February 15, 2021

Reopening, recovery, reflation and rates

The strong “reopening and recovery” narrative has lathered up a reflation trade on markets. While setbacks could present themselves along the way, the vaccine rollout, expectations around a new fiscal stimulus package and continued monetary support have investors looking beyond the current reality towards a bright, post-pandemic future and a return to a positive growth environment. However, with growth back on the menu, the *accompagnement* could well be higher inflation (something we have grown unaccustomed to in recent years). As we wrote in our 2021 Outlook, inflation is the most important long-term issue facing investors. Recent developments could mean that portfolio adjustments become increasingly necessary.

Across the dashboard, all indicators point to reflation: The dollar has lost muscle, while commodities (which have been out of vogue for the best part of a decade) have risen in unison. Their ascent is fuelled by expectations about an economic reopening, fiscal measures which will see billions of euros, dollars and yuan funnelled into infrastructure projects (especially around the energy transition), and demand from China - the world’s biggest buyer of natural resources. Copper, for example, a key component in electric wiring, has risen around 40% year-to-date.

Even oil – the beleaguered commodity that saw its price temporarily turn negative last year - has risen back towards pre-corona levels. Equities (based on the MSCI World) have scaled new all-time highs, yields have set off on a northbound journey (the US 10-year Treasury yield has moved up towards the 1.2% level, while the 30-year yield brushed the 2% mark for the first time since February 2020) and market-based inflation expectations all point to an economic upswing.

The key question is whether inflation will actually follow and to what extent. As the Ketchup Theory cautions, inflation can appear stuck for while until suddenly, it all comes out at once.

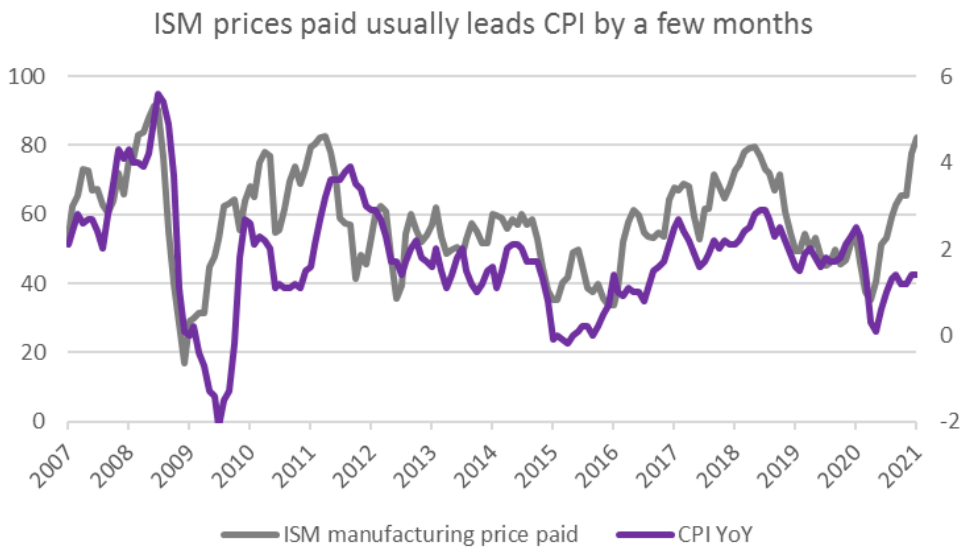
In Europe, it seems the ECB will have a harder task in coaxing inflation upwards, but in the US, the Fed (who has said it will tolerate a temporary overshoot above its 2% target as it strives to pull the labour market out of its convalescence) may indeed have some tomato sauce on its hands in the coming years.

While adding a disclaimer that inflation is notoriously difficult to predict – even for central banks – it is notable that certain stars are aligning for higher inflation in the US.

Firstly, inflation expectations are rising - the 10-year break-even rate in the US has reached 2.20%, its highest level in 5 years. Rising expectations alone can kickstart a self-fulfilling prophecy whereby expectations of higher inflation provoke behaviours that actually push up inflation.

Secondly, we are living in an era of unprecedented monetary support. In the US, the Fed and Treasury have injected massive amounts of liquidity into the system (visible in the M2 money supply); the Fed is buying at least $120 billion worth of bonds per month and its balance sheet has swollen to a staggering $7.5 trillion. Though the correlation between sharp rises in money supply and future inflation appears to have broken down since 2008 (because of the decline in money velocity), “this time is different” theories are gaining credibility. With the Fed holding rates on the floor, real rates are deeply negative. In turn, negative real rates are a blessing for most assets and the economy.

Thirdly, recent data from the survey of purchasing managers at manufacturing firms confirms that prices paid in the production process are rising. This is a leading inflation indicator because producers will most likely pass along the price increases to consumers.



Source: Bloomberg, BIL

Moreover, there will naturally be higher inflation in the next months due to base effects. Just remember that oil price quoted below zero in April 2020. Everything above this will mechanically drive higher energy costs for the world economy.

Lastly, the supply shock that was catalysed by the pandemic has not fully reversed. Due to a shortage of containers, shipping costs are elevated, and we are seeing a shortage in the supply of certain goods – for example, semi-conductors (so acute that US factory activity has drawn to a halt in some sectors). As people replace services (which they cannot currently consume as normal) with the purchase of physical goods, demand is ticking up, while supply is still reduced. Further, some expect that when services can operate again, the resurgence in demand could compel establishments such as restaurants, airlines and hotels to hike prices. Reduced competition (given that certain names did not weather the storm) gives them additional leeway to do so while households could be poised to pay and in position to afford. US savings rates shot up during the crisis and government stimulus checks left many Americans better off financially than they were before Corona struck.

Ultimately, reflation is a reasonable expectation in the US, but this does not necessarily mean we have to position for a 1970s-style inflationary spike. Despite all the reasons for higher consumer prices over the next couple of years, a scenario of persistently higher inflation is not a foregone conclusion. Inflation has been much lower and more stable since the mid-1990s than in earlier times. Identified deflationary forces in recent years, like the “Amazon effect” and demographics are still at play, what is clearly changing now is the “sticky effect” with inflation expectations starting to oscillate towards the awakening of "sleeping beauty". It is also worth noting that the path of inflation will largely be determined by labour market dynamics. If the economy sees rapid jobs growth and wages start to rise (Biden has mentioned a $15 minimum wage), this is when inflation could indeed become too hot to handle. But for now, there are still 10 million less Americans in the work force.

The risk of runaway inflation appears small, but we expect inflation to move (modestly) higher as the economic recovery gains traction. Because inflation erodes the future value of bond coupons, faster price rises make these investments less attractive. For some time, we have anticipated an uptick in US rates, compelling us to cut our Treasury exposure by half mid-December, and to reduce duration. We kept a thin layer for the purpose of diversification, but now, as the reopening and recovery narrative takes hold, the case is less compelling.

At a recent ad hoc Asset Allocation committee, we decided to close all positions in US Treasuries (with the exception of TIPS), switching instead to European government bonds. Already, the yield differential between the US and Europe is increasing and this trend has the potential to continue. We do not believe that European rates will be immune to rising US rates, but we do not think that they will move to the same extent.

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