Rising inflation not the only risk for investors

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Higher inflation in the wake of recent demand and supply chain constraints is forecast to pass, although investors still face several pandemic-related risks according to speakers at Frontier's opening annual conference session.

"Inflation is likely to come down, but not right away," according to Columbia University Director of Initiative on Central Banking and Financial Policy, Patricia Mosser.

"Most policymakers are expecting inflation to be above their target next year, as well as this year. It's going to take some time for no other reason than a lot of the rest of the world beyond the advanced economies are behind in their recovery."

The initial COVID-19 pandemic in early 2020 initially cut demand, but massive monetary and fiscal support propelled a quick recovery, particularly in the US. However, global supply chains have not recovered at the same pace.

Mosser said the US Federal Reserve was likely to let inflation run hot, given it had not reached its target for the past 12 years. However, she believes central bankers will not make the mistakes of the 70s and 80s when they slowly lost control of rising inflation.

"That was basically a failure in central banking. It is a mistake that nobody wants to repeat, not in emerging markets – nobody. So, are they going to let inflation run hot for a while? Yes. Are they going to let it run hot for 10 or 12 years? I'm very doubtful."

Meanwhile, President Biden's huge infrastructure spending bill has stalled, which would cut the deficit from 13% of GDP to 5% in just one year.

"There's going to be fiscal tightening in the United States first and it's going to be big. There's only a question of how big it's going to be – and that's one of the big unknowns."

There remains a risk that inflation will continue to rise or that COVID-19 will again wreak havoc as the northern hemisphere heads into winter and vaccination rates slow.

Frontier Director of Investment Strategy, Chris Trevillyan, said its research suggested that the current inflation spike was transitory, although there were few comparable moments in history to learn from.

Higher fiscal stimulus would not automatically lead to higher inflation, just as easy monetary policy in the wake of the 2008/09 global financial crisis failed to kickstart inflation.

"Post-GFC there were a lot of commentators stating as fact that all this monetary creation was going to lead to inflation… what we actually had was a decade of very low inflation and in many cases having to fight deflation."

PineBridge Investments Senior Vice President and Portfolio Manager Global Multi-Asset, Mary Nicola, said factors such as an aging population, slowing growth in China and productivity challenges would help contain inflation over the next five years.

"We've been of the view for quite some time that what we're seeing in inflation is a result of supply chain bottlenecks and we do believe that it's transitory and not persistent."

PineBridge had a position in short-dated TIPS which performed well but recently took it off given valuations. It has been looking at selective real assets to hedge inflation risk, such as industrial real estate catering to e-commerce.

Greater fiscal stimulus will help drive a return to trend growth and higher (but not high) inflation, characterised by excess liquidity and low bond yields, although China's slower growth will be a counterweight.

"We think cyclical and high-quality equities will be beneficiaries of the healthier growth and inflation environment resulting from that policy mix shift," Nicola said.

"It will be a challenging environment for nominal risk-free bonds, so the twin liquidity blots from private sector savings, central bank balance sheets, will continue to repress bond yields."

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frontier

Frontier Level 17, 130 Lonsdale Street

Melbourne, Victoria 3000

Tel: +61 3 8648 4300

www.frontieradvisors.com.au

@frontier_adv

