Cry wolf !

Inflation is getting a lot of airtime these days. Bond yields are increasing rapidly, and much ink is spilled on guessing whether inflation or a rapid return to growth is the culprit. Inflation will affect all other asset in not-so-simple ways. Asset allocation methods will have to be adjusted if inflation returns. And just talking about inflation has provoked a beginning adjustment of inflation risk premia.

In golf it is well-known that "driving is for show, putting is for dough". A parallel exists in the financial markets. Bonds are by far the largest asset class, but most other asset classes - including equities – have more interesting stories.

So it is a nice change when the entire financial sector have noticed that bond yields in the long end are heading north, and quickly.

The question is if higher yields is a result of returning inflation. It is relevant in the medium term. In the short term, not so much. Bond yields are likely to continue upwards anyway.

A post-pandemic boom?

Last year, we saw negative yields on 10-year government bonds, 30-year bonds yielded less than one per cent. Bond markets clearly understood the crisis would be deep. And nobody knew how long it would last. Massive government expense programs were introduced. It became clear that most decision makers had underestimated the economic consequences of the pandemic.

In September 2020 it all changed as it became clear that vaccines were on the way. From that moment on, bond yields have been creeping up and recently, they have accelerated. It has become clear that the vaccines are more efficient than first believed. Despite some initial fumbling, the world is rapidly ramping up vaccine production. Distribution is getting better by the day.

So within 6 months the pandemic will have receded and we will be in the middle of a boom of epic dimensions. Bond yields will increase further in this scenario.

Do central banks want inflation?

It is just a bit harder to argue for the inflation. After all, inflation has been falling for the past two decades.

There is one big reason we should at least consider what higher inflation will do to investment assets. Last summer Federal Reserve published a new monetary policy framework, making some seemingly small changes to the way inflation is targeted.

But in the accompanying remarks, Fed chief Powell laid out a rather more radical agenda: Fed wants to push up inflation.

The reasons are clear. Fed is very mindful of the fact that the decade following the financial crisis brought about a dramatic increase in economic inequality. Said Powell:

"The single most important thing that we can do is support a strong labour market. Getting wage gains only in the 8th or 9th year of a recovery is not the best outcome."

"Many find it counterintuitive that the Fed would want to push up inflation. We are certainly mindful that higher prices for essential items, such as food, gasoline, and shelter, add to the burdens faced by many families, especially those struggling with lost jobs and incomes. However, inflation that is persistently too low can pose serious risks to the economy."

There you have it: the world's most influential central bank has decided that higher inflation will be a positive. Only ECB is still holding out against inflation

One could even argue that with exploding government debt, it would be practical to have a somewhat higher inflation to hollow out the real value of the debt. It would also ease the burden on future generation that will have to repay the debt.

So yes, central banks do not any longer see their mission as fighting inflation, but to be guiding inflation expectations upwards.

Inflation affects all asset classes

Even if higher bond yields seem to be a done deal, the current focus from the financial press on inflation is an expression of something deeper. It is for a simple reason: higher bond yields will affect every investment decision going forward. But the effects of inflation and of growth are not the same across asset classes.

So, in order to get the asset allocation right, one must take a stand whether one believes in growth with higher inflation or growth with a continued anaemic inflation.

Just look at other investments than bonds:

Safe-haven assets (so-called) ie. unproductive investments such as gold and cryptocurrencies will benefit from inflation. They have the "advantage" of not representing a cash flow whose value depends in inflation. So, pricing of such assets will likely continue to be tethered to emotions.

Commodities will gain in line with the economic recovery and will increase further in case of inflation.

Real estate will continue increasing until the financing costs become relevant. That can happen with or without higher inflation. Winners will be investors who can increase their income flows to match higher financing costs.

Infrastructure investments are anyway driven by government subsidies and thus defy normal market logic.

High yield bonds behave either as a bond or an equity. HY bonds fell in tandem with the stock market last year in March. When it became clear that central banks would treat them like bonds, HY bonds recovered sharply.

In case inflation returns, we believe that *credit analysis* will gain in importance, with the issuer of a given bond being the most important factor – just like in equities.

Equities are in an investment context nothing but two cash flows, an income stream from operations and a (most often negative) income stream from the financing operations. Different discount factors are used for the two, and of course higher inflation will influence the

discounting factors. The uncertainty about future cash flows will increase. The uncertainty about the present value of such cash flows will also increase.

Conclusion

So there you have it: Mounting inflation fears will lead to higher risk premia across the board. Inflation will change the asset allocation game radically. Mounting inflation fears will undermine any investment based on long cash flows.

As we wrote back in 2008, in an inflationary boom, sell bonds and inflation sensitive stocks. Buy cyclical stocks and assets in limited supply.

26 February 2021
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