CAPITAL GENERATION PARTNERS

Monday Macro Highlight: Developed Market Inflation: Up, Up and Away… or Not.

20th August, 2018

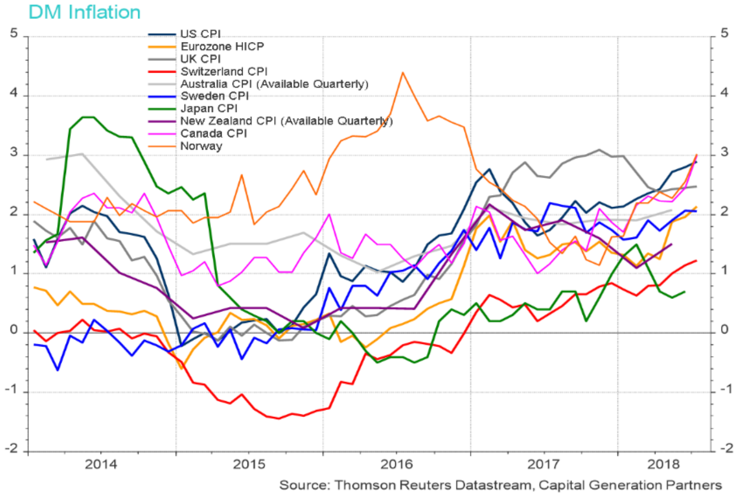
Inflation has been on quite a ride over the past few years in the developed markets. Following the collapse of oil prices in 2014, goods prices moved into deflationary territory. Over the past few years it has started to creep slowly back up and now, headline inflation is heading towards central bank targets or has indeed overshot them.

The question is what happens next for inflation? The chart below looks at headline inflation, which includes volatile goods such as energy and food prices. Core inflation (which excludes volatile components) is slow to move and in fact in many economies it is below target and will remain there because of theories such as secular stagnation; the end of the Phillips curve (the inverse relationship between wages and unemployment); declining demographics in advanced economies; and the fact that advances in technology are seen to be deflationary. So, the argument goes that inflation in the long-term will have to continue trending downwards, like it has since the late 1970s/80s, and bond yields will continue to fall alongside inflation for perpetuity or just sit at zero percent.

On the other hand, it is argued that inflation bears are going to be in for a nasty surprise because in reality economists are notoriously bad at estimating economic slack. One argument being that every month the market and economic commentators are dumbfounded that unemployment continues to fall (the commentators in the paragraph above would argue that this is the death of the Phillips curve) but if estimates of the output gap are over-estimated, then unemployment can fall further, and if the Phillips curve is not dead then inflation may rise. Another argument is that inflation is a lagging indicator of GDP (a simple estimate says it's about 18 months) and it is not clear GDP has peaked yet and so inflation can continue to rise. One final concern for now is the end of central bank independence: Trump complains about tighter Fed policy; "people's QE" is proposed by Jeremy Corbyn in the UK; and the argument (presented by some, not us) that the ECB kept rates low to help the periphery countries avoid a sovereign debt crisis. Central banks who lose credibility lose the ability to anchor inflation expectations and inflation will run-away from them. All of these argument point to higher interest rates.

This is an argument that will rage on for a while but the implications for our clients' portfolios are significant. Bond yields cannot fall forever if inflation heads towards zero, if this does come to pass investors will have no desire to buy. Banks don't have the luxury of choice and have to hold them for Tier 1 Capital requirements. Pension funds will not want to hold bonds in this scenario either, and may be encouraged to take more risk by moving into equities or private equity/real estate. If, on the other hand, inflation rises, then bonds look less attractive to buy as yields rise, and clients will require some active management of bond portfolios and its duration exposure to make the most of this environment. Passive products don't offer this flexibility. Higher rates will encourage some buy, hold and rollover investment strategies and then provide some capital gain when yields fall, whether that be for cyclical or secular reasons.

What an interesting time to be an investor.



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