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WE HAVE TO GET USED TO INFLATION

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Investors are still being surprised by the persistent nature of inflation, and aren't taking sufficient account of the structural shifts underlying the long-term increase in consumer prices. This is a stepping stone towards what will be a lasting trend. In this kind of economic climate, actively managed fixed-income investments will certainly need to be a major component of diversified portfolios.

The return of inflation after an over-40-year absence is wreaking havoc in financial markets. Few of the traders behind computer screens today were around in the days of ticker tape and trading pits back in the 1980s. How many of us still remember what it was like to watch US and European inflation rise unremittingly towards the 15% mark?

For those who still believe that studying the past can help us better understand the present and envision the future, there are some important lessons to be learned from the period from 1965 to 1980. The oil crisis during these years brought an end to an extended period of subdued consumer price growth and ushered in an era of sustained inflation. In other words, basically the same configuration as we're seeing today.

But not all investors view today's post-Covid spike in consumer prices as the first step in what will be a genuine inflationary cycle. Inflation expectations in the US currently estimate a return to around 2.75% by mid-2023, and then a levelling off at 3% in subsequent years. These investors believe that the jump we're now seeing is a one-off event of the kind that's happened just two or three times in the past four decades.

However, this view fails to consider the structural inflationary forces at work, whether in terms of demographics (with a trend towards fewer savers around the world and a smaller population of Chinese youth to absorb into the workforce at all costs), trade (since global trade is declining as a percentage of GDP, competitive disinflation policies are playing a less-important role, and the prices at online retailers are reaching their lower bound), sociology (as businesses and consumers prioritise ethical practices over immediate efficiency gains), or the energy transition.

These deep-seated structural shifts mean inflation is here to stay. Will a handful of rate hikes by central bankers really be enough to wipe out this kind of upward price pressure?

It's hard to imagine that the US Federal Reserve will respond today like it did in 1980 under the leadership of Paul Volcker. He pushed the fed funds rate up to 20% at a time when inflation was sliding back down to 10%. That same year, then-US President Ronald Reagan broke the wage-price spiral by firing 11,400 air-traffic controllers who had gone on what he declared was an illegal strike to demand higher salaries. This was also the year when the US began to reap the benefits of its hefty investments in domestic oil production in the wake of the 1973 oil-price shock.

In a similar vein, many analysts today believe that the surge in energy prices will peter out once the hostilities in Ukraine come to an end. But as long as Vladimir Putin remains in power, there's no guarantee that Russia will quickly ramp back up its supplies of oil and natural gas. Meanwhile, alternative energy sources aren't yet up to capacity, and the underinvestment in fossil-fuel production over the past ten years is pushing up their cost. The fact that we're experiencing an energy crisis even though China's manufacturing powerhouse is at a standstill shows just how serious the situation is.

> *“The main thing shaping today's business cycle is central bankers' response to the return of inflation”*

The end of the pandemic has served to catalyse the rebound in inflation. The US government's large-scale stimulus programmes lifted demand at a time when production-plant shutdowns were constraining supply. US consumers built up excess savings equal to some 12% of GDP during the Covid lockdowns. As a result, workers now find themselves in a strong wage-bargaining position; salaries are up by an average of 7% year on year. When inflation does start to recede, wage growth will decline at a slower pace, thus pushing up households' real incomes. This will serve to fuel economic growth and mitigate disinflation.

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Therefore, the recession that'll be needed to absorb the consumer-price appreciation isn't on the cards for now. Fed Chairman Jerome Powell will probably continue to surprise us with his hawkish stance.

Investors are still being surprised by the persistent nature of inflation (initially thought of as only "transitory"), and aren't taking sufficient account of the structural shifts underlying the long-term increase in consumer prices. This is a stepping stone towards what will be a lasting trend. What's more, because today's central bankers have a low pain threshold, we can safely assume that they'll rush to cut interest rates – much too soon in our view – at the first signs of a decline in core inflation.

What does this mean for our investment portfolios?

The main thing shaping today's business cycle is central bankers' response to the return of inflation. This is unknown territory for many investors, making it an auspicious climate for active fund managers. Because an extended period of high inflation is a very real prospect, we have structured our diversified investment portfolios so as to be in phase with the business cycle.

Our equity investments consist of a high allocation to defensive stocks that can withstand successive periods of economic recession, along with holdings in companies whose stocks, unlike most, tend do well when inflation is strong. Our total equity exposure is adjustable through futures contracts on equity indices.

Contrary to popular belief, an inflationary economic climate is not bad news for fixed income. When inflation turns abruptly in one direction or the other, this generally triggers sharp movements in bond prices, opening up opportunities for active fund managers. Those who pay close attention to the business cycle can implement strategies likely to contribute to their funds' performance for each segment of the fixed-income market.

Fund managers who believe that inflation will soon start to fall can implement strategies to take advantage of a steepening of the yield curve (i.e. an increase in the spread between short- and long-term yields). These strategies can come alongside more directional bond-buying moves to benefit from the expected drop in yields.

On the other hand, if fund managers believe that inflation will soon start to climb, they can implement strategies designed for a flattening or even an inversion of the yield curve (i.e. when short- and long-term yields converge or when short-term yields rise above long-term ones).

Corporate bond prices also tend to become more volatile when inflation changes course. But the main thing driving the prices of these bonds is the business outlook and whether companies will be able to repay their debt. The yields on corporate bonds have become very attractive recently as higher interest rates and expectations of a sharp economic slowdown have widened credit spreads (in response to the higher perceived risk).

In an inflationary economic climate, actively managed fixed-income investments will certainly need to be a major component of diversified portfolios. An extended period of high inflation doesn't mean fund managers need to brace themselves for losses on their bond holdings. Rather, it calls for an active approach to managing these holdings so that they become significant drivers of positive performance.

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