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Investment Insights

What do the unprecedented monetary and fiscal measures mean for inflation?

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What do the unprecedented monetary and fiscal measures mean for inflation?

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Key takeaways

- There seems to be a growing gap between financial market pricing and economic fundamentals. A much stronger recovery could lead to lower financial asset prices in some markets such as investment grade corporate debt or high yield.
- With fed funds close to the zero-bound, currencies that offer access to economies with higher real growth and interest rates look more attractive.
- Parts of the world that have exited the pandemic in a stronger position offer higher real yields and attractive investment opportunities.

As the largest vaccination programme in history commences, risk markets appear to be ignoring the logistical challenges or near-term downside growth risks from tighter lockdowns imposed after infection rates in Northern Hemisphere countries soared over the winter. With the S&P at or close to all-time highs and many investment grade corporate bond spreads trading through pre-COVID levels, financial markets appear to be priced for perfection. The accommodative stance of monetary policy, direct central bank interventions, and a supportive supply/demand technical backdrop should continue to support credit risk appetite. However, financial market pricing most likely reflects monetary stimulus more than economic fundamentals. Since the current stance of developed market central bank policy is predicated on inflation remaining low for the foreseeable future, understanding the path that inflation is likely to take over the coming years will be critical for investment returns.

Inflation is likely to remain benign, although opposing forces are at play

An important question is whether the secular trends apparent at the onset of the pandemic are likely to remain the same, accelerate, or reverse and getting this right will determine whether inflation is likely to remain benign or move into a higher regime.

Factors that are likely to be inflationary

Central bank policy: Arguably, monetary policy has been too tight in the past decade as developed market output gaps have closed only gradually. This is likely to change in favour of accepting a higher inflationary impulse with the Federal Reserve (Fed) now pursuing an Average Inflation Target (AIT) and other global central banks pursuing low/negative interest rates and quantitative easing (QE). While large monetary stimulus did not lead to inflation following the global financial crisis (GFC), the current circumstances are quite different. In contrast to the financial crisis, banks are now being encouraged to lend to businesses and consumer balance sheets are far healthier.

Money supply: Economic theory suggests that rapid changes in the money supply can impact inflation. Global money supply has rocketed in response to the pandemic growing at an unprecedented rate.

Globalisation: Over the last 30 years, globalisation has been a disinflationary tailwind but has been slowly reversing in recent years, demonstrated by a sustained fall in global trade volumes. The pandemic has highlighted some obvious weaknesses in reliance on foreign supply chains, and continued reshoring of these (some of which will have strategic importance) is likely to be an inflationary force, going forward.

Factors that are uncertain

Fiscal policy: Higher inflation helps reduce government debt and deficits and so governments have a strong incentive to inflate away debt burdens. In contrast to the post-GFC era, policymakers are concerned that monetary policy has reached its limits and greater emphasis is now being placed on fiscal policy as the main tool to generate growth and inflation. Channelling money to lower-income cohorts could lead to higher inflation as this group generally has a higher propensity to spend.

Whilst continued transfer payments to those on lower incomes would likely push prices up there is a risk that the urgency for expansionary fiscal policy wanes as the global growth outlook improves. Positive news on vaccine efficacy increases the likelihood that we remain stuck in a world where deficits still matter.

Demographics: The debate on demography and inflation is ongoing. Many believe dependency ratios are consistent with higher inflation because dependents produce less and consume more. However, since the young now know they will be living longer they will need to increase savings today, which is a disinflationary force. In addition, as younger generations struggle to meet rising living costs associated with higher asset price valuations, the older generation may have to save more to support younger generations.

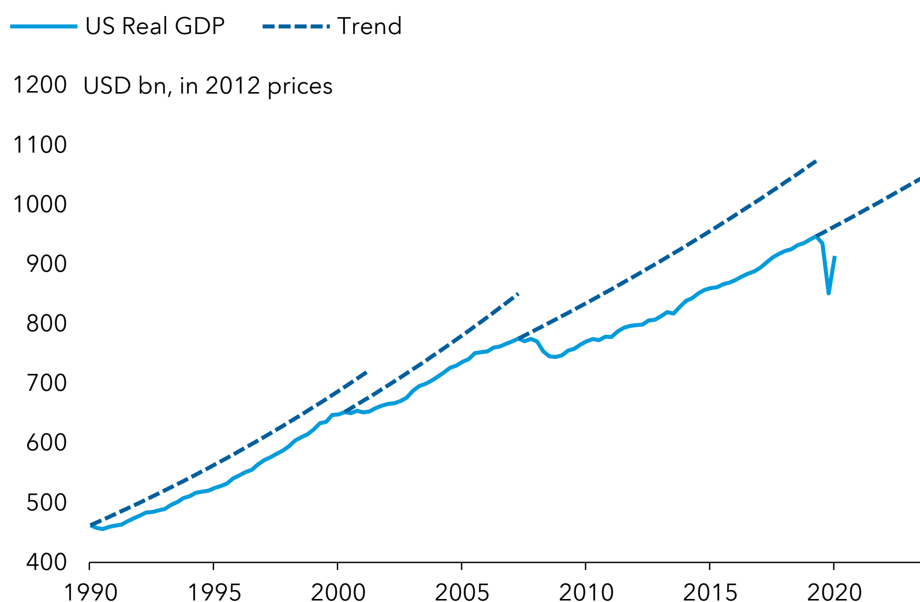
Velocity of money[1]: As the global economy re-opens, a release in pent-up demand should drive spending increases in the service sector, although it is possible this surge in spending is short-lived. After a brief cyclical upturn the longer economic outlook is likely to remain uncertain and individuals and businesses will be cautious about taking on more debt. The rise in inequality is also consistent with lower velocity, as lower income cohorts who have done relatively worse post-pandemic have a higher propensity to spend. Much of the expansion in narrow money has manifested itself in inflated asset prices. Those gains accrue to higher income cohorts who have a higher propensity to save, which in turn leads to lower velocity. Velocity has fallen again during the pandemic and is an important swing factor for inflation given the expansion in the global monetary base. Fiscal policy and redistributive tax policies could move the dial, but big changes look unlikely in the near future.

Factors that are likely to be disinflationary

Debt: Above a certain level, debt is disinflationary. Deficit spending on productive capacity (equipment, education etc) can improve real outcomes but this takes coherent government policy and time. Take the UK for example; we have a record deficit and most of this has been spent on labour furlough schemes or life support grants to businesses. It has not been spent productively. One can argue it was necessary, but the accumulation of debt has not funded capacity that can pay the debt back. In the long run this is disinflationary.

Output gap: By design, government support schemes have ensured as much economic capacity as possible remains intact for when the economy re-opens. As we recover it will take a long time for that capacity to erode and this will be disinflationary. Looking at the last three cycles, trend growth in the US has fallen following every recession. An argument for why it may be different this time is that we have had limited impairment in the banking system so the cyclical rebound might be stronger; even if that is correct it will take years before the lost GDP is recovered.

1. The velocity of money is the rate at which an average unit of currency is used to purchase goods and services within a given time period.



For Illustrative purposes only

Source: US real Gross Domestic Product (SAAR, USD billion, in 2012 prices), Bureau of Economic Analysis. Data from 30 September 1990 to 30 September 2020.

Inflationary forces over the past 10 years and next 5 years

	Past 10 years		Next 5 years?
Technology	Technology advancement will continue to put downward pressure on prices.	Deflationary ↓	Deflationary ↓
Global debt	Debt levels have increased post COVID Higher debt burdens force borrowers to spend more on debt servicing in the absence of ever lower yields.	Deflationary ↓	Deflationary ↓
Inequality	Inequality leaves wealth in the hands of those who are more likely to save than spend.	Deflationary ↓	Deflationary ↓
Output gap	It will take many years for developed market economies to close the post-COVID output gap.	Deflationary ↓	Deflationary ↓
Demographics	Less immigration and ageing populations could put upward pressure on prices.	Deflationary ↓	Unclear →
Money velocity	Money velocity has been low and fallen further in 2020. Changes in public and private sector behaviours will determine if this is likely to change.	Deflationary ↓	Unclear →
Fiscal policy	Fiscal policy has been restrained as governments focused on keeping debt ratios contained. Post-COVID governments look likely to enlarge fiscal policy.	Neutral →	Unclear →
Central bank policy	Central bank policies have failed to generate inflation. Policy is slowly shifting away from containing inflation to generating higher inflation.	Neutral →	Inflationary ↑
Money supply	Money supply has increased substantially to support a larger financial system.	Inflationary ↑	Inflationary ↑
Globalisation	Globalisation has been a deflationary tailwind. Populist policies and post COVID responses have seen companies reshore supply chains.	Deflationary ↓	Inflationary ↑

Source: Capital Group

Technology: Technology is disinflationary. As we consume more services and do more online the potential supply of those services is unlimited. The pandemic has forced more consumers online, a disinflationary trend that was already in place and will probably accelerate post-pandemic. Even if we consume goods online, increased price transparency for those goods will keep prices contained.

Inequality: The recovery is an unequal one. Inflated asset prices have benefited the wealthy who tend to spend more modestly, in an effort to nurture their investments. This is a significant disinflationary force.

Investing in this environment

A stronger than expected recovery could impact risky assets and favour those markets that reflect economic fundamentals already

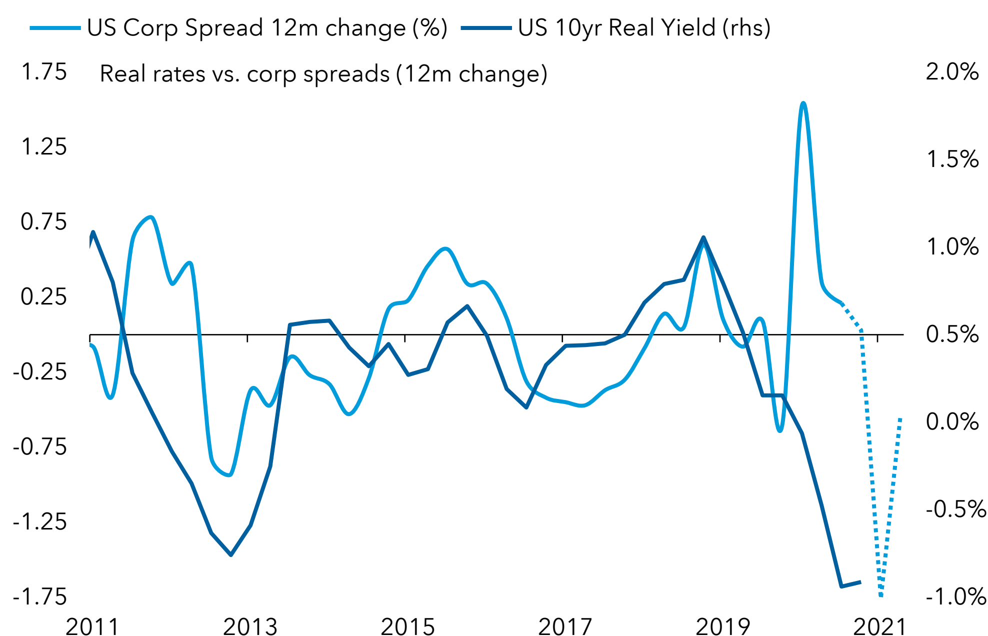
With inflation low, central banks will likely keep interest rates negative or close to the zero-bound, as well as pursue various rounds of quantitative easing to support the recovery. Real yields are likely to remain in negative territory in most developed economies, ushering in a long and protracted period of financial repression. Continued stimulus is likely to provide a floor to support risky asset prices although at current valuations we are becoming concerned about the widening gap between elevated asset prices and economic fundamentals. When economies improve central banks could begin removing support, which should push real yields higher.

It might seem counter-intuitive but a much stronger recovery that leads to less monetary support could eventually lead to lower financial asset prices in some markets like investment grade corporate debt or high yield. This is because post-GFC markets have increasingly reflected the stance of monetary stimulus and not economic fundamentals. In short, what might be good for economic growth could be bad for financial assets.

As an example, we can compare the 12-month change in US corporate spreads versus the 10-year US real yield over the last 10 years. When growth has shifted down, the Fed has stepped in to lower real interest rates and this has led to a rally in investment grade corporate spreads. As the economy has recovered, real yields have moved higher to a point where they have started to impact financial assets once more. Today, with 10-year real yields at around-1%[2], there is plenty of support for investment grade corporate spreads. The start of the year has seen higher yields led by higher inflation expectations with real yields remaining largely unchanged. I am increasingly concerned about the impact higher real yields will have on investment grade corporate bonds. At a minimum I think investors need to pay close attention to issuer-specific fundamentals that will become increasingly important.

2. Source: Bloomberg. As at 28 January 2021

Real US rates versus corporate spreads (12-month change)



Past results are not a guarantee of future results.

Source: US corporate spread is Bloomberg Barclays US aggregate corporate average option adjusted spread. Bloomberg. US real yield is the 10-Year Treasury Inflation Indexed Note Yield at Constant Maturity (average, % per annum). As at 31 December 2020.

China looks to be in a strong position

China has exited the pandemic in a much stronger position than the developed world. Firstly, it managed the pandemic better and brought manufacturing production back online faster. It also exports much of the medical equipment that is in global demand. China has gained market share against export competitors and is unlikely to relinquish all of that when the world is back to normal.

Viewing China through a Western lens might be misguided in the short term. We might think China needs to lower interest rates to stimulate demand but the government stimulates its economy differently from developed economies. It uses fiscal levers more aggressively via state-owned enterprises (SOEs) and has used real interest rates less. Higher real rates in China have also helped to attract capital from the rest of the world.

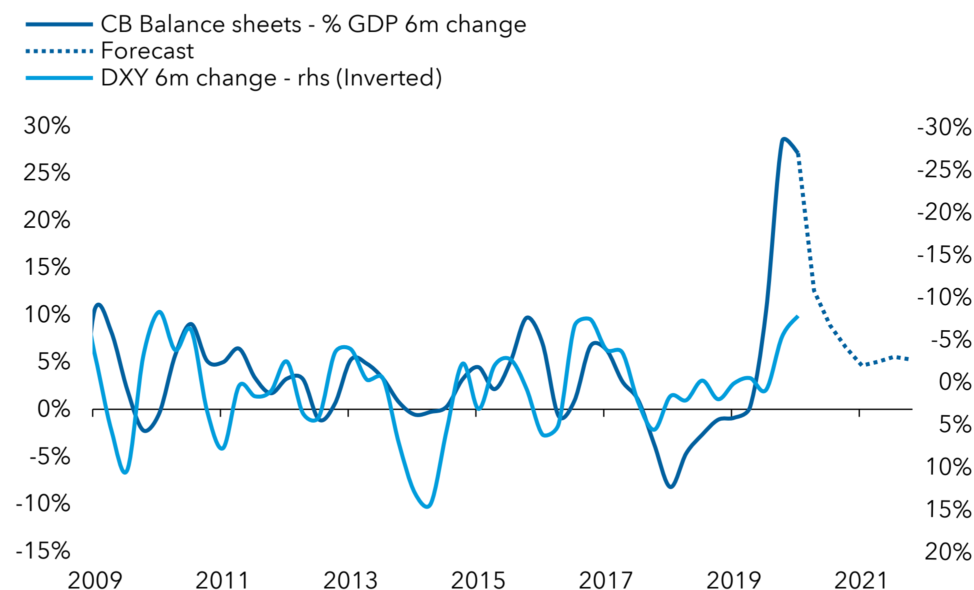
China is pursuing Modern Monetary Theory (MMT) in all but name. Developed economies, meanwhile, lack the ability to force parts of the economy to spend and political differences and constitutional challenges make a leap to pure MMT a difficult one. Rates and credit spreads in China may now be a cleaner reflection of market-driven prices. In developed markets, rates and spreads are heavily distorted by current central bank policies. This could leave China in a much stronger economic position on a 5- to 10-year view.

US dollar depreciation has further to go

One casualty of the impending economic recovery amidst abundant global liquidity is the US dollar. With fed funds close to the zero-bound, currencies that offer access to economies with higher real growth and interest rates look more attractive. Diversifying exposure amongst a number of Asian currencies like the Chinese renminbi, Korean won and Malaysian ringgit continue to look attractive despite recent strength. At the same time undervalued emerging market

currencies like the Russian rouble and Mexican peso should also do well. A simple chart looking at the global central bank impulse defined as the 6-month change in additional asset purchases (Fed, Bank of England, European Central Bank, Bank of Japan, Swiss National Bank and the People's Bank of China) suggests the recent dollar depreciation has further to go.

US dollar exchange rate versus central banks' balance sheet expansions



CB balance sheets include balance sheet expansions of the US Federal Reserve, the European Central Bank, the Bank of Japan, the Bank of England, the Swiss National Bank and the People's Bank of China. DXY is the US dollar index versus a basket of major world currencies. Data as at 31 December 2020. Source Bloomberg and Capital Group.

Investing through volatility

The new market environment potentially skews the risk-return profile of fixed income assets, masking bad credit fundamentals and introducing significant volatility driven by monetary/fiscal policy changes or shifts in growth expectations.

While the outlook remains uncertain, one certainty is that the market will continually price in alternative outcomes as the post-COVID recovery continues and this will create volatility. Whilst I do not foresee a sharp selloff in bond yields, the total returns experienced by traditional global fixed income benchmarks of the past are unlikely to be repeated.

With increased volatility, maintaining as much flexibility as possible while being anchored to longer term fundamentals will be critical in my opinion. It is now even more important that investment managers engage in deep research to be selective about their investment, and a well thought out investment approach is required to navigate the market.

No-one can precisely predict the course of the pandemic and global economy, but we have an approach that has stood us in good stead so far in the crisis and we believe will continue to protect our investors' wealth.

All in all, there are benefits to being highly selective in the current market environment where downgrades and defaults are prevalent. Navigating this crisis, we believe, requires a long-term perspective, increased focus on risk management and a considered approach to security-by-security research to drive investment decision-making.

Andrew Cormack *is a fixed income portfolio manager at Capital Group. He has 17 years of investment industry experience and has been with Capital Group for two years. Prior to joining Capital, Andrew worked as a portfolio manager at Western Asset Management. He holds a first-class honours degree in actuarial science from the London School of Economics and Political Science. He also holds the Investment Management Certificate. Andrew is based in London.*

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