Why financial markets shouldn't fear inflation

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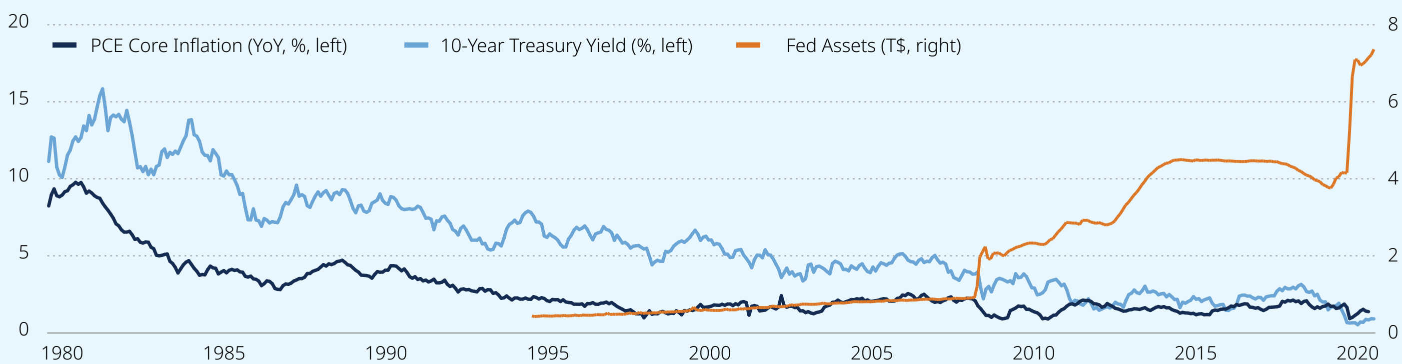
Highlights

- Persistently high inflation beginning in 2021 remains unlikely in our view, although temporary price pressures are possible once vaccinated countries re-open their economies, especially in those sectors hit hardest by the pandemic.
- Inflation's closely related risk for asset prices, an earlier-than-expected lift-off in central bank policy rates, is less likely with the Federal Reserve adopting a more flexible policy framework. With a fixed nominal rate around zero, short-lived inflation pressures would imply a dip in real yields, a potentially bright prospect for risk assets.
- While not our baseline expectation, high and persistent inflation would be bad news for many assets. Inflation risk can be hedged in a portfolio, but often has a cost in the form of lower expected returns.

Warnings of upcoming inflation risks are eerily similar to previous false alarms in the last decade. As Democrats come closer to a "Blue Wave" following their surprise victories in the Georgia runoff elections, markets have become increasingly concerned about the prospect of larger fiscal stimulus and infrastructure programs stoking inflation and steepening the yield curve. However, in the aftermath of the Great Financial Crisis (GFC), many in the financial world also expected consumer prices to balloon as direct asset purchases by the Federal Reserve and other central banks found their way into the real economy. Similarly, after the surprise election of Donald Trump in 2016, markets expected higher inflation due to large deficit-financed tax cuts. In fact, we witnessed the opposite: the 2010s were generally a time of low and stable inflation (Figure 1).

Figure 1 | Dramatically higher Fed asset purchases have not translated into higher inflation or rates in the past decade



Notes: Data via Bloomberg. Fed Assets are Total Assets (Wednesday Level).

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While the past is not always a reliable indication of the future, we continue to believe that a sharp increase in inflation is mainly a tail risk – that is, an event that is unlikely but with large potential consequences, should it happen. There are several potential drivers of a higher inflation scenario. Unprecedented government spending could act as a pipeline for central banks' purchases of government bonds to reach the pockets of consumers and businesses. In addition, business borrowing has been healthy, in contrast with the GFC when businesses and households deleveraged. Pent-up demand because of the lockdowns could also lead to a consumer spending spree in late 2021, financed by the sharp buildup of cash account balances during the lockdowns.

We do see the potential for short bursts of inflation, especially in hard-hit sectors during the pandemic. This should not prompt a rise in policy rates as major central banks like the Fed look through temporary increases and allow higher-than-target inflation in 2021 to compensate for many years of inflation undershooting. Somewhat higher inflation in 2021 is likely simply because prices were depressed in 2020 due to lockdowns and the most severe economic downturn since the 1930s. However, high and persistent inflation in the medium term remains a tail risk for portfolios.

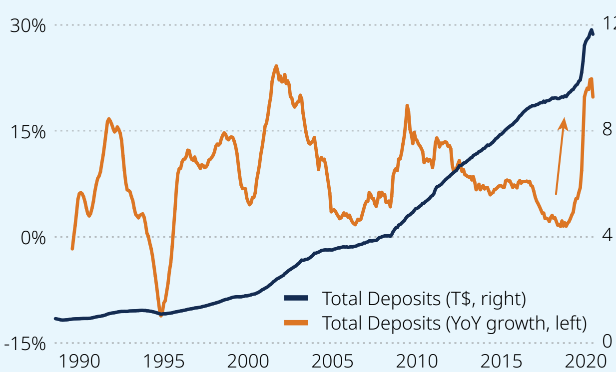
Missing ingredients in the recipe for inflation

While we're witnessing some of the ingredients for inflation, current conditions remain far from a perfect storm in our view. Money supply growth has exploded in many countries, driven in part by central banks purchasing assets to stimulate the economy. But the relationship between money supply and inflation is a long-term one that has seemingly weakened since 2008. It does not necessarily hold in the short term, as Figure 1 illustrates. Weak aggregate demand suggests new money will not circulate as rapidly in the real economy. Coming out of the Covid crisis, private sector demand will likely take some time to recover. Many small businesses have shut down and the surviving ones could be skittish about spending, hiring and investment when the economy starts reopening. Having learned from the GFC experience, it takes time for the structurally or long-term unemployed to re-enter the labour market.

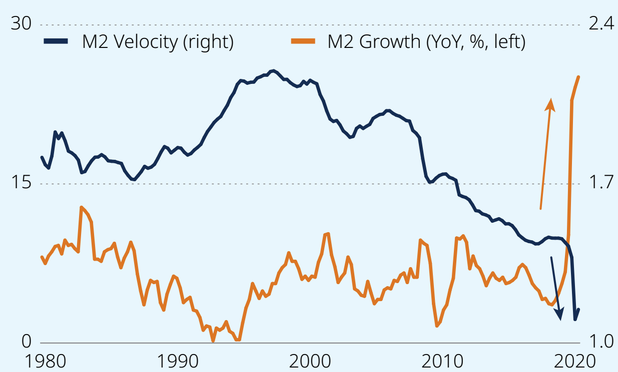
Solid corporate bank borrowing and debt issuance by larger firms are potential a pipeline for central bank asset purchases to reach the real economy. Induced by low rates and the Fed's backstop of the US corporate bond market, many large firms have been borrowing while they can, given the uncertainty of the pandemic. Instead of sitting in bank reserves as during the GFC, these funds have boosted businesses' cash reserves. While "broad" money aggregates grew fast last year, signalling that newly created liquidity is not being held up as bank reserves, money velocity, i.e. the speed at which money circulates, nosedived like never before because these funds have not yet been spent to drive national income higher (Figure 2).

Figure 2 | A portion of the fresh money supply is sitting in cash deposits

Cash deposits grew by more than 20% in 2020



Broad money supply surged, velocity dropped



Notes: Data via Bloomberg.

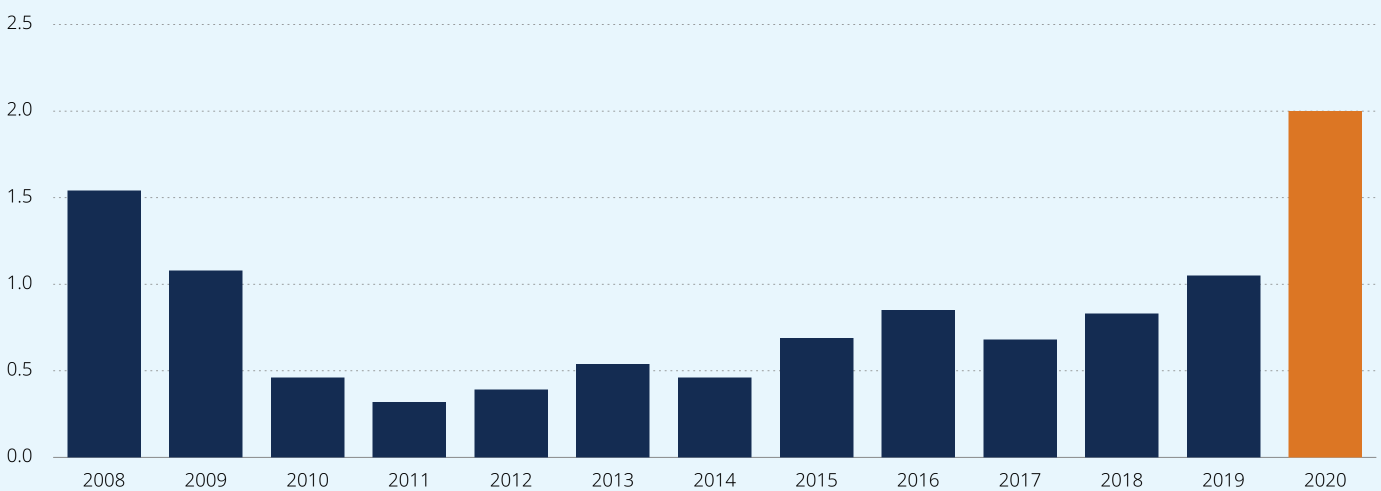
We believe that it is unlikely businesses' cash reserves will generate strong inflationary pressures in the future. If the recovery gets delayed, businesses will use their cash reserves to support their day-to-day operations and stay above water. Corporate leverage also increased sharply in 2020 so higher cash balances could be needed to reduce debt, especially if interest rates rise. However, in our view, the possible inflationary pressure from a drawdown of cash balances will likely be offset by continued low aggregate demand relative to an economy operating at full employment.

High cash balances can also be explained by household "excess savings" during the pandemic, especially from households above the median income line. Many of them kept their jobs throughout 2020, were forced to cut spending by pandemic-related restrictions and benefited from tax rebates. The resulting pent-up consumer demand could fuel a spending spree once mass vaccination is complete. But in general, these households have a low marginal propensity to consume the services that were unavailable to them in pandemic times. After all, just because someone couldn't travel in 2020, it doesn't mean they will double their trips in 2021. As we expand on below, this pent-up demand will likely generate temporary sector-specific inflationary pressures once economies reopen, but we don't believe it has the potential to trigger persistently high inflation.

Another potential pipeline for newly created central bank reserves to reach the real economy is through higher deficit-financed public spending. Governments in most countries have accrued huge budget deficits in 2020 and expect to extend their fiscal support in 2021. However, government spending in the Covid crisis should be seen as a reaction to extremely depressed private sector demand. The goal is simply to act as a replacement for lower private spending. By our estimates, the US$900 billion pandemic relief bill passed by Congress in December 2020 is just enough to temporarily close the US output gap. As the economy recovers, government budget deficits should decline with the health of the private-sector economy. If and when the private sector comes back, fiscal stimulus should retreat proportionally. In its latest economic projections, the IMF forecasts that government budget deficits will steadily decline towards their pre-pandemic shares of GDP over the next five years as the economic activity recovers.[1]

The main risk is that excess government spending becomes *structural* rather than cyclical, overheating the economy as private spending recovers and generating persistent inflation. If governments cannot scale back their spending and close fiscal deficits as the cycle progresses, inflationary pressures become more likely. Persistent inflation pressures could lead to higher nominal bond yields, raising the risk of debt distress for many corporations with shaky balance sheets after a surge in borrowing in 2020 (Figure 3).

Figure 3 | Zombie firms are sitting on a record $2 trillion in corporate debt
(in trillions of US dollars)



Data via Bloomberg. Zombie firms are defined as firms whose earnings are insufficient to cover their interest expenses. 2020 figures are as of the most recent quarterly data.

1 World Economic Outlook database, IMF. October 2020.

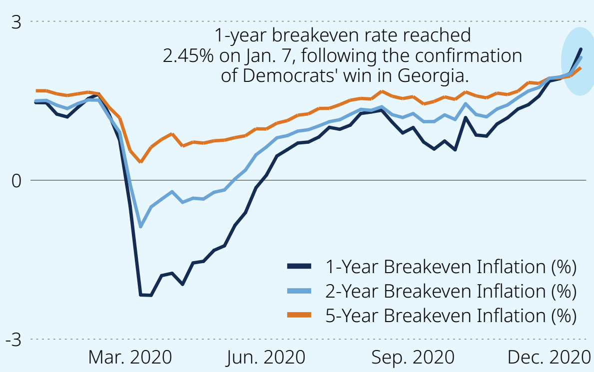
Temporary demand-driven inflation might not be so bad

Market pricing of inflation-linked bonds indicates that high and persistent inflation is unlikely in the medium term. The US five-year breakeven rate, a proxy for the market's expectation of the average US inflation rate in the next five years, has climbed recently, but is still only around 2% (Figure 4). Far from a dire prediction, market forecasts are broadly in line with central bank inflation targets in the US and Canada.[2]

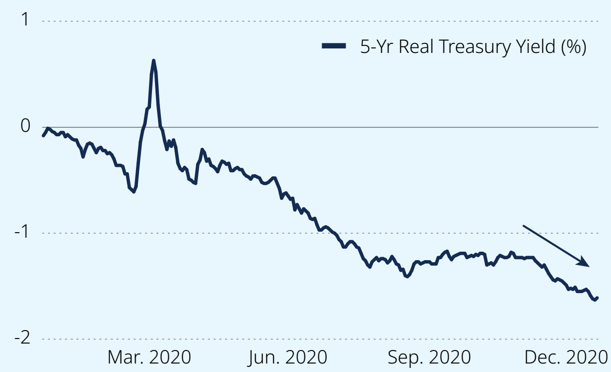
Interestingly, one- and two-year inflation expectations are now above the 5-year rate, uncharacteristic at this early phase of the business cycle recovery. Indeed, inflation is expected to surge slightly in the short term, before settling back below the central bank's 2% target. This makes sense from a macro point of view. Once mass vaccinations are completed, consumer demand will likely jump in previously restricted sectors of the economy, including tourism, hospitality and entertainment. It will be hard for dormant firms to ramp up capacity immediately to meet the surging consumer demand. This temporary mismatch between demand and supply will push prices up those sectors until firms adjusts. The Democratic Senate wins in Georgia further increased the gap between short- and medium-term inflation expectations, given that additional fiscal stimulus could increase pent-up demand and temporarily overheat the economy. We believe the same dynamic of temporary inflation pressures in the short term coupled with subdued inflation in the medium term is likely in Canada, although inflation is expected to be lower on average over the next five years than in the US.

Figure 4 | Inflation expectations inch up as real yields keep sliding

Breakeven inflation rates on an upward trend, but still around 2%



Real yields are retesting all-time lows



Notes: Data via Bloomberg.

We don't think that sector-specific or temporarily higher inflation would spur earlier-than-expected rate hikes. Neither do markets, based on market-implied forecasts that suggest flat policy rates of around zero until at least 2023. An excess supply of savings globally relative to desired demand for those funds has pushed real yields well into negative territory. This imbalance has made it challenging for major central banks to keep policy rates low enough to stimulate the global economy with stable 2% inflation. In this context, policy interest rates in many countries are likely still higher than they "should be", stuck around the lower effective bound. In addition, the Fed can tolerate temporary inflation with its new average inflation targeting framework. In this way, a temporary demand-driven inflation might not be a bleak scenario, especially if overheating accelerates post-pandemic hiring and prompts firms to invest.

For risk assets, inflation-adjusted or real discount rates are a key driver of asset valuations. A simple approximation for real interest rates (i.e., ignoring liquidity premiums, term premiums and other special factors) is given below:

Real rates = nominal rates – inflation expectations

2 Breakeven rates include an inflation risk premium and a liquidity premium, so true expected average inflation is even lower than 2%, around 1.6% according to the Cleveland Fed's decomposition method.

If nominal rates are fixed near their lower effective bound, and inflation surprises to the upside, the impact would be lower real yields that put downward pressure on discount rates that support high asset valuations. To that point, Figure 4 shows that real bond yields fell recently as breakeven inflation rates were rallying.

Inflation hedging is challenging

Historically, higher-than-expected inflation has been a negative factor for the real return profile of many asset classes. Inflation surprises are negative for both traditional public equity and fixed income in multi-asset portfolios. Higher inflation is also associated with a rotation from growth stocks, such as the tech names and FAANGs that have driven the US stock market rally in recent years, to more cyclically-sensitive sectors and emerging markets. With both stocks and bonds under negative pressure, expected diversification benefits in a higher inflation scenario would also be weaker than expected.

Figure 5 summarizes how different asset classes are expected to perform in specific macro environments. Increasing portfolio allocations to gold, commodities and inflation-linked bonds can increase resilience to a surprise inflation. Commodities, especially energy commodities, offer a measure of inflation protection. Energy returns have around a 30% correlation to inflation.[3] Gold has a low correlation with inflation in the short term, but it is a more effective hedge for long-term inflation. However, unlike traditional asset classes, energy commodities and precious metals generally do not offer a long-term expected excess return. Inflation-linked bonds, such as TIPS in the US or Real Return Bonds in Canada, can be useful inflation hedges if the cash flows generated by the security are well matched to an investor's liabilities. However, a laddered TIPS portfolio has a lower correlation with inflation because real yields are also volatile in a higher inflation regime. Most inflation-sensitive asset classes offer a low or negative yield, reducing the long-term expected return.

Figure 5 | Economic scenarios and expected asset class performance

	Growth	Inflation
Higher	• Equities • Credit • Commodities • Corporate credit • EM credit	• Commodities • EM credit • Inflation-linked bonds
Lower	• Nominal bonds • Inflation-linked bonds	• Nominal bonds • Equities

Notes: See Bridgewater, "The All Weather Story". https://www.bridgewater.com/resources/all-weather-story.pdf

For investors concerned about inflation risk, investing in inflation-sensitive assets can blunt the impact of temporary and unexpected price pressures, but often at the cost of reducing long-term expected portfolio returns. Because markets have already priced-in a significant increase in expected US inflation for 2021 (Figure 4), we continue to recommend holding a well-balanced asset mix that is diversified across geographies, asset classes and currencies to investors with a long investment horizon.

3 Andrew Ang (2014), "Asset Management". Calculation extended to 2020 by the Multi-Asset Strategies Team.

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