Psigma
Investment Management

23rd September 2020

View from Psigma

"How worried should I be about inflation?"

Tom Becket
Chief Investment Officer

Introduction

In our second of three September Views, we will attempt to address another regularly raised question from our clients: whether we will see a rise of inflation in the coming years, due to the after-effects of the medicine applied to tackle the COVID-19 crisis. In today's update, we will discuss our refreshed views on inflation, what the implications are for investors and how we can find investments from around the world to protect against a rise in our living costs.

COVID-19 is a deflationary shock

As with so many other subjects this year, we have been forced to entirely overhaul our views on inflation because of the extraordinary events we have witnessed. In very simple terms, we had expected a moderate rise in official inflation rates to occur through this year and next, as the global employment backdrop was "tight" and wages were growing, which normally leads towards a rise in the price of consumer goods and services. In addition, with clear evidence of "de-globalisation" and "re-nationalism" taking place in certain industries, we felt that the prices of industrially produced goods could also increase. COVID-19 acted like a "wrecking ball" to those forecasts, and the actions of our governments contributed to both a severe deterioration in both consumer and corporate confidence, and a weakening of economic activity. Indeed, the tale of the first six months of this year was an almost unprecedented collapse in both supply and demand. Within generally falling inflation rates there were some expected trends: hotel room rates and air ticket prices plummeted, whilst the cost of certain basic foods and elements of technology rose, with the latter being considered "pandemic beneficiaries".

Inflation starts to rebound

In recent weeks, many have been surprised by the clear recovery that has been witnessed in inflation rates, which is being chiefly driven by a combination of two factors. Firstly, one should naturally have expected a reflexive bounce in prices, as the global economy reopened and activity gradually "got back to normal". In addition, some of the trends from the pandemic have persisted, with one analyst recently highlighting the fact that used car prices are soaring in the US as an example of an inflation driver; notably, used car prices at auction are 25% higher now than at the start of the year, as American consumers remain reticent to get on a train or bus to go to work. It is our view that such factors could continue to lead to short-term inflation rates that "surprise to the upside", as various bottlenecks remain throughout the world, at a time of disorganised supply chains and governmental actions to limit our ability to return to living life and working as we did before COVID-19.

Longer-term dynamics

Whether we will see a short-term, cyclical rise in inflation is of secondary importance to the overarching question of whether the longer-term inflationary dynamics have structurally shifted.

Over the last decade since the financial crisis, we have experienced deflationary pulses sent around the world by an ever-integrating global economy, with companies always able to employ cheaper staff in less developed locations around the world and an abundance of goods and products available to consumers. "Recency bias" across consumers and economists alike has contributed towards a view that such trends will persist, but there is now the chance that there are a number of factors that could lead to a rise in inflation in the coming decade, a period of time which as you know we have entitled the "Turbulent Twenties".

The world gets more complicated

In our view, the greatest change is that the global economy is undergoing is a balkanising of supply chains that could well lead to constraints on the ability of companies to continue to reliably source cheap inputs in the future, meaning that there could be intensified competition for commodities and other inputs in to products. In addition, the COVID-19 crisis and rising geopolitical tensions around the world have caused national governments to ensure that important products are produced domestically, so that their populations are not at risk from shortages at a time of need. The likely "reshoring" of the production of various goods will lead to further distortions in global supply chains and could well contribute towards rising prices, as many companies have recently admitted. In very simple terms, it remains much more expensive to make semi-conductors in the US than it does in China or South-East Asia. If such production is "re-shored", either companies must bear the brunt of cost increases themselves, reducing profit margins, or pass on the costs to their end consumers. Either way this is not a pleasant outcome and, if it occurs, will be a major change from the last few decades.

When "good medicine" goes bad

In addition, there is certainly the chance that the necessary medicine applied by central banks and governments to counter the worst effects of the COVID-19 crisis could have unpleasant side effects. The monetary and fiscal response has been so hurried and so vast that there is certainly now the chance of inflation as an unintended consequence. Again, many will use the last decade of relatively subdued inflation rates as a guide to the future, but we think there are some significant differences between what we observed in the last decade by comparison to what we are seeing now. It is our job as investors to try and analyse why "this time might be different".

Unprecedented actions

The first signpost to an inflationary "regime change" is simply that the scale of the response to this crisis has gone far beyond anything that was applied in the post-financial crisis years. As an example, we have seen money supply growth rising in the US this year at a 25% year-over-year rate (at one point in Q2 it was over 80% higher than a year before), as the Federal Reserve flooded the financial system with unprecedented liquidity measures to arrest the seizure suffered in financial markets in March. This might seem an arcane measure, but it is important, and, in our view, it has been the primary reason why most asset markets around the world have recovered nearly all their losses suffered in the early months of the year. So far, the trends we have seen have replicated those that we saw in the last decade: the central bankers have pumped money into the financial system, it ends up with banks and wealthy investors, and we see asset price inflation but far less goods and services price inflation. The potential difference this time around is the combination of the liquidity tidal wave being combined with both increasing government fiscal support and the dawn of fresh bank credit guarantees.

"Hey, Big Spender"

These two latter points could well be the missing pieces that finish the inflationary jigsaw. We have "crossed the Rubicon" in the last few months, with pressure now being on governments to spend more, not less, money. The days of real or perceived "austerity" are over. The governments obviously have no money to fund their spending commitments, so they are forced to rely on the largesse of private investors to fund their ever-growing promises through government bond issuance, as well as being increasingly reliant on the financial alchemy of central banks and their quantitative easing programmes. As you know, we have long felt that we were moving in to "you ain't seen nothing yet" territory this decade with regards to government spending, but COVID-19 has expedited the passage to unchecked amounts of government spending and the monetisation of the debt created by central banks. Anyone who thinks this is a temporary measure is wrong; given the unfunded promises of governments and the likely low trajectory of economic growth, this is our future being unveiled before our eyes.

The missing link

The decisions by governments and central banks to offer bank credit guarantees is also vital to understanding why there is potentially a shift ahead in inflationary trends. The "missing link" in the last decade was that central banks would create a huge abundance of liquidity (much of which would end up in asset markets), but they couldn't force banks to lend money into the "real" economy, thereby meaning the "transmission mechanism" of lower interest rates just did not work. The issue was that banks had been forced to take less risk by regulators in the wake of the financial crisis of 2007-9 and understandably refused to make risky loans. Basically, those who the banks wanted to lend to didn't want to borrow, whilst those that wanted to borrow were considered "high risk" by the banks. Now, the fact that many cheap loans offered by the banks are guaranteed by the government (i.e. you and me, let's not forget the government has no money) could be a "game changer" and allow money to flow in to the parts of the economy that have been starved of economical lines of credit for over a decade.

How can we protect against inflation?

Hopefully we have presented a sensible argument as to why future inflation could well be being underestimated. Any view on inflation does not necessarily need to be "right" or "wrong", but we need to understand the likely direction of travel and the effects that might occur upon financial markets. We have reflected the views outlined today across our investment strategies to ensure that we have limited exposure to assets, such as government bonds and low yielding corporate bonds, which could potentially suffer in a rising inflationary environment. The fixed interest exposure that we own for our clients deliberately has low sensitivity to rising inflation and we own several bonds that could benefit from any increase in inflation. In addition, we own both commodities and gold investments, which should provide protection against a rise in prices. We have also ensured that we have exposure to both the debt and equity of companies for whom a backdrop of rising prices would be an advantage, with healthcare as an obvious example. Finally, if governments are set to spend more money in the future, we need to position ourselves in sectors such as infrastructure and "green technology" that can enjoy the tailwind of increased spending.

Conclusion

In truth, it is increasingly hard to protect clients' wealth against a potential rise in inflation in traditional asset markets, so we are working very hard to find less obvious methods of achieving our clients' aims with regards to inflation. We are confident that we can do so. Our central view is that even though COVID-19 is a near-term deflationary shock, there are conditions in place that might mean that inflation could well surprise to the upside in the coming years. We know that the Federal Reserve and other Central Banks will ignore any rise in prices, not least because what they really want to do is to use inflation as a tool to whittle down the gargantuan debt piles that have been amassed by governments over the last twelve years. This is another reason why we believe the "Turbulent Twenties" moniker is so relevant to the years ahead of us. We all need to ensure that we have taken action today to prepare for an uncertain future.

Tom Becket
Chief Investment Officer

For further insights from our CIO Tom Becket check out the Psigma Voice, our communication platform providng you with a variety of investment and market commentary.

www.psigma.com/psigma-voice/

Psigma
Investment Management

client.services@psigma.com
businessdevelopment@psigma.com
www.psigma.com

@PsigmaIM

company/psigma-investment-management

London

11 Strand,
London,
WC2N 5HR

+44 (0)20 3327 5450

Birmingham

4 Temple Row,
Birmingham,
B2 5HG

+44 (0)121 230 1937

Edinburgh

The Capital Building,
12/13 St Andrew Square,
Edinburgh, EH2 2AF

+44 (0)330 094 0090

defaqto 2013 – 2020 DFM Bespoke

defaqto 2013 – 2020 DFM MPS Direct

defaqto 2016 – 2020 DFM MPS on Platform

3D 2020 PSIGMA INVESTMENT MANAGEMENT AWARDED BY ARC

Important information

This document is prepared for general circulation and is intended to provide information only. The information contained within this document has been obtained from industry sources that we believe to be reliable and accurate at the time of writing. It is not intended to be construed as a solicitation for the sale of any particular investment nor as investment advice and does not have regard to the specific investment objectives, financial situation, capacity for loss, and particular needs of any person to whom it is presented. The investments contained in this document may not be suitable for all investors. Prospective investors should consider carefully whether any of the investments contained in this document are suitable for them in light of their circumstances and financial resources.

If you are in any doubt whether any of the investments contained in this document are suitable, you should speak to your Investment Director, or take appropriate advice from a professional adviser, such as an accountant, lawyer or Financial Adviser authorised and regulated by the Financial Conduct Authority.

Investment Risks:

- The value of investments and the income from them can fall as well as rise. An investor may not get back the amount of money that he/she invests. Past performance is not a guide to future performance.
- Foreign currency denominated investments are subject to fluctuations in exchange rates that could have a positive or adverse effect on the value of, and income from, the investment.
- Investors should consult their professional advisers on the possible tax and other consequences of their holding any of the investments contained in this publication.

©2020 Psigma Investment Management. This document has been approved and issued by Psigma Investment Management. Psigma Investment Management is a trading name of Punter Southall Wealth Limited, which is authorised and regulated by the Financial Conduct Authority. Registered in England and Wales No. 5374633. FCA Registration No. 478840. Registered office: 11 Strand, London WC2N 5HR. A Punter Southall company.

(L6_VFP-2309_2020-051_FINAL)