Where next for inflation?

Inflation is by far the most crucial investment consideration today, yet it's not all bad news for long-term investors. In this paper, our Research, ESG and Investment teams explain the factors shaping their inflation outlook, the dynamics behind resilient equity markets, why ESG and sustainable development is here to stay despite short-term price pressures, and where to find investment opportunities in today's uncertain environment.

Markets are priced for disinflationary perfection

Inflation was dormant for long, and even considered dead in the wake of the Great Financial Crisis. Yet 2022 saw the genie get out of the bottle. We are confident that price pressure is past its peak. But its decline will be slow and bumpy, requiring a prolonged period of high rates – and some patience until central banks pivot. Underlying price pressure may reach targets over the next 2-3 years. The outlook is surrounded by substantial uncertainties, with the risks tilted towards a stickier overshoot.

Five key factors drove last year's inflation surge – and will be key for whether inflation reverses back to normal or not.

- First, the Covid pandemic **severely disrupted supply chains**, sending prices for intermediate and final goods soaring. Fortunately, most of this is behind us, with global supply chain pressures closer to pre-pandemic norms. In fact, US core goods prices are already declining.
- Second, governments in the US and Europe spent massive amounts of money to stabilize economic activity during the pandemic. A lot of this stimulus is still sitting with consumers as **excess savings** – which not only cushions demand, but also allows firms to protect margins and to pass high input and production costs more easily on to consumers. Much of these savings will be depleted over 2023. This will prolong, but not perpetuate, price pressures.
- Third, Russia's invasion of Ukraine sent **energy and food prices** sharply higher, mostly so in Europe on fears of winter gas shortages. Mild weather and successful curbs of energy consumption have helped this surge to fully reverse, with gas prices now less than a sixth of 2022 peak levels. Base effects from annual comparisons will reverse last year's inflationary impact from energy over the coming months. That said, a Chinese reopening bounce into spring may take energy prices higher again, mitigating this disinflationary force.
- Fourth, **labour markets have proven highly resilient**, both due to fiscal stimulus and labour hoarding amid a demographic drag on workforces. The US unemployment rate was at its lowest since 1969 in January at 3.4% (even if inching up to 3.6% in February). This provides workers demanding compensation for high inflation with a strong bargaining power. On the demand side, rising wages will cushion real disposable income. This setup can be a fertile ground for a wage-price spiral to unfold. Persistently high services inflation is underpinning this risk *(Figure 1).*
- Finally, various survey-based **inflation expectations** remain elevated. De-anchored price expectations among consumers and firms risk becoming self-fulfilling if they start determining future price settings by firms and wage demands by workers.

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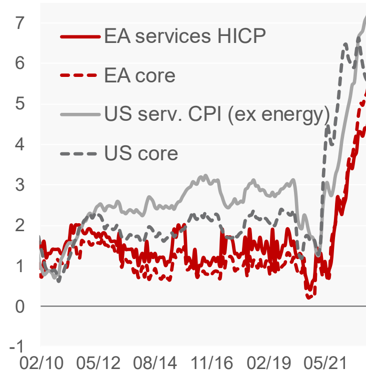
Figure 1: Broadening price pressure

STICKY PRICE IN PRESSURE [in % yoy]

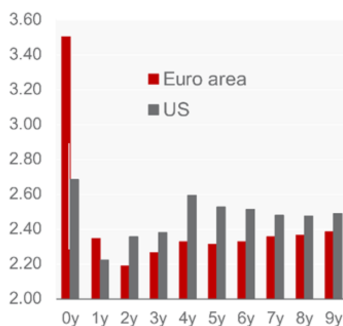


Source: Datastream, GIAM as of end of March 2023.

The first three factors underpin our confidence that inflation will gradually recede towards central banks' targets over the next 2-3 years. Yet the latter two factors inject upside risks to this central outlook. The experience of the 1970s and 80s suggests that inflation, once entrenched, is very stubborn to fight. Central banks' massive tightening and recent banking sector woes will tighten credit extension and demand. This may help to cool price pressure, but may not yet be enough to bring inflation quickly back to targets. Markets now seem priced for disinflationary perfection *(Figure 2)* – and that is a narrow path leaving scope for unpleasant surprises.

Figure 2: Inflation pricing: Implied 1-year forward pricing

INFLATION PRICING [implied 1y fw pricing in x years]



Source: Refinitiv, GIAM as 21/03/2023.

Inflation and equities: Not all bad news

Looking at history, a smooth pick-up in inflation is not detrimental to equities, as firms are normally able to use their pricing power to benefit sales growth. In the last 20 years, with inflation at 1-3%, equities performed at their best. Higher inflation than this drives higher risk premiums and lower valuations. On a much longer term horizon, however, real equity returns vs bonds look quite resilient.

After the initial shock last year, equities rallied: headline inflation started declining in Q3 2022 while bond volatility retraced from high levels (recent banking events however injected a lot of monetary policy uncertainty, pushing rates volatility to new highs). This revealed unexpected resiliency in developed markets, especially in the euro area, with corporates able to generate substantially high sales growth and margins, providing a boost to earnings.

Cautious in the short term on high multiples…

Current market multiples range from fair (Europe) to expensive (the US) but the lagged negative effect of monetary policy could hurt growth and earnings over the next quarters. Recent banking events are likely to aggravate already tightening lending standards: the risk of a full-blown credit crunch is rising. For this reason, we remain tactically cautious on equities.

In an average cycle, low but positive inflation is associated with higher equity returns and valuations. In the US in the last 20 years, the highest PEs and positive equity Sharpe ratio differentials vs. bonds[1] occurred when inflation and 10-year US yields were between 1-3%.[2]

We have adjusted our forecasting band for 2023 headline inflation from 3-4% to 4-5%. This makes a significant difference. In the last few decades such a

[1] Total return adjusted for risk.
[2] Source: GIAM proprietary cross-asset analysis, March 2023.

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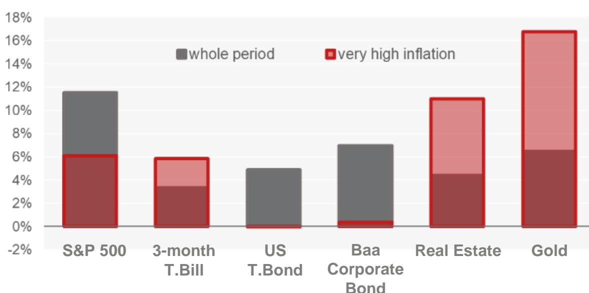
leap in inflation triggered a higher equity risk premium (ERP), corresponding to a lower equity valuation (average ERP = 4.3 for inflation between 3-4%, and ERP= 5.4 for inflation between 4-5%, so almost a 25% rise in the ERP). [3]

…but longer term equities remain an attractive relative inflation hedge

Having said this, historically, equities have represented a good hedge against inflation relative to bonds. Across 21 countries over the last 122 years, average real annual equity returns have been superior versus bonds almost across all inflation percentiles. The only exception is during marked deflationary periods[4] in which equities experienced on average +13% returns vs. 19% for bonds. Highest real equity returns versus bonds occurred with inflation between 0.5% and 4%. When inflation was very high – above 7.4% – equities nullified their real returns but still beat bonds. In the US, during very high inflationary periods, annual equity returns were higher than those of bonds on average in the last century *(Figure 3).*

Figure 3: Annual investment returns since 1928



Source: NYU, GIAM Research. High inflationary periods defined as years with an inflation rate 1/2 standard deviation above the long run average: 1916-1920, 1942-1943, 1946-1948, 1951,1970, 1973-1982, 2022.

Moreover, after inflation peaked from very high levels (like in the current cycle) average equity returns were usually higher than bonds up to a 1-year horizon *(Figure 4).*

Figure 4: US equity returns minus fixed income after peak CPI

peak in h.line CPI	peak in core CPI	TR of Equity vs	3M	6M	12M
Dec-74	+2m	10Y Treas	19%	21%	1%
		IG	21%	29%	24%
Mar-80	+3m	10Y Treas	-9%	10%	20%
		IG	0%	5%	19%
Oct-90	+4m	10Y Treas	2%	21%	20%
		IG	4%	21%	18%
		HY	6%	9%	-1%
Jun-22	+3m	10Y Treas	2%	4%	
		IG	2%	2%	
		HY	1%	0%	

Source: Datastream, GIAM as of end of March 2023.

There is a notable difference during US hiking and easing cycles. During hiking cycles, average annualized equity real outperformance was near 3%, while during easing cycles it was 6%. Sharpe ratio[5] differentials also remained positive for equities versus bonds, in both hiking and easing cycles. In summary, there is scope for equities to be maintained in a diversified portfolio, even during high inflation periods.

ESG in an inflationary environment

Rising production costs are forcing companies to focus on short-term cost-cutting solutions at the expense of long term ESG strategies. Investors will however remain committed to their ESG objectives and expect companies to combine short-term inflationary remedies with commitment to long-term sustainable development.

We identify the three most important aspects of sustainable investment during current market conditions:

1. **Exclusions are here to stay**. Compared to previous inflationary periods, investors now consider ESG performance in addition to financial performance and resilience. Companies with no credible ESG path will be restricted or excluded

[3] Source: GIAM proprietary analysis based on historic Shiller PE data, March 2023.
[4] Less than -3.5%, i.e. the lowest 5% inflation cases.
[5] Returns adjusted for volatility.

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by many investors. Meanwhile, companies belonging to more inflation-resilient sectors with strong ESG performance will have the advantages of attracting investment to accelerate ESG transformation.

2. **Rising social risk from product affordability**. Deterioration of consumer purchasing power requires careful and responsible price adjustments to retail clients and may ultimately require companies to absorb profit margin declines. Government subsidies may help ease this issue. However, given the possibility of elongated energy shortages, subsidies will be used cautiously by regulators to maintain fiscal stability. Companies making strong efforts to increase production efficiency instead of depending on subsidies or passing price increases to consumers will be better placed to maintain both their financial stability and ESG profiles.

3. **Ambitious US and EU policies**. Besides short-term fiscal support, ambitious long-term plans to align fiscal policies and climate change mitigation have been issued by the US and European Commission: the US Inflation Reduction Act in 2022 and the EU Green Deal Industrial Plan in February 2023.

   Their main focus is subsidies for key industries for the green transition such as real estate, capital goods, automotives, utilities, energy, materials and technology. Despite the objectives of accelerating the green transition, both policies will undoubtedly create global trade disruption due to rising protectionism. However, government subsidies can help reduce the transition cost and ultimately ease potential inflationary pressure linked to rising demand for raw materials and skilled workers. That said, the capacity of governments to raise additional funding will have to be tested against the surge in public debt over the past 15 years.

   We expect the EU will face more hurdles than US in implementation due to its need to balance the interests of multiple states. Although the European Commission is accelerating the relaxation of state aid rules to speed up the deployment of sustainable technologies, how accessible the funding is for eligible companies remains to be seen.

Inflation-linked bond opportunities still have power

Volatility and the profound impact on global commodity prices induced by the war in Ukraine is here to stay considering the impasse in the conflict. Europe's gas dependency exposes it in the short term to further upside risk while in the medium term deglobalization is a structural and long-lasting undercurrent that will reshape trade links.

This slew of deep-rooted structural trends could push inflation systematically higher and make it more volatile. In the short term, inflation should drop back mostly driven by base effects but where it will land is less certain. Average inflation may be well higher than in the past decade and the range of outcomes wider but skewed to the right-hand tail of the probability distribution.

Against this backdrop, we see value in increasing an allocation to inflation-linked assets. The two viable options are: 1) a funded one via purchases of inflation linked bonds or 2) an unfunded one buying inflation swaps. The latter is a pure inflation hedge, while with inflation linked bonds investors gain exposure to additional risk from real yields, which have risen from extremely depressed levels since the rates sell-off in 2022.

Buying inflation-linked bonds exposes investors to a further rise in higher real yields. Those concerned about better-than-expected economic growth or

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supply/demand conditions may thus prefer to build an inflation hedge mainly through euro inflation swaps.

The short-end of the inflation curve is more sensitive to the commodity cycle, while to benefit from structurally higher inflation we are focusing on the belly of the curve, mainly in the 10-20-year maturity range.

Energy and financials are relative winners from inflation, but face more challenges just now

As explained earlier, low but positive inflation is associated with higher equity returns and higher valuations: the highest PE ratios are usually seen when inflation is between 2-3%.

Equity headwinds come when inflation is elevated and sticky, as it raises the question of whether companies have the ability to pass price increases to consumers. Value sectors, like energy and financials, have usually the highest positive correlation to inflation *(Figure 5).*

Banks are supported by significantly increased interest rates. Higher inflation accompanied by higher bond yields is a clear positive for banks, allowing them to expand Net Interest Income, their main revenue driver, which measures interest received from assets less interest paid for liabilities. The recent US banking sector turmoil should not affect large listed Eurozone banks that look more solid and better regulated. Nevertheless, lending conditions will continue to tighten, implying modest negative EPS revisions going forward. Near term, the sector also faces greater competition for deposits from money market funds, which may imply lower interest rate income.

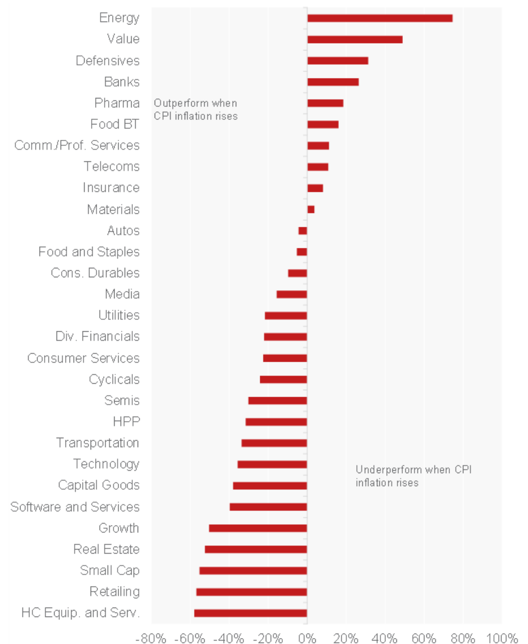
Following the rise in agricultural commodities pricing, we increased exposure to the food retail sector, which is typically a fixed-cost industry. As food inflation was growing faster than SG&A, labour or rent costs, we have seen positive operating leverage and margin expansion on some operators with high volumes and strong market share. More recently, however, with wage increases in Europe putting more pressure on profitability, switches to luxury sector companies may be warranted, as they have fewer commoditized products and therefore stronger pricing power.

In terms of style, inflation is unsupportive to growth companies like tech and healthcare equipment. A rise in long rates tends to lead to multiple compression and de-rating as these fast-growing industries are more based on projected future earnings. This is why we have been selective there, favouring companies that can deliver earnings progression that offsets part of the derating pressure.

We are closely monitoring company debt levels, since interest rates may remain higher for longer. This may hamper highly levered sectors with refinancing needs, given elevated borrowing costs and tougher accessibility following the recent banking turmoil. In this context, we remain cautious on real estate despite the massive derating in 2022.

Figure 5: Sector sensitivity to European inflation

Correlation using yoy data since 2010



Source: Datastream, GIAM calculations.

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