

Inflated expectations?

by Stephen Nguyen, CFA

It has been one of the main discussion points of the past three years, five years and even decades in the case of Japan: will inflation return? Low prices and ultra-low rates must surely end at some point; or maybe not... We are amid a pandemic and going through a period of depressed economic activity, so why would inflation even register on investors' radars? As an asset allocator, it is imperative we consider what might happen to inflation and inflation expectations in the coming years in order to effectively build robust portfolios for our clients.

Most major economies collapsed in the second quarter of this year. However, we have seen a strong pickup in activity in the third quarter, due to the easing of lockdowns, while the intervention measures taken by governments and central banks globally to prevent a massive deflationary shock have gone a long way to replace the loss of income for businesses and individuals. With no clear end to the pandemic in sight, inflation is likely to be subdued in the near term, but further out is it plausible to expect it to pick-up?

In late August the Fed announced changes to its long-term monetary policy strategy. Among other things, they announced an average target level of inflation of 2% over the business cycle. This means the Fed will be more tolerant of deviations around the 2% number in the short term, and so there is some scope to overshoot which could potentially lead to a bias towards, and tolerance of, higher inflation.

For inflation to undershoot we would need to see more restrictive monetary policy sooner should business activity accelerate. This outcome would be less popular in the post COVID environment and higher rates would be damaging for corporates and the more highly indebted governments relying on Dollar funding markets. On the other hand, generating an overshoot requires rates to be kept low, whilst enabling unemployment to fall back to the pre COVID low levels. This is a more popular policy option but one which could potentially result in structurally higher inflation. Policymakers globally seem to be more tolerant of an inflationary response to this crisis, and of course that would help to debase the huge amount of debt governments have taken on in recent years. It does, however, limit their ability to respond to future

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slowdowns in growth if rates have not normalised to higher levels as business activity accelerates; a trap in which Europe is currently caught.

Both supply and demand factors may drive potentially higher inflation post COVID. The supply side may be constrained as businesses need to build local supply chains which pushes up costs, while on the demand side there should be positive effects from the increased fiscal response to this crisis.

The counter argument is that structurally disinflationary forces such as demographic and technological advances are still present and as a result could serve to put a cap on inflation. If the growth trajectory post COVID surprises to the downside, then inflation is likely to stay under the radar. Finally, any shift towards austerity would be a risk, albeit one that looks unlikely at this stage.

If inflation were to materialise, albeit only moderately higher, we would expect nominal bonds to struggle whilst equities to a certain degree will be able to pass on some of their rising input costs in the form of higher prices at the till. Cash and shorter duration assets should fare better but given the negative real yields on offer, the returns are less exciting. Commodities should do well and potentially emerging markets equity as these firms are used to operating in higher inflationary environment. Real assets and inflation linked bonds should be considered in such environment.

It is difficult to anticipate the inflationary trajectory, so at Momentum we believe in smart diversification and robust portfolio construction, in order to maximise our chances of delivering on the outcome. We aim to avoid our portfolios becoming exposed to any one scenario by allocating investments that can benefit incrementally from both higher inflation and a disinflationary environment. At the margin, the risk today of higher than expected inflation in the future has increased and as a result we took the opportunity over the summer, while prices remained somewhat depressed, to add to our inflation linked bonds, funding largely from their increasingly asymmetric nominal counterparts.

Market Focus

- » Global equities fell -5.6% on the week as the number of Covid-19 cases surged in Europe and the US
- » The US economy expanded at a record 33.1% annualised rate in Q3, which beat market expectations
- » Brent crude fell -10.3% ending the week at \$37.5 a barrel
- » Gold fell -1.2% to end the week at \$1878.8 an ounce

US

- » The large-cap US equity benchmark returned -5.6% over the week
- » An agreement on the latest round of fiscal stimulus has not been reached before this week's presidential election
- » September's reading of the Chicago Fed National Activity Index was 0.27 against 1.11 last month, indicating that growth has slowed significantly, though it is still positive
- » New home sales in September totalled 959k, down from 994k in August and well below the expected figure of 1,025k
- » Weekly initial jobless claims were 751k in the week ending 24th October, down 40k from the previous week. It was the lowest initial claims total since the week of March 14th, when they came in at 282k.

Europe

- » The main continental European equity index returned -5.9% last week
- » France, Germany, Belgium and Greece have become the latest countries to announce second lockdowns.
- » Preliminary official data indicates that Eurozone GDP grew 12.7% in the third quarter, after contracting -11.8% in Q2
- » The ECB meeting saw monetary policy left unchanged and a unanimous post-dated decision made to act at the next meeting in December
- » October's Euro Area manufacturing PMI came in at 54.4 against 53.0 expected, while the services PMI was 46.2 against 47.0 expected
- » Germany's manufacturing PMI was 58.0 against 55.0 expected

Rest of the World/Asia

- » Global emerging markets fell -2.9% last week
- » South Korea's Q3 GDP came in at 1.9% quarter-on-quarter, against 1.3% expected
- » China released details of its new five-year economic plan, which aims to make the country technologically self-reliant.
- » China reported that profits from the industrial sector grew approximately 10% in September year-on-year, driven by electronic equipment manufacturing
- » The Bank of Japan lowered its growth outlook for the remainder of the fiscal year and kept interest rates unchanged

UK

- » UK equities fell -4.9% on the week
- » Intense Brexit negotiations continued over the weekend, as substantial progress was made last week but divisions over issues such as fishing rights remain. Both sides are hoping that the ratification process will be started by mid-November
- » England will enter a month-long national lockdown beginning on the 5th November

Asset Class / Region	Currency	Cumulative returns			
		Week ending 30 October	Month to date	YTD 2020	12 months
Developed Markets Equities					
United States	USD	-5.6%	-2.7%	2.3%	8.8%
United Kingdom	GBP	-4.9%	-5.1%	-25.5%	-23.1%
Continental Europe	EUR	-5.9%	-5.2%	-12.6%	-9.3%
Japan	JPY	-2.8%	-2.8%	-6.2%	-2.9%
Asia Pacific (ex Japan)	USD	-2.5%	2.4%	5.2%	12.1%
Australia	AUD	-3.9%	1.9%	-9.1%	-8.5%
Global	USD	-5.6%	-3.1%	-1.4%	4.2%
Emerging Markets Equities					
Emerging Europe	USD	-8.9%	-9.7%	-35.5%	-32.0%
Emerging Asia	USD	-1.9%	3.3%	11.6%	20.5%
Emerging Latin America	USD	-8.2%	-1.1%	-36.8%	-33.7%
BRICs	USD	-2.2%	3.4%	5.5%	14.0%
China	USD	-0.7%	5.3%	22.6%	35.7%
MENA countries	USD	-4.5%	-2.5%	-10.3%	-4.8%
South Africa	USD	-5.4%	0.5%	-20.9%	-13.0%
India	USD	-3.3%	2.3%	-7.7%	-5.5%
Global emerging markets	USD	-2.9%	2.1%	0.9%	8.3%
Bonds					
US Treasuries	USD	0.0%	-1.0%	8.3%	8.0%
US Treasuries (inflation protected)	USD	-0.3%	-0.7%	9.0%	10.2%
US Corporate (investment grade)	USD	-0.2%	-0.2%	6.4%	7.7%
US High Yield	USD	-1.1%	0.5%	1.1%	3.3%
UK Gilts	GBP	0.4%	-0.6%	7.8%	6.2%
UK Corporate (investment grade)	GBP	-0.1%	0.2%	5.0%	5.5%
Euro Government Bonds	EUR	0.5%	1.0%	4.8%	3.2%
Euro Corporate (investment grade)	EUR	0.0%	0.8%	1.6%	1.5%
Euro High Yield	EUR	-1.0%	0.2%	-2.6%	-0.6%
Japanese Government	JPY	0.0%	-0.2%	-1.1%	-1.6%
Australian Government	AUD	0.2%	0.2%	5.2%	3.8%
Global Government Bonds	USD	-0.3%	-0.3%	7.0%	6.8%
Global Bonds	USD	-0.5%	-0.1%	6.2%	6.5%
Global Convertible Bonds	USD	-2.8%	0.3%	12.1%	16.4%
Emerging Market Bonds	USD	-0.7%	-0.5%	0.8%	4.1%

Asset Class / Region	Currency	Cumulative returns			
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Property					
US Property Securities	USD	-5.3%	-2.6%	-20.0%	-22.2%
Australian Property Securities	AUD	-3.6%	-0.4%	-18.0%	-21.3%
Asia Property Securities	USD	-3.6%	-3.6%	-20.8%	-18.1%
Global Property Securities	USD	-4.7%	-2.9%	-19.9%	-19.2%
Currencies					
Euro	USD	-1.7%	-0.6%	3.7%	4.8%
UK Pound Sterling	USD	-0.7%	0.2%	-2.4%	0.6%
Japanese Yen	USD	0.1%	0.8%	3.8%	4.0%
Australian Dollar	USD	-1.4%	-2.1%	-0.1%	2.2%
South African Rand	USD	-0.3%	2.5%	-14.1%	-7.9%
Swiss Franc	USD	-1.3%	0.5%	5.4%	8.1%
Chinese Yuan	USD	-0.1%	1.5%	4.1%	5.4%
Commodities & Alternatives					
Commodities	USD	-4.1%	-1.8%	-20.8%	-18.1%
Agricultural Commodities	USD	-2.0%	3.5%	3.2%	7.3%
Oil	USD	-10.3%	-8.5%	-43.2%	-38.2%
Gold	USD	-1.2%	-1.0%	23.4%	25.8%
Hedge funds	USD	-0.9%	-0.1%	1.5%	3.9%

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