Spectrum

Inflation: What if they are wrong?

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Federated Hermes International

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Andrew Jackson, Head of Fixed Income

An old married couple have just moved into their dream home. They're surrounded by half their life savings in the form of new furniture and decor. As the husband puts his feet up in front of the fireplace, his wife suggests they talk about buying home insurance, you know, just in case of flooding or a fire. He replies, "Nah, the chances of a flood or of, indeed, a fire burning down this house is so slim, it's not really worth considering."

On a scale of one to 10, how loudly would you scream at this couple to act on the possibility of a fire anyway; not because the chances of it happening are slim, but because, if it did happen, the impact would be cataclysmic?

Where markets are concerned, uncontrolled inflation is as close to a house fire as you can get. Left to rage, the impact could be devastating for economies, markets and portfolios that are not appropriately prepared. Like the couple in our story, it would be reckless for investors not to think about how their portfolios will fare if the worst were to happen.

There is no crystal ball

Inflation remains the single biggest investment risk on the horizon. On this point, it seems that most market participants agree. Similarly – along with industry and central banks – they are largely united in the view that present inflation is transitory and will likely remain under control. On the whole, we share this view and our senior economist Silvia Dall'Angelo will, in the next section, outline why. But inflation has, in the developed world, been so well constrained for close to 40 years that the market has been quick to shrug off the possibility – slim as it may be – that all of us could be wrong. It is this complacency that concerns us.

There is no crystal ball; and history has a way of telling us what we want to hear. After all, there is a history to support every possible point of view. Parallels can be drawn between where we are today and the Great Inflation of the 1960s and 70s, when policymakers put rapid inflation down to transitory factors — droughts, oil prices and union activity — and were ultimately proved wrong.

When inflation woke from its decade-and-a half-long sleep in the spring of 2020, there was the widespread presumption that it would fade away by the summer. Now, on the cusp of another winter of rising prices, even the chair of the US Federal Reserve admits that "we have to be humble about what we know about this economy."

While we may be able to make educated guesses about the impact of current inflation on wages, economies, and demand; we are less certain about its impact on the most unpredictable of variables – human emotion. Enter, the turbo charger effect.

Let's return to the couple in our story above, and imagine that they also own a jam shop. As they sit in front of their new fireplace watching the 10 o'clock news, they see a story about inflation rising to 10%. They nod along because they have, indeed, already begun to feel the pinch of higher costs. The next day, they go to their jam shop, pull out their pricing gun and discuss how high they should raise their prices to offset their rising costs. They dismiss hiking their prices by just 10% because, after all, inflation is still rising; they don't know where it will end and they don't want to have to get their pricing gun out again any time soon. Meanwhile, they see that the clotted cream seller across the street has risen her prices by 12%. And, of course, there is no afternoon tea without clotted cream and jam, so they decide they can get away with raising their prices by 15%.

Now, imagine this conversation is going on up and down high streets across the world. All over the globe, pricing guns are going off as people make a guess about how high they will be able to raise their prices without impacting demand.

With US inflation already at 6.8%, the turbo charger effect raises the real possibility of inflation hitting double digits before it eventually recedes.

As we look forward to the Christmas break, I hope I haven't made it feel too much like Halloween! In fact, there is much to be positive about as we look towards 2022 but I hope I have, nonetheless, made the case against complacency where inflation is concerned. I encourage investors to take a close look at their portfolios in light all that we know – and all that we don't know – about the economic environment we are in.

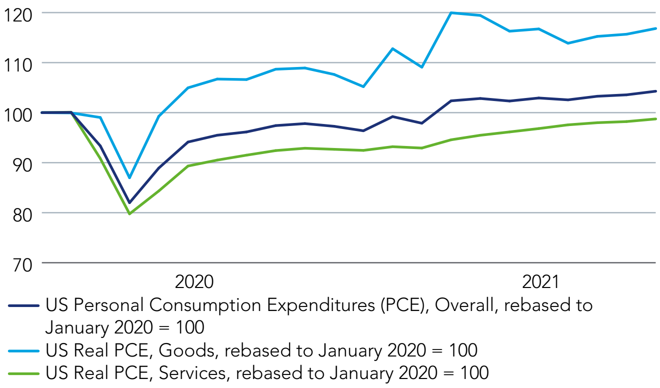
With that in mind, I'd like to handover to our senior economist Silvia Dall'Angelo who offers a more sanguine outlook based on what the leading economic indicators are telling us today.

Silvia Dall'Angelo, Senior Economist

Inflation has been on the rise globally since the spring of 2020, driven mainly by a range of pandemic-related factors, including:

- Asynchronised re-openings and stop-start recoveries as waves of the pandemic and restrictive measures (zero-tolerance policies in some countries, notably China) hit different countries at different times, resulting in supply-chain disruptions, shipping delays, port congestion etc.
- A shift in consumption patterns from services to goods has resulted in demand for goods outstripping capacity and putting a strain on production. This partially explains supply bottlenecks, and shortages of semiconductor chips and energy commodities.
- Labour market shortages as Covid-19 fears, lack of childcare, generous unemployment benefits, early retirements, extended education, and regional, sectorial and skill mismatches contributed to depress supply.

Figure 1: Consumption shifting from services to goods



Source: Refinitiv Datastream.

The factors listed above have persisted for longer than much of the market expected, probably due to their interconnected and mutually amplifying nature. In addition, the pandemic itself has also proved more enduring than predicted. In general, it looks like the extreme two-year swing in activity has resulted in pronounced dislocations and spread-out knock-on effects. As a result, supply-demand imbalances will take time to unwind. Yet, we believe that the current drivers of inflation are likely to fade as the pandemic evolves towards endemic equilibrium. In the meantime, however, there is no quick fix that policymakers can resort to: monetary policy can affect aggregate demand but cannot address supply-side issues. In addition, monetary policy typically works with a lag of 12-18 months before it affects the real economy.

Worse before it gets better

Going forward, the inflation picture is set to get worse before it gets better. The current gas crisis and recent increases in energy commodity prices imply that inflation will remain elevated throughout the winter months, reaching peaks of between 4.5% and 7% in Q4 2021- Q1 2022 across the various advanced economies (with the exception of Japan, where inflation has remained muted). Base effects, a likely moderation in commodity prices and a gradual easing of supply constraints should drive inflation down over H2 2022. We expect inflation in most advanced economies to revert closer to the central banks' 2% target in 2023.

The key factors driving our outlook include:

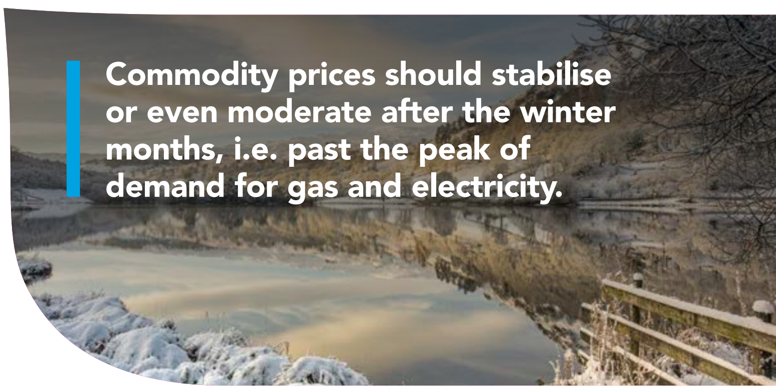
- Commodity prices should stabilise or even moderate after the winter months, i.e. past the peak of demand for gas and electricity.
- Supply constraints should ease after Christmas and Chinese New Year (early February 2022).
- Base effects should also push inflation down from Q2 2022 as large price gains that were recorded a year earlier roll out of annual comparisons.
- In addition, China's economic slowdown may become deflationary if it persists and intensifies going forward.

When should we worry?

It is undeniable that the longer that inflation remains elevated, the higher the risk that it becomes entrenched. For a start, if we see no signs that inflation is easing by Q2-Q3 2022, our narrative would be challenged, and we may well begin to worry.

Most survey-based gauges of long-term inflation have been on the rise recently, and are now running at close to the top end of the range that prevailed in the few years before Covid-19. Market inflation expectations have been somewhat more exuberant and are, for most advanced economies, running at their highest levels in about 10 years.

Crucially, our base line view for inflation relies on the assumption of a return to pre-Covid patterns e.g. consumption shifting back to services from goods, participation rate in the labour market going back to roughly pre-Covid levels, smooth correction of supply chain disruptions. However, there is a risk that some of these Covid-induced changes become more permanent and structural.



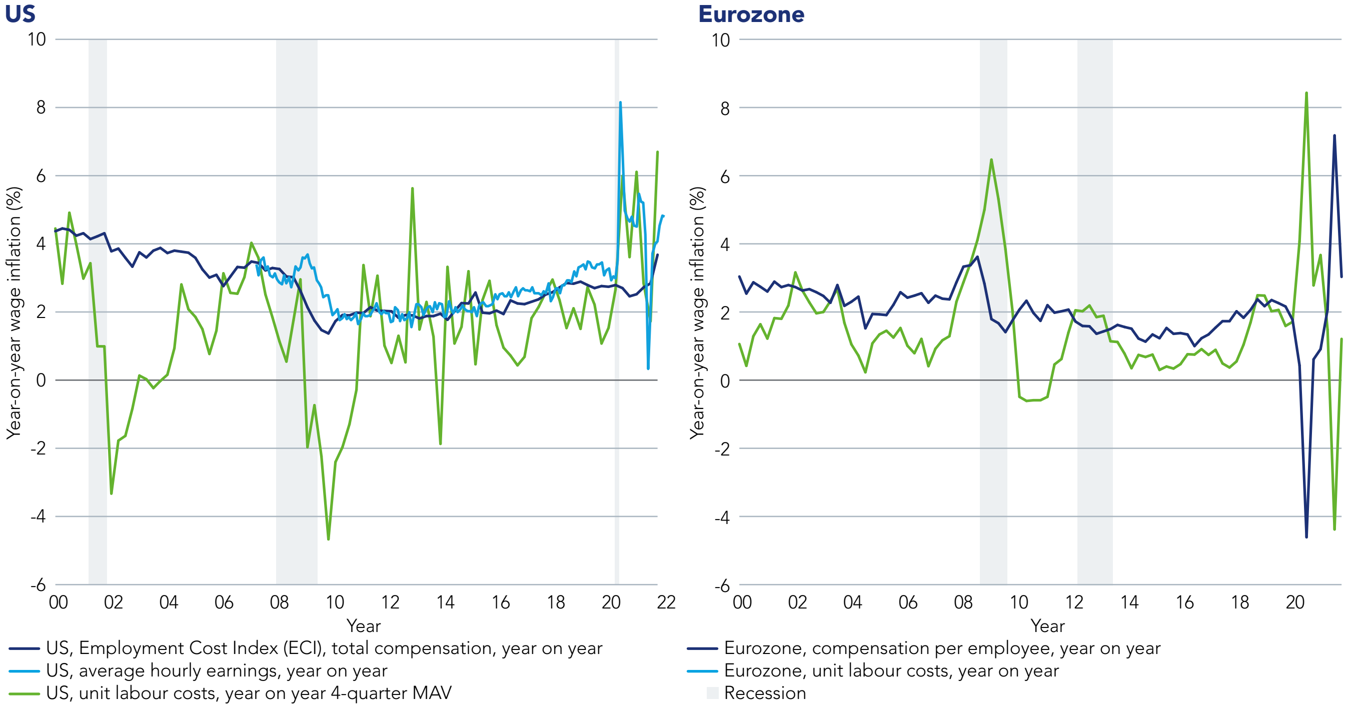
The wages of inflation

Cost-push price pressures (from bottleneck effects and higher commodity prices) are short lived and self-adjusting, if they are not accompanied by demand-pull pressures, such as higher wage inflation that is not justified by productivity gains.

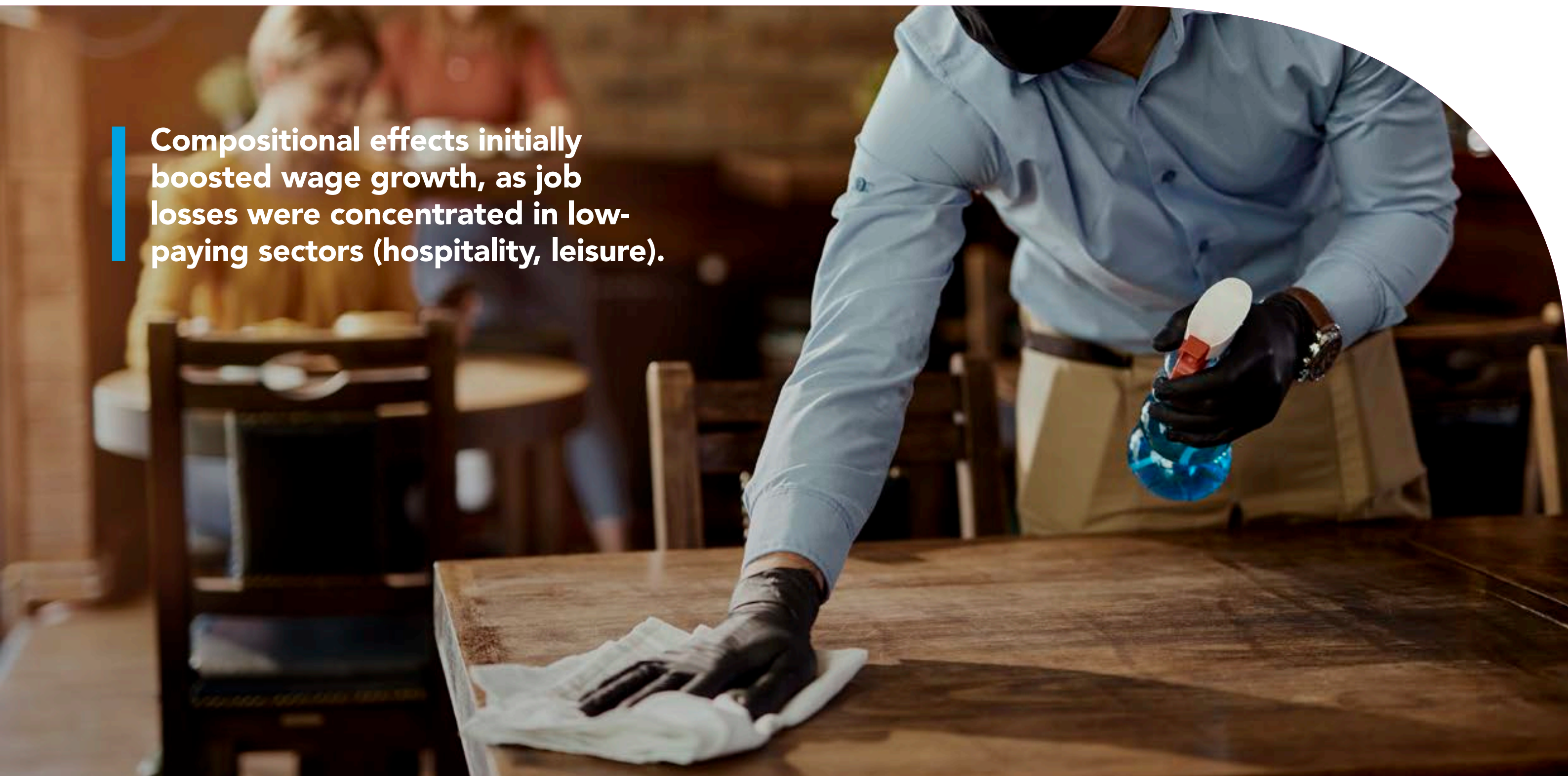
Wage inflation has picked up since the onset of the pandemic across advanced economies, but pandemic-related distortions have played an important role. Compositional effects initially boosted wage growth as job losses were concentrated in low-paying sectors (hospitality, leisure).

Subsequently, furlough and wage subsidy schemes supported wage growth in European countries. As the recovery progressed, it has become increasingly difficult to interpret underlying trends in the labour market and in wages. In the US and the UK, the labour market appears to be tight, with vacancy rates running at very high levels and wage inflation trending up, but that largely reflects depressed supply, as the participation rate is still well below pre-Covid level.

Figure 2: A muddled picture for wage inflation
Wage inflation has picked up, largely reflecting pandemic-related distortions



Source: Refinitiv Datastream.



In our view, most shortages in the labour market should fade over time as Covid-driven distortions ease. In the short term, the dissipation of Covid-related fears, improvements in the availability and reliability of childcare, and the fading of the impact from support measures should draw workers back into the labour force, including in sectors that were most severely hit by the pandemic. It will take longer to work out the regional, sectorial and skill mismatches that have arisen and intensified during the pandemic.

Yet, there is a risk that labour supply remains permanently lower than pre-Covid trends, resulting in stronger wage pressures.

It will take longer to work out the regional, sectorial and skill mismatches that have arisen and intensified during the pandemic.

Productivity is also an important piece of the inflation puzzle as higher productivity drives labour costs lower. Productivity data were also volatile around the recession, but it looks like digitalisation and the forced adoption of technologies likely supported productivity during the Covid-induced recession and might deliver further productivity gains down the line. In addition, it is yet to be seen whether the recent pick-up in capital expenditure will persist and will result in a more sustained productivity revival down the road.

Overall, it will take time for the dust to settle and to get full clarity on underlying trends in the labour markets and productivity.

In the following section, our lead portfolio managers across the key asset classes share their perspectives from within the trenches of the market.

Fraser Lundie on fixed income

Inflation and supply chain disruptions, along with the moderating pace of the post-pandemic earnings recovery, have made us more cautious on corporate fundamentals as we enter year end. While we do not expect a material deterioration in credit profile on the back of these factors, the more challenging operating environment does require caution from credit investors.

The fundamental entry point to this uncertain phase is solid: credit market fundamentals have seen an impressive rebound and are set to remain strong in 2022, with the reopening of the economy fuelling recovery in balance sheets. Corporate earnings have exceeded expectations but are likely to exhibit more differentiation going forward. The distinction will be driven by supply constraints causing disruptions in some areas creating pressure on output growth and inflation, which we think is already beginning to bite. This may transition the backdrop to more of a 'muddle through' one, where margin deterioration poses the primary headwind to credit fundamentals. This is unlikely to be enough to challenge the allocation case, but may test the valuations currently reflected in more cyclical sectors, parts of emerging market debt, and in the lowest segments of credit quality.

Going forward, we will continue to take an active, conservative approach to credit investing that uses detailed, bottom-up analysis of company creditworthiness and sustainability credentials – something we believe will help us seek out the opportunities that are so often overlooked.

Fraser Lundie is Head of Credit.

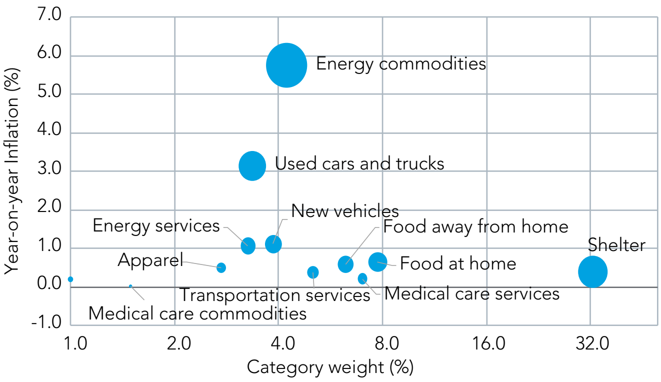
Martin Todd on global equities

Across the spectrum of global equities, the impact of higher inflation is likely to vary greatly between regions and sectors.

Within our sustainable global equity funds, we exclude the most carbon-intensive sectors such as oil and mining, which tend to perform well during periods of high inflation. For this reason, and like much of the market, we do not want to see inflation rising unsustainably higher. However, across the sectors we are exposed to, our quality bias means that the companies we hold tend to have enough pricing power to pass rising costs onto the end consumer. We are confident, therefore, that our funds are positioned to withstand an environment of higher inflation.

Along with monitoring the pace at which prices are rising, it is also important to look under the bonnet at what is driving the numbers. In the US October inflation report, energy costs and used cars and trucks accounted for a significant proportion of overall inflation (see Figure 3). Evidence that a handful of sectors are skewing the overall number, suggests current inflation is unlikely to reach levels whereby it would cause a problem in portfolios.

Figure 3: Consumer price inflation by component



Source: Bloomberg.

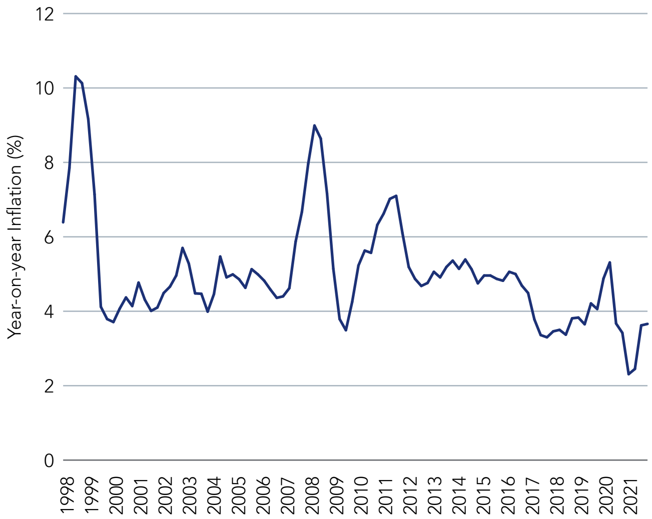
Martin Todd is Portfolio Manager for Sustainable Global Equities.

Kunjal Gala on global emerging markets

Inflation continues to rise in most emerging markets. The swap markets are already expecting policy tightening in several economies in the region – primarily in LatAm.

Against this backdrop, creditor economies will fare better than their more indebted counterparts. EMEA and parts of LatAm are vulnerable to rising bond yields; Asia (over 75% of the index) is relatively resilient – including the traditionally vulnerable India and Indonesia as high foreign exchange (FX) reserves provide a buffer to any FX shocks. Many commodity exporting countries are experiencing high inflation, for example Brazil and South Africa. Russia is a slight exception, and Peru and Chile have political issues to consider.

Figure 4: Emerging economies – consumer price inflation (%)



Source: Bloomberg.

Our funds are positioned to withstand an environment of higher inflation

In most cases, the cure for inflation (high prices) is high prices themselves. Consumers in the US are now beginning to feel less confident of rising inflation as it impacts their ability to spend at the same rate. A recent University of Michigan survey, suggested an increasing number of respondents are seeing limited value in purchasing big-ticket items such as housing, autos and appliances.

This suggests that demand conditions are unlikely to remain benign as the next marginal buyer is unlikely to spend at the same rate as before, resulting in demand cooling off. In the meanwhile, the portfolio has several inflation hedges in place:

- An overweight position in Russia
- Exposure to key commodities – copper and aluminium
- Exposure to gold
- Exposure to key commodity producing economies – Chile and Peru.

Over the medium term, growth (not inflation) is likely to be the greater challenge, hence long-term investors are better focusing on secular growth drivers as opposed to chasing momentum in value stocks.

> **The cure for inflation (high prices) is high prices themselves.**

Kunjal Gala is Portfolio Manager for Global Emerging Markets.

Jonathan Pines on Asia Pacific

Should current inflation rise higher or prove more permanent than the market expects, Asian stocks will be impacted in two ways:

- First, through the mechanism of interest rates. Higher and more persistent inflation will result in relative underperformance of growth and currently loss-making stocks as these owe a higher proportion of value to further-off cash flows that will be harder hit by rising rates.
- Second, the 'real' (non interest rate) impact of inflation will affect stocks based on the ability of the underlying companies to pass on costs to customers. Companies with strong market power should benefit, as should companies that have invested in excess productive capacity which have a lower cost base, but can charge for production based on rising product prices.

In addition, upstream (especially) but also downstream commodity producers should both benefit from inflation. In countries where regulators sometimes control prices (such as China), outcomes become less predictable as a contest ensues between the input and product prices that might be subject to different levels of control.

Jonathan Pines is Portfolio Manager for Asia ex Japan.

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Ingrid Kukuljan on impact investments

We are firmly in the transitory camp. Recent price increases are not sustainable, in our view. However, as long-term investors, we focus on megatrends that we expect will play out over the next five years and beyond.

To that end, we see long-term structural trends as deflationary, driven by technological advancements, demographics, the slowdown of growth in China and elevated debt levels.

Figure 5: Impact megatrends

Across our impact offering, we invest in stocks that are providing innovative solutions to critical needs of the planet and the society. As such, they are exposed to scalable and enduring sources of demand. Post the current price surge, we expect growth to trend lower which favours quality and growth stocks, where our portfolio is positioned. We are favouring healthcare and financials sectors that are currently exposed to strong megatrends, and also have a history of defending margins and long-term earnings growth.

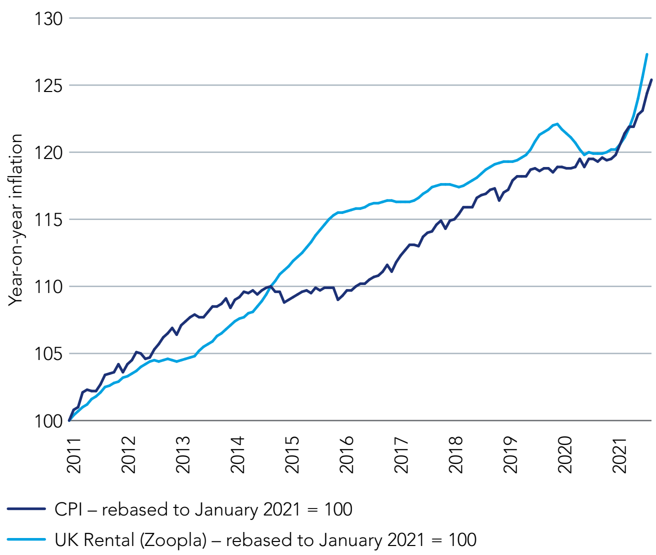
Ingrid Kukuljan is Head of Impact Investing.

Will Gibby on for-rent real estate

For-rent housing has historically been a part of the institutional real estate universe, and its lower expected sensitivity to inflation risk has been a key determinant of its defensive characteristics.

> **Residential real estate leases are overwhelmingly short term, primarily 12 months, allowing for relatively rapid adjustments to new price levels.**

Figure 6: CPI and UK rents



Source: ONS; Zoopla Rental Index.

Most for-rent housing markets and sectors have performed well and are attracting greater investor interest than pre-crisis. Residential real estate leases are overwhelmingly short term, primarily 12 months, allowing for relatively rapid adjustments to new price levels. Nonetheless, an institutions desire for sustainable income leads to a continual assessment of the benefits of rental growth relative to factors of depreciation in determining rental values. More broadly, what supports the stability and robust income profile of our clients' assets are the communities created and maintained within these schemes.

Will Gibby is Director, Fund Management for Global Residential and International Real Estate.

Conclusion

The factors influencing inflation are complex, varied and non-linear. No two sectors, asset classes or portfolios will be impacted in the same way and there is no history that quite aligns with where we are now. While we firmly hold the view that current inflation is transitory and likely to remain under control, before easing over the course of 2022, this edition of Spectrum has been a call for vigilance. We are asking investors to think the unthinkable if only long enough to look at your portfolio through the lens of the worst case scenario.

We encourage our clients to get in touch with to us via your relationship managers, and we look forward to working with you to ensure your wealth is fully protected whatever turn prices may take next.

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Federated Hermes is a global leader in active, responsible investing.

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