An end to the long holiday from inflation?

April 2021

The world has had a long holiday from inflation, but like any vacation, this one too must eventually end, with important bond and share market implications.

Complicating assessments of how bond markets may behave is the realisation that 'price discovery' – the process by which market prices adjust in response to information changes – has been absent from the bond market for some time.

Instead, bonds have traded on 'forward guidance' (where the US Federal Reserve (the Fed) charts what they believe, on *current* information, will be the path for future interest rates), and been heavily influenced by central bank intervention through Quantitative Easing (QE).[1]

For the record, current Fed guidance is for no increase in official US interest rates until 2024. To be clear, 'guidance' doesn't equal a guarantee.

Nevertheless, all this has subdued price discovery and resulted in bond market instability. Unexpected changes in forward guidance (or dialling down QE) could have outsized impacts on bond prices as investors have been unable to work out the 'fair' price for bonds due to these interventions and policies.

This matters, as central banks are about to face-off against an uptick in inflation. What happens then?

Will higher inflation be transitory or persistent?

Annual US inflation, as measured by Consumer Price Index (CPI) movements, is poised to blow through the 2% mark; 2% typically being the level considered consistent with price stability. The pandemic caused an abrupt price decline last year as the global economy came to a halt. This created an artificially low base from which prices can rise as the vaccine rollout and government stimulus reignites activity.

Annual US inflation pushed through 2% in March 2021, and even if prices don't increase from March to April 2021, inflation for April 2021 will be 3.3%, all because of the base effect stemming from last year's price collapse.

Base effects, however, are not the only explanation for inflationary pressures. Supply constraints arising from the pandemic have seen shortages in certain sectors, resulting in price increases also. For example, there's a global shortage of microchips, which affects industries from autos to TVs.

No doubt, some shortages will be overcome as resources gradually come back online, and so some price increases will be transient in nature. However, some companies and industries will aim to address their supply vulnerabilities – perhaps by looking for suppliers closer to home – to avoid being caught out again and this will come at a cost. How much of this cost can be absorbed by companies in lower profit margins or passed on to customers as higher prices, will take time to assess. But these effects will not be temporary.

Another contributor to inflationary pressures has been the level of stimulus provided by governments putting money into people's pockets and increasing disposable incomes by doing so. It means that pent-up demand, as economies reopen, is chasing constrained supply in certain sectors, increasing prices. Again, these could be temporary but once a company has made the decision to put prices up, they tend to be reluctant to lower them again absent an economic shock. Price rises tend to be sticky.

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[1] Quantitative easing (QE) is a form of unconventional monetary policy in which a central bank, such as the Reserve Bank of Australia or US Federal Reserve, purchases longer-term securities, such as government bonds, from the open market in order to increase the money supply and encourage lending and investment. QE has the effect of reducing interest rates (yields).

What's ahead for bond and share markets?

Inflation is bad for bond prices as their interest payments become less valuable in an environment where prices are going up. In a normal functioning market with price discovery, we would expect bond prices to adjust lower to reflect the inflationary pressures.

Central banks, led by the Fed, are making reassuring statements that the rise in inflation will be temporary, and inflation will return to a comforting 2%. Based on current information, this may be a valid assessment. However, if the information changes so will investor views and potentially so might central bank actions.

The pending increase in reported US inflation, whether temporary or not, also has implications for shares. This can be done by unpacking what's happened in the US S&P 500 Index; overall earnings are down around 9% since last year yet share prices are up 35% over the same period! This has been made possible by the price-earnings (PE) multiple[2] expanding from 18 to 27 times.

The elevated PE multiple will be at risk if inflation increases. Our research suggests PE multiples are negatively impacted by rising inflation – any increase in inflation results in a decrease in PE multiples. To be clear, the research is not saying **inflation** is bad for shares, but it **is bad for PE multiples**.

Portfolio positioning

We've positioned the MLC Premium and Value model portfolios for diverse and resilient returns across asset classes in the following key ways:

- **Active decision to allow growth assets allocation to move towards top of rebalancing band** – We see the likely continuation of the 'recovery and reopening' thematic supporting slightly higher allocations to Australian and global shares. During April we have taken the opportunity to rebalance growth allocations back toward targets as share markets rallied strongly.
- **Foreign currency diversification** – Within global shares we continue to see foreign currency exposure as an important diversifier (holding both hedged and unhedged global shares).
- **Active fixed income** – Fixed income funds are actively managed, which we believe is essential in effectively navigating a rising interest rate environment. Our fixed income duration is relatively short to help reduce the portfolios' exposure to rising interest rates, and we selectively pursue investments in credit through Bentham's funds.

Inflation Plus changes – MLC Wholesale Inflation Plus portfolios provide important real return exposure and sources of low correlation return streams. Activity was focused on our 'participate and protect' strategy, where we introduced a protected US share market exposure. The structure allows for cheap participation in US share market rallies (up to a point) while avoiding exposure to falls beyond a lower bound. We also purchased a currency option to buy US dollars and sell Japanese yen to help protect the portfolios against the possibility of share markets falling at the same time as interest rates rise. The option allows us to sell Japanese yen exposure from the portfolios in this scenario, because it performs poorly.

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[2] The P/E multiple is the price of a share, divided by its earnings per share (EPS). It shows what kind of earnings growth investors may expect from a company.

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