



Tapering in November, business as usual in December



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The rising consumer prices recorded on both sides of the Atlantic since economies have re-opened suggest we may be seeing stickier inflation, possibly accompanied by a broad upward trend in interest rates. Though this kind of development has surfaced only a few times over the last forty years, it could become more menacing in the United States now that wages are contributing to the inflationary trend under way.

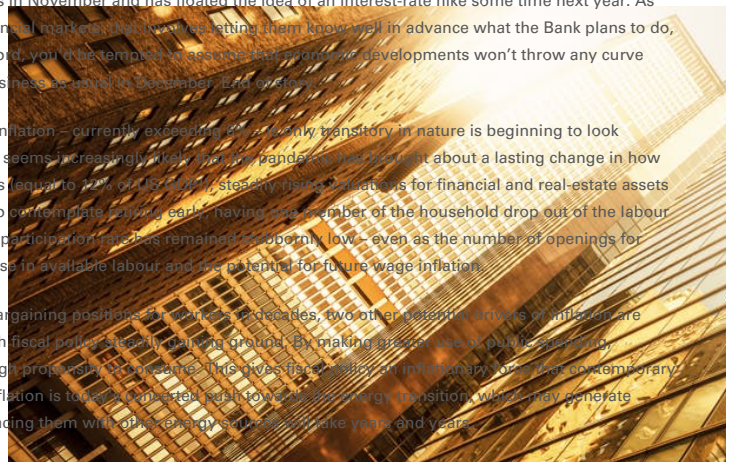
Such a scenario currently seems unlikely to materialise. But if it does, the effect on financial-asset returns will be so strong that we feel it's well worth trying to explore the key factors at work. An end to persistent disinflation would force us investors to throw off the conditioned reflexes we've developed over the last few decades and learn to adapt to a changed environment.

For now, of course, this is just an alternative scenario. In fact, to keep it from occurring, a number of central banks have begun reversing their monetary policies in a bid to ease inflation expectations. Several of them – in commodity-exporting nations and a few other emerging economies – have already taken steps to push up interest rates in the past few weeks. The US Federal Reserve has meanwhile started winding down its asset purchases in November and has floated the idea of an interest-rate hike some time next year. As Fed Chair Jerome Powell has made very clear, his primary aim is to avoid unsettling financial markets; that involves letting them know well in advance what the Bank plans to do, how large the changes will be and at what pace they will unfold. If you take him at his word, you'd be tempted to assume that economic developments won't throw any curve balls that could upend his plans or catch investors off guard. *Tapering*¹ in November, business as usual in December. End of story.

How nice it would be to share Powell's assurance. The trouble is, the argument that US inflation – currently exceeding 6% – is only transitory in nature is beginning to look doubtful. Not only are a number of industries still saddled with supply bottlenecks, but it seems increasingly likely that the pandemic has brought about a lasting change in how Americans view work. The excess savings they've built up over the past eighteen months (equal to 72% of US GDP!), steadily rising valuations for financial and real-estate assets and growing concern about quality of life are apparently leading a good many workers to contemplate retiring early, having one member of the household drop out of the labour market or shifting into jobs with less constraining schedules. The fact that the workforce participation rate has remained stubbornly low – even as the number of openings for decent-paying jobs approaches record highs – provides an objective gauge of the decrease in available labour and the potential for future wage inflation.

In addition to bottlenecks in a number of supply chains and one of the strongest wage-bargaining positions for decades in decades, two other potential drivers of inflation are worth considering. The first one has to do with a change in the economic policy mix, with fiscal policy steadily gaining ground. By making greater use of public spending, governments can directly boost disposable income, particularly for households with a high propensity to consume. This drives fiscal policy, an inflationary force that contemporary monetary policy has never managed to achieve. The second potential driver of higher inflation is today's concerted push towards the energy transition, which may generate lastingly higher natural gas and oil prices, due to weaker investment in fossil fuels. Replacing them with other energy sources will take years and years.

It's entirely possible that we'll be seeing a wage-price spiral which could give inflation greater strength and staying-power than anticipated



So it's entirely possible that we'll be seeing a wage-price spiral which could give inflation greater strength and staying-power than anticipated, forcing central bankers and investors to follow its own, unpredictable pace.

Financial-market reactions to the first upticks in benchmark interest rates and the increasing prospects for tighter monetary policy in the United States have initially been much the same across the various countries affected. Short-term rates have risen more markedly (in some cases even sharply) than long-term rates, suggesting that investors believe central banks have the monetary cycle well under control, and expect GDP growth and inflation are heading for a soft landing. Traders are therefore betting on a scenario of perfectly orchestrated monetary tightening – one that will include a succession of rather swift hikes in short-term rates that central bankers will carefully calibrate to keep GDP growing at a reasonable clip, while anchoring inflation expectations somewhat lower. The Fed's recent announcement was also well received by both equity and corporate credit investors. What makes that sign of trust so noteworthy is that equity markets currently stand at record highs, often with stretched valuations, while corporate bonds are trading at negligible spreads – likewise a sure sign of elevated prices. Because prices are so high, central banks can ill afford to make a mistake. If they hike policy rates too fast or by too much, they may trigger a sharp selloff of financial assets, and given how high debt levels currently are, it's easy to imagine the collateral damage.

The fact that such an ominous outlook has barely caused a ripple in financial markets tells us quite plainly that investors feel the economy has yet to depart from its path of the past several decades – i.e., secular weak inflation that has no chance of bouncing back, therefore guaranteeing that interest rates will stay low. Those low rates are expected in turn to facilitate debt financing that can generate enough GDP growth to keep investors happy. Assuming such continuity, the risk most commonly associated with the necessary monetary-policy tightening under way is that it may lead to much slower economic growth. Forty years of disinflation have ultimately anchored GDP growth expectations at lower levels – or is it the other way round? In any event, no one finds it easy to break habits, especially when they're so firmly, well, anchored.

The opposite danger – that central banks might react too little or too sluggishly and as a result lose control over long-term interest rates – doesn't appear to be a major concern for market participants. Many observers view the rising yields on the short end of the yield curve today as evidence of active anti-inflation vigilance among investors. Similarly, coupon payments on inflation-linked bonds have jumped to heights not seen in twenty years or more, depending on the maturity. But given that the nominal yield on 5-year paper is 1.2% in the US while inflation is forecast to average 3.1% over the same 5-year period, such "active anti-inflation vigilance" somehow looks rather unconvincing. The truth is that the adverse effects of lastingly high inflation on fixed-income markets would be much greater than any positive effects from a return to the negligible inflation seen in recent decades. So there you have an unambiguous indicator of how investors are currently positioned.

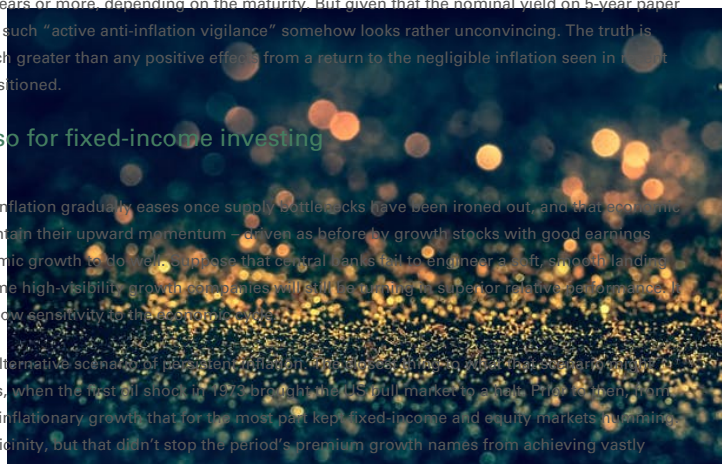
Fairly clear guideposts for equity investing, much less so for fixed-income investing

The current outlook provides fairly clear guideposts for equity investing. Assuming that inflation gradually eases once supply bottlenecks have been ironed out, and that economic growth doesn't get undercut by tighter monetary policy, equity markets are likely to maintain their upward momentum – driven as before by growth stocks with good earnings visibility. And contrary to what their name suggests, those stocks don't need high economic growth to do well, because that central banks fail to engineer a soft-shoulder landing and instead trigger a heftier economic slowdown than anticipated. In that case, those same high-visibility growth companies will still be trading at superior relative performance, and would take an out-and-out slump for more defensive stocks to carry the day, given their low sensitivity to the economic cycle.

An outcome that would be more thought-provoking – because it's less intuitive – is our alternative scenario of persistent inflation, which would mean a much less early and less entailed would be the era of the Nifty Fifty, extending from the mid-1960s to the early 1970s, when the first oil shock in 1973 brought the US bull market to a halt. Prior to then, from the 1950s to the mid-1960s, the country's economy had experienced impressive yet non-inflationary growth that for the most part kept fixed-income and equity markets humming. Round 1965, inflation began trending upwards, driving 10-year bond yields into the 8% vicinity, but that didn't stop the period's premium growth names from achieving vastly superior price/earnings ratios. The stocks that did best in that environment, the fifty-or-so high-flying names that could easily shrug off inflation, were called the Nifty Fifty. They were to be found in sectors ranging from new technology – already – (Digital Equipment) to entertainment (Disney), from pharmaceuticals (Eli Lilly) to consumer products (Kodak) and to industrial conglomerates (General Electric). When the oil shock hit, those stocks were trading at an average of roughly 50 times earnings, compared with barely 10 for the rest of the equity market. Today's tech giants, luxury-goods makers and pioneering pharmaceuticals companies can arguably claim to be their contemporary counterparts.

Due to their apparent ability to take any and all currently imaginable scenarios in their stride, this set of dazzling growth names unquestionably offers considerable relative value.

As an asset class, fixed income seems to be harder to assess. With long-term yields so low despite such high inflation expectations and such narrow credit spreads, there is little incentive to make bold investment moves, considering the risk of volatility inherent in this paradoxical state of play. Regarding the longer term, investors' job will involve spotting possible signals that, after forty years of radio silence, inflation is squarely back in town. Those signals must not be overlooked, as they would call for an investment outlook geared to higher yields. Such an approach would be better equipped to create value than the scenario expected today by central banks of a reversion to lacklustre economic growth – propped up by more and more debt. Until such time as inflation becomes a cause for sleepless nights among savers (if it ever does), we plan to play it safe through a cautious but constructive stance on developed-world government bonds.



Investment strategy

Equities

Stock markets are gradually pricing in the prospect of higher, longer-lasting inflation against a backdrop of ongoing supply bottlenecks. Though equities took a hit from sharply rising short-term yields in September, they staged an impressive comeback in October. It's worth noting, however, that with the exception of commodities, the sectors that typically rally in periods of rising inflation haven't stood out from the crowd. Instead, tech stocks have outperformed. As the latest uptick in inflation has been accompanied by slower GDP growth, investors have been hunting down companies that can look forward to strong and dependable top-line growth while keeping profit margins up.

We are maintaining our overall constructive stance on equities as an asset class, given that they still offer attractive risk premia. But in today's unsettled environment, we are sticking with our preference for secular growth names. Those in the tech sector are in a unique position to cash in on rising capital expenditure at companies seeking to boost productivity in response to the prospects of rising inflation and declining economic growth.

That said, careful stock-picking will remain essential. Though the latest earnings season showed mostly encouraging results, it proved bruising to the few companies that were unable to meet investors' expectations. For example, the season vindicated our cautious approach to digital advertisers, who have tended to suffer more than anticipated from Apple's updates to its privacy policy. As 2021 draws to a close, we are keeping a close watch on companies that have scored gains during the pandemic. After a disappointing year, investors are trying to gauge how well these firms' earnings growth will hold up going forward. Netflix and a few others have already managed to reassure shareholders that they have the wherewithal to go on delivering more of the same.

Fixed income

The bond market is increasingly steeling itself for interest-rate hikes in the next two years as investors come to realise that inflation will have greater staying-power than previously assumed. This has led to significant repricing and what can be considered highly aggressive positioning. For example, investors currently expect the US central bank to scrap its asset purchase programme and carry out two rate hikes between now and the end of 2022, though the Fed has signalled only one. The market is even betting on four rate increases in the United Kingdom over the next twelve months. This means it's taken us just one year to go from a cosy outlook of permanently low interest rates and endless bond-buying by central banks to forecasts for a cycle of extremely swift, relatively severe monetary policy tightening.

At the same time, longer-term yields – which tend more to reflect long-range growth expectations – seesawed during the third quarter before settling in at fairly tame levels.

The current combination of high bond-market volatility, uncertainty about inflation, low interest rates – which make it harder to take that volatility in stride – and radically changed expectations for near-term monetary policy underlines how crucial it is to actively manage interest-rate risk. This is particularly true now that sovereign bonds issued by the countries with the highest credit-ratings – a key risk-management tool over the past decade – have seen their safe-haven status steadily erode. That's due to the low yields they offer and such complicating factors as high leverage and inflation, which are rattling fixed-income investors. The US dollar and substantial cash holdings accordingly look like the best guarantees in the event of a surge in volatility. At the same time, we expect ongoing financial repression and the continuing availability of cheap financing will enhance the appeal of market segments offering higher yields (e.g., corporate credit and emerging-market sovereign debt) – provided, that is, that you follow a stringent approach to bond-picking.

Source : Carmignac, Bloomberg, 12/11/2021

¹ The word "tapering" in this context means slower bond purchases by central banks.

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