When it comes to inflation, investors shouldn't be complacent

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Inflation is not likely to return to, and stay at, 2.5%. The decarbonisation of the economy and shifting attitudes towards work are depressing supply and fuelling consumer price-growth, creating a headache for central bankers. Yet the sticky inflation – and the increased cyclicality it causes – will create many opportunities for active investors.

The decline in US inflation since June has given equity markets a shot in the arm over the past few months. Inflation expectations as derived from inflation-indexed bonds point to consumer price-growth of around 2.5% starting in June, and then a stabilisation in subsequent years. This outlook is akin to a return to the market conditions we saw in the 2010s, when real yields were largely supportive of financial-asset and property prices and made it easy for passive investors to book gains. But we don't believe in this scenario of lastingly low inflation.

Developed-world economies are entering an extended inflationary phase of the business cycle in which supply will struggle to keep up with demand. We're in for a rapid succession of inflationary growth spurts driven by structural factors, followed by disinflationary slowdowns orchestrated by central banks. This will bring renewed cyclicality to the economy. That's bad news for passive investors, but good news for active portfolio managers and for investment themes that had fallen by the wayside when the business cycle disappeared.

Secular trends will curtail the supply of goods and services

In addition to structural factors like demographics and a deceleration in global trade, **inflation is also being fuelled by two secular trends: the decarbonisation of the economy and shifting attitudes towards work**.

Decarbonisation has led to a sharp drop in investment in fossil-fuel production (meaning structurally lower oil and gas reserves) and pushed up energy prices. Trillions of dollars have been invested in the energy transition over the past decade, but the share of fossil fuels in the global energy mix has fallen by just slightly over 1 percentage point, to 81%. This portends an energy crisis along the lines of the one that contributed to the last major inflationary period, from 1965 to 1980, which was compounded by the 1973 oil-price shock. Opec (unsurprisingly) estimates that to secure the world's energy supply, an investment of $1.5 trillion per year in fossil-fuel production is needed between now and 2045, which is much more than the current level of $1.0 trillion per year. The actual figure is probably somewhere between these two estimates. And we shouldn't let the war in Ukraine keep us from seeing the bigger issue, which is the structural energy-production deficit that's getting wider and wider.

Where did all the workers go?

At the same time, shifting attitudes towards work – leading to shorter working hours, fewer workers, increased mobility, and, consequently, diminished productivity – will also likely contribute to a structural supply shortage. Businesses are unable to hire enough employees to meet the healthy demand they're experiencing. Predictably, wages are starting to climb in an impressive fashion. For example, Inditex (the owner of Zara) and its Japanese rival Uniqlo have bumped up salaries by 20%–40%.

Economic slowdowns resulting from depressed supply are necessarily inflationary, and they make steering monetary policy more complicated. Here, it's interesting to note that the US Federal Reserve's recent round of rate hikes, of an unprecedented pace and magnitude (475 basis points in 10 months), ironically coincides with the lowest US unemployment readings since 1969.

In the near term, the battle against inflation will be won with a few more rate hikes, as they'll probably trigger the recession needed to put the brakes on price growth by undermining demand. But they won't address the issue of depressed supply. The consequences of the shrinking pool of workers and rising energy prices will be countered only sporadically by fiscal and monetary policy, since the pain threshold in advanced economies is so low. And the recessions orchestrated by these policymakers to stymie inflation will be short-lived, shallow and insufficient to permanently halt the upwards march in prices.

Inflation isn't cause for fear: it harbours many opportunities

At Carmignac, our fixed income team has been successful in taking advantage of movements in sovereign and corporate bond yields amid a higher-interest-rate environment, in spotting asymmetrical investment opportunities in emerging markets, and in effectively managing our portfolios' interest-rate sensitivity. These skills will be particularly advantageous in the current economic climate.

Real interest rates are expected to remain low, which will support equity markets and warrants significant exposure to gold. China offers attractive diversification potential given the lack of inflation in the country for now.

We plan to introduce an inflationary bias in our investment portfolios in order to take advantage of the many opportunities that the increased cyclicality in the economy will offer, while providing for the necessary diversification. And crucially, we'll invest with inflation as our ally.

Glossary

Inflation-indexed bonds: Bonds in which both the principal (face value) and interest payments (coupons) rise and fall with the rate of inflation**Fossil fuels**: Fuels like petroleum, natural gas, and coal that are combusted to produce energy. **Productivity**: The amount of output produced from a given set of inputs such as natural resources, labour, and capital.

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