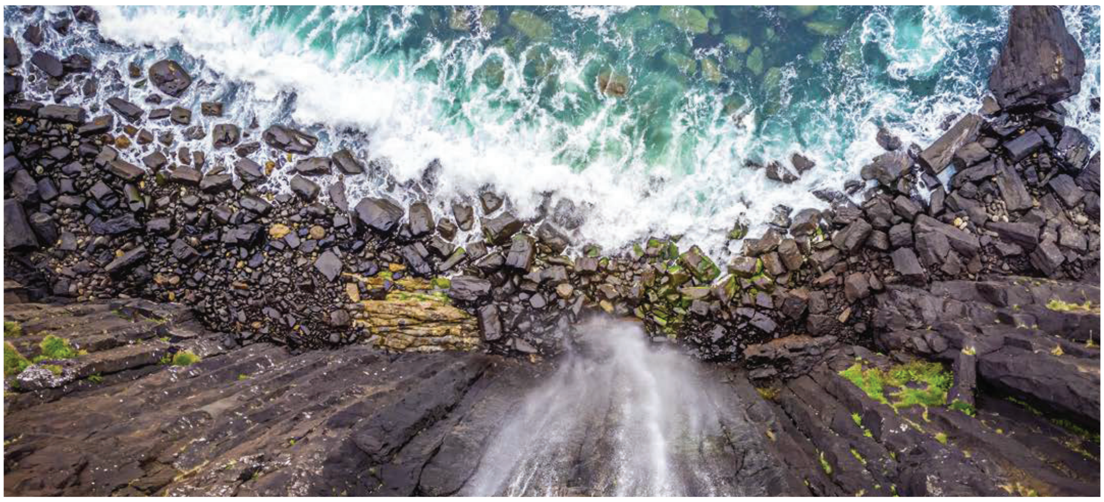
Inflation, disinflation, inflection Who is right?

The market narrative remains focused on a single topic – inflation – but the overall picture is markedly different to that of late 2022. Equity, credit and rates markets are not synchronised in their pricing or probabilities of the outcomes from here. This conflicting picture of significant rate cuts just around the corner, dovetailing nicely with median levels of credit spreads and a somewhat lofty equity multiple valuation backdrop, leave us asking: 'Who is right?'

Fraser Lundie
Head of Fixed Income – Public Markets



The main issue with having a view on inflation is the ever-present cacophony of short-term noise, much of it backward looking, leaving both investors and central bankers in a difficult position to champion long termism. That said, looking at what has been reflected in forward curves can be informative. Right now, the picture it paints is of a market that has priced in the prospect of inflation moderating, with interest rates cuts and looser conditions to follow in 2024 and 2025. Volatility in front-end rates is being sucked out, providing oxygen to the rally.

Whisper it, but we believe there is now a decent chance inflation could be on its way to very low levels again, perhaps inside of 2%.

Scouring the spectrum

The wide range of scenarios that might play out depending on the broader inflation picture are crucial to the views across all the asset classes in our fixed income, as well as to many of the sectors we analyse for opportunities with a bottom-up approach. Everything from emerging markets to European structured credit are affected. It's therefore a source of both pride and pleasure to me that we can call upon such a breadth of experience and expertise when our fixed income group comes together in the form of our Multi Asset Credit Strategy Meeting (MACSM).

While this framework has now been in place for nearly two decades, the depth and quality of resource has never been this strong. Our views remain highly nuanced, with multiple areas of opportunity which we find exciting, as well as others we avoid, either for fundamental concerns, or because the value is simply not there.

Robin Usson, our Senior Credit Analyst, for instance, makes a compelling case for corporate hybrids, given how they benefit from complexity premia and relative value when compared to dividend yield and senior yields at a company-specific level. In contrast, it appears that fundamental cracks are appearing in the leveraged loan market where many issuers are experiencing unprecedented changes in their cost of capital as the floating-rate nature of their debt begins to ratchet up interest expense ratios.

Analysing companies holistically

In the face of all of this, we remain selective in our allocations, maintaining discipline through our credit committee processes to ensure eligibility is earned. We continue to benefit from a process that considers a company from various perspectives, both financial and sustainability-related. This is particularly important in the more 'material' and carbon-intensive sectors, of which there are plenty in the credit space.

Pricing risks to a company's enterprise value (and therefore credit worthiness) stemming from ESG risks is paramount. In this, we work with our companies to encourage good corporate governance and ambitious decarbonisation policies. Our belief is that this ultimately leads them to mitigate risk, become more investible to more investors, and reduce costs of capital – in other words, a genuine win-win.

These selections are long term in nature, but the market can, and will, prove to be volatile in the near term, and our ability to be dynamic in our repositioning and hedging will also be important in the months to come.

So, as we look to Q2, the referee in the inflation tussle will be the data. But we keep our eye on the mid- and long-term scenarios too – and, here, the potential for disinflation is very real. Take the secular stagnation theme, for instance. Has that been written off too soon? Sure, we might be seeing a change from what we've experienced over the past decade or so, but is it wise to entirely discount the effects of ageing and shrinking demographics on aggregate demand? Likewise, the same can be said for advances in technology and the impact on aggregate supply. These mega trends must not be forgotten as we strive to maintain a long-term approach to investing.

To find out more information, please read the full report: 360° (hermes-investment.com)

To find out more about our wider credit offering, please visit our website: Credit | Federated Hermes Limited (hermes-investment.com)

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