is going to be first to re-impose austerity on the doctors, nurses, tube and train drivers and gig economy workers who have literally just kept our economy and our lives going?

All of this comes at a time when governments were moving en masse towards a new spending paradigm anyway. Even before coronavirus hit, sending the government's spending plans off the scale, it was already clear that in the UK Boris Johnson and Rishi Sunak had intended to turn away from the austerity that characterised previous administrations, financing the government's promises about "levelling up" the voters of northern former "red wall" constituencies with extensive deficit spending.

This same impulse is evident across the Western world, where populist governments (or those seeking to stave off the threat of populism), are reintegrating into the workforce those in traditional industries hollowed out by globalisation. Re-onshoring of jobs requires vast capital outlay – effectively reversing the efficiency gains of globalisation – but there appears to be a general acceptance among politicians of a future marked by structurally higher budget deficits and dramatically more inflation than we have been used to.

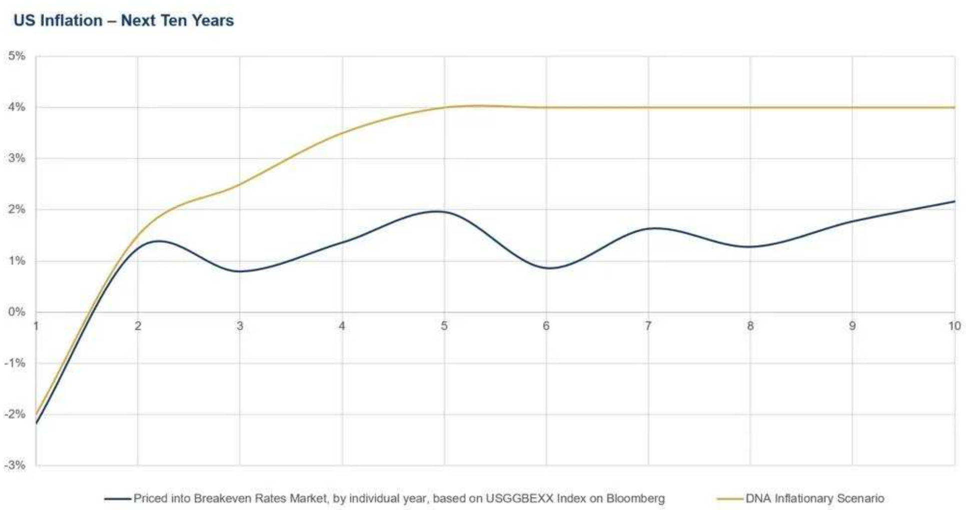
## How to prepare

It may seem like a strange time to be thinking about inflation – just as the world is in shut-down and deflationary signals abound. In our opinion it's clear there are likely to be several quarters of deflation as a result of the supply shock instigated by the drop-off in consumer demand associated with coronavirus-related job losses and furloughing. But it's precisely because inflationary signals are not yet fully visible that we need to be preparing ourselves now.

Over the coming months, these are the key signs that we believe investors can look out for to indicate the onset of inflation:

- Talk of "inflation make-up" by central banks, an early-warning sign of governments allowing inflation to creep back into the system;
- A move from ballooning central bank balance sheets to ballooning money supply: remember, financial QE alone didn't move the money stock – fiscal QE can;
- Increase in fiscal deficit and increased government spending plans;
- Signs of greater protectionism/less globalisation;
- Perhaps the most important signal of all: a change in the relationship between stocks and bonds. An increase in the correlation between the two asset classes – the extent to which they move together – has historically been a sign of a pick-up in inflation.

The problem as we see it for investors is this: by the time these inflationary signals pick up, it's going to be too late to do anything about it. Below we set out in a chart the stark difference between what the market is currently pricing in in the US in terms of inflation, and what we believe may be a likely path given the unprecedented scale of fiscal stimulus combined with the broader secular inflationary pressures in play. The distance between the two represents a vast amount of investor pain.




Illustrative scenario – for information only. There can be no guarantee that the scenario will occur or that any scenario identified will provide similar results.
Source: Bloomberg, Man DNA team calculations. As at April 2020

We are unprepared for inflation and few of us alive have ever experienced what it's like to trade in an inflationary environment. It's traditionally thought that equities do well in periods of inflation, but this relationship typically breaks down above 4 per cent inflation, when almost all asset classes have historically seen real returns go negative.

Attempting to protect portfolios could mean buying not-so-liquid inflation-linked securities and floating-rate bonds; pursuing value and momentum strategies in equities; and purchasing commodities, gold in particular. We are all going to have to learn to live – like Alice in Wonderland – in a world turned on its head, when after decades of a benign inflationary environment, the dominant story of the next decade becomes one of structurally higher inflation.



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It seems like it's not just Nick Robinson's mates who haven't a clue.

JULY 31 2020 By: Jemima Kelly

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