

Inflation: Transitory or Not?

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Cast your mind back to 1990: Nelson Mandela was released from prison, Tim Berners-Lee published a proposal that would lead to the creation of the World Wide Web, East and West Germany reunited after the fall of the Soviet Union and British Gilt-edged securities paid investors 12.74% (in April 1990) annually guaranteed by the taxpayer.

At the time, high yields were so taken for granted that many insurers offered guaranteed annuity rates of more than 10% for little or no excess premium. Ultimately that led to the collapse of some of them, notably Equitable Life. Actuaries are as subject to the vagaries of “fat-tail” events as the rest of us.

What, of course, drove yields to those stratospheric levels was the level of inflation which in 1990 was over 8% having been as high as 18% a decade earlier. The “fat-tail” event that undid the actuaries was the dramatic fall in inflation that started in 1975 and which appears to have troughed, in the UK, in 2015, at 0.36%. That is less than 1/60th of the rate that prevailed in 1975 shortly after the oil shocks of the time.

Since 1990, the principal economic problem facing policymakers has been the general drift into disinflation or deflation: the polar opposite of inflation. However, for the first time in a long time, central bankers and other policymakers are beginning to fret about a turn in the inflation cycle where prices begin to rise rapidly generating the wage-price spirals familiar to those who lived through the 1970s.

This is important for a whole host of reasons but for investors the issue is mechanical and mathematical.

Asset prices have performed exceptionally well since inflation peaked, notwithstanding periods of acute stress and financial volatility. Partly, that is due to rapid technological change, partly it is due to the Greenspan “Put” and the policy of Quantitative Easing where central banks “bailed-out” markets in bad times, but it is also partly due to the dramatic and one-way decline in interest rates that has been a feature of financial markets for the past forty years. So much so, that very few financial traders have been through a sustained tightening cycle.

However, if inflation begins to rise, interest rates will certainly follow. There will be loud debate about whether banks are “ahead of” or “behind the curve”, but where inflation goes interest rates will surely go too. A great deal follows from that but fundamentally the textbook will tell you, “as yields rise, prices fall.”

Fixed income securities are very exposed in that environment but, slightly paradoxically from a risk perspective, companies with pricing power, revenue and profits growth are much less exposed. They have the ability to increase their prices to compensate for higher input costs, but in doing so, they confirm the shift to an inflationary environment.

Now, although the new Governor of the Bank of England has expressed “unease” surrounding inflation, he and his international colleagues regard the current rises in inflation as “transitory.” Interestingly, the bond market appears to agree. The “instantaneous implied inflation forward curve”, a market-derived measure of the path of future inflation calculated by the Bank of England, has UK inflation sticking around 4% for the next 5 to 8 years and falling thereafter, albeit staying modestly above target between 2 and 3% rather than at or below 2%.

Looking through the archives, the same curve in January 2000 put inflation in 2015 at slightly more than 1% which was very close to the actual outturn.

It is probably right for central bankers to express a certain optimism regarding inflation, particularly taking account of the impact of a unique and catastrophic economic event which is the Covid Pandemic, but there are three reasons to be cautious:

- Deglobalisation: Paul Volcker is usually given the credit for slaying the inflation dragon in the early 1980s, but this was also the period when international capital controls were dismantled and when Japan, followed by China, introduced a vast and low-paid pool of manufacturing capacity to the world economy. That was disinflationary, but now the opposite appears to be happening where there seems to be a retreat from globalisation. That might be inflationary.
- Where have all the workers gone? That was a headline in one of the papers this week but in the United Kingdom's case, the answer is home. There is a well-documented shortage of workers in specific sectors, notably transport and care. Rising wages in one sector is not necessarily inflationary, but it is if it leads to a generalised rise in wages that is not paid for by a rise in productivity, then it likely will be.
- The so-called "Energy Transition." Moving to a fossil-free future will incur costs and certainly a change in relative prices of different types of energy and transport. Moreover, it is likely that carbon-pricing will become more prevalent reflecting the true cost of production, but it will certainly feel inflationary.

Nothing is certain in financial markets but the inflation outlook, whilst unclear, does seem biased to more upward pressure than the disinflation that we have become accustomed to in recent years. It seems likely that the forty-year decline in interest rates has finally come to an end and investors need to begin to factor in a turn in the long cycle of ever cheaper money. This will have an impact on many assets but is likely to be most painful in those equities that do not make profits and have been propped up by 'free money'. Some of these companies will be solid longer-term businesses, however the majority will be remembered as another investment bubble.

As Warren Buffett has said, you never know who is wearing swimming trunks until the tide goes out.

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