Governments' ways means higher inflation?

The Covid-19 pandemic has reminded us how hard it can be to predict even a few months ahead, with very few commentators having speculated at the start of the year the extreme events that have unfolded since. Yet, however unclear the current situation, governments, central banks and businesses are desperately trying to understand the scale of what's happened and plan for the months, years and decades ahead. Many decisions they make will be wrong: there are simply too many 'unknown unknowns'.

A key challenge currently is the residual dislocation of financial markets following the initial impact of the crisis. At Royal London Asset Management (RLAM), our view is that the current environment continues to provide buying opportunities for longer-term investors, for example, in the high yield market.

But in addition to the shorter-term impact on investment markets, investors also need to consider how recent events will feed through to longer-term economic expectations for economic growth, interest rates, exchange rates and price inflation. Investors have typically paid less attention to inflation in recent years, with most developed market countries seemingly having this well under control.

However, huge stimulus packages have now been deployed around the world to fight the Covid-19 crisis. For example, the UK government has been making increasing use of its 'Ways and Means' facility with the Bank of England (BoE) to fund increased expenditure. In the context of such significant additional monetary and fiscal stimulus, and the associated challenges of paying for this, can investors remain complacent around inflation risk?

Crisis averted?

The initial crisis is already well behind us, at least from an investment perspective. The falls in markets were rapid and precipitous, and experienced managers who have traded through previous crises were surprised how fast markets unravelled this time. This crisis was measured in days and weeks, rather than months and years. However, the relative stabilisation of markets was almost as quick.

This owed much to the response of governments and central banks. International political cooperation has declined since 2008, but central banks have learned that scale and speed are key elements in the success of financial stimulus. The 'big bazooka' has to be deployed quickly and be ready to fire unlimited shells – or at least markets have to believe it will.

Yet, despite their short-term effectiveness, the myriad monetary and fiscal stimulus measures have thickened the longer-term fog. Markets have recovered, but at what cost, and how will this distort the longer-term market and economic environment – in particular around inflation?

Inflation – the hidden risk?

For most investors, higher inflation is undesirable as it can reduce their long-term purchasing power, in particular for fixed investments.

Lower inflation in the short to medium term has been factored into inflation linked bond prices and other markets. This is a global trend, and investors are now expecting an extended period of ultra-low interest rates and low inflation, or even deflation. We believe this could be dangerously myopic.

In the next year or two, inflation ought to remain benign as the recession plays out and oil price and other commodity

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effects dampen prices. Beyond this, however, the inflationary outlook is less clear and the benign scenario might not persist. Pulling back from globalisation, more defensive supply chains, greater protectionism and higher government spending could push prices higher. Financing costs of government debt will rise globally, despite ultra-low interest rates; in the medium term this should push real yields higher.

With austerity out of fashion, governments will likely seek to reduce debt levels by holding interest rates low and letting inflation rise slightly to erode the debt's real value. The Office for Budget Responsibility in the UK recently highlighted the scale of the challenges by adjusting its forecasts for the current financial year. The fiscal deficit was increased by £25bn to £298bn, more than five times its pre-crisis estimate of £55bn.

This will need to be borrowed. For now, there's no problem. The BoE has been buying government debt at the rate of £13.5bn a week, more or less matching the Debt Management Office's increased supply. It has denied that it is monetising debt, citing differences in the maturity profiles, and the market has gone along with this… for now, at least.

The challenge is that there are no rules to follow. Other than wartime, the levels of borrowing are unprecedented; equally, no-one knows how much the market will allow the BoE to push the boundaries of financial sophistry. We'll only know when we reach the tipping point, but there seems to be a reasonable chance that the outcome from this process will eventually be higher inflation.

More immediate risks?

There could be challenges in the near term. In June, the BoE committed to additional quantitative easing (QE) as the market can't absorb the planned supply without this. Will this be construed more explicitly as debt monetisation? The BoE has defended this accusation and has reduced the rate at which debt is being bought in this second round of QE. This could be considered as a tapering of purchases, similar to the Federal Reserve. This could force up gilt yields and inflation expectations over the medium term.

Beyond that, we think that a 'no-deal' Brexit would likely cause a further sharp fall in sterling, which would be inflationary as exports would be instantly more expensive.

A wild card is the challenges in producing accurate inflation data during the lockdown. If you can't buy things, how can they be priced accurately? The goods and services that would be stripped out of the data could be the most deflationary, such as flights, meaning any Covid-19-adjusted inflation data could be surprisingly strong.

How could investors react?

There are various assets that will provide either a direct hedge for price inflation, such as inflation-linked government and corporate bonds, or more indirect hedges such as infrastructure debt including Private Finance Initiatives. The latter in particular has the potential to benefit from increased fiscal stimulus as a result of the Covid-19 crisis.

For many investors, buying global inflation may be an effective solution when there is the aspiration for a broader inflation hedge within their portfolios. This approach has several attractions:

- As the pandemic is a global phenomenon and other governments and central banks have reacted in a similar way, inflation rates would be expected to be reasonably correlated, particularly in a high inflation environment.
- In most cases, real yields are significantly higher than the UK, yet inflation expectations are lower. At the time of writing, the implied inflation rates for US and German five-year index linked bonds are 1.1% and 0.4%, respectively, with the UK at 2.5%.
- The duration of the underlying markets is also important. For example, the average duration of UK inflation funds is significantly higher than most global funds. If economies recover faster and inflation expectations pick up, owning some of the longest duration assets in the world could be painful.
- Furthermore, UK investors also face the unpredictable issue of Retail Price Index (RPI) reform, which will soon be back on the agenda.

The likely impact of RPI reform

Later this year the Government will opine on the consultation around RPI reform. The simple question is whether the calculation of RPI will be adjusted to resemble that of Consumer Price Index (CPI). The Bank of England currently target a CPI level of 2.0% when setting monetary policy, but RPI has historically averaged 0.7% above CPI at 2.7%.

UK inflation linked gilts are priced using RPI, resulting in UK implied inflation trading at 2.90% (at the 10-year point) and 2.97% (at the 30-year point). Assuming that the Chancellor decides to convert the RPI calculation to resemble that of CPI, it would be natural to assume that over time the implied inflation rate in the UK should average 2.0%. This change would imply that UK index linked assets are currently 0.9% overpriced versus a 2.0% target. To quantify the impact of this decision, a 0.9% rise in yields on the FT All Maturity Index Linked Gilt Index would equate to a capital loss of 20%.

How to protect against rising inflation but hedge against RPI reform

The risk of a large capital loss is unwanted, but equally it may not happen if RPI reform is kicked down the road. One way to protect against rising inflation but avoid UK concentration risk is to consider global inflation investments. At RLAM we developed a suite of global inflation funds (short duration and all maturity) to assist investors in diversifying away from UK exposure, which looks very expensive versus global peers. These two funds have 30% UK exposure, with the rest focused on global inflation bonds in the US, Japan and Europe. The central banks of these non-UK countries target CPI of 2% - the same target as the BoE. Inflation expectations in these markets have taken a hit during the pandemic and look very attractive versus the UK, which has largely ignored both the pandemic and RPI reform implications. Implied inflation in Japan, US and Germany currently stands at 0.15%, 1.3% and 0.7% respectively (all below the 2% target) versus UK inflation at 2.9% (0.9% above a CPI target of 2.0%).

Central banks globally have employed similar measures in their fight against the virus, and if successful, the extraordinary stimulus is likely to be felt globally. In our view, this means that investors should consider diversifying into global assets. As well as providing cheaper inflation protection our global index linked funds also have a much shorter duration (5 years and 12 years respectively for the short duration and all-maturities funds) than a UK index linked fund (c. 22years). Having significantly shorter duration means that these funds will be more influenced by inflation expectations and should have a lower impact from rising yields than would be felt on a typical UK index linked fund.

It's not just all about inflation… unprecedented measures create significant value opportunities

The RLAM Rates and Cash team have worked together for over 10 years – a period where we have witnessed the global financial crisis, Euro crisis, Brexit, Covid-19, a sharp increase in geopolitical volatility and extensive quantitative easing both in the UK and beyond. Throughout these events the team have looked to use volatility and the relative value opportunities this can provide. You can visit our website at www.rlam.co.uk to see details on our index linked range, as well as see further updates on our funds and positioning as the fall-out from the coronavirus continue.

Keep calm… and diversify

The effects of the coronavirus are not just short term. While many of us are thinking about changes to working patterns, holidays and the like, we also need to consider that we would see changes to inflation. These come with significant risks which may materialise: it is hard to quantify the chances of these risks occurring as we expect to face significant uncertainty for some time. However what we can say with complete confidence is:

- Global inflation looks very cheap versus the UK and versus central bank targets (ex UK).
- UK RPI reform will happen at some point and could be as early as this year.
- Brexit 'No-deal' is a possibility but the likelihood is a 'deal' in an already uncertain world.
- The longer the duration of your fund the less your inflation protection.
- We expect to see opportunities to add relative value for years to come.

Contact us

For more information about our range of products and services, please contact us.

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