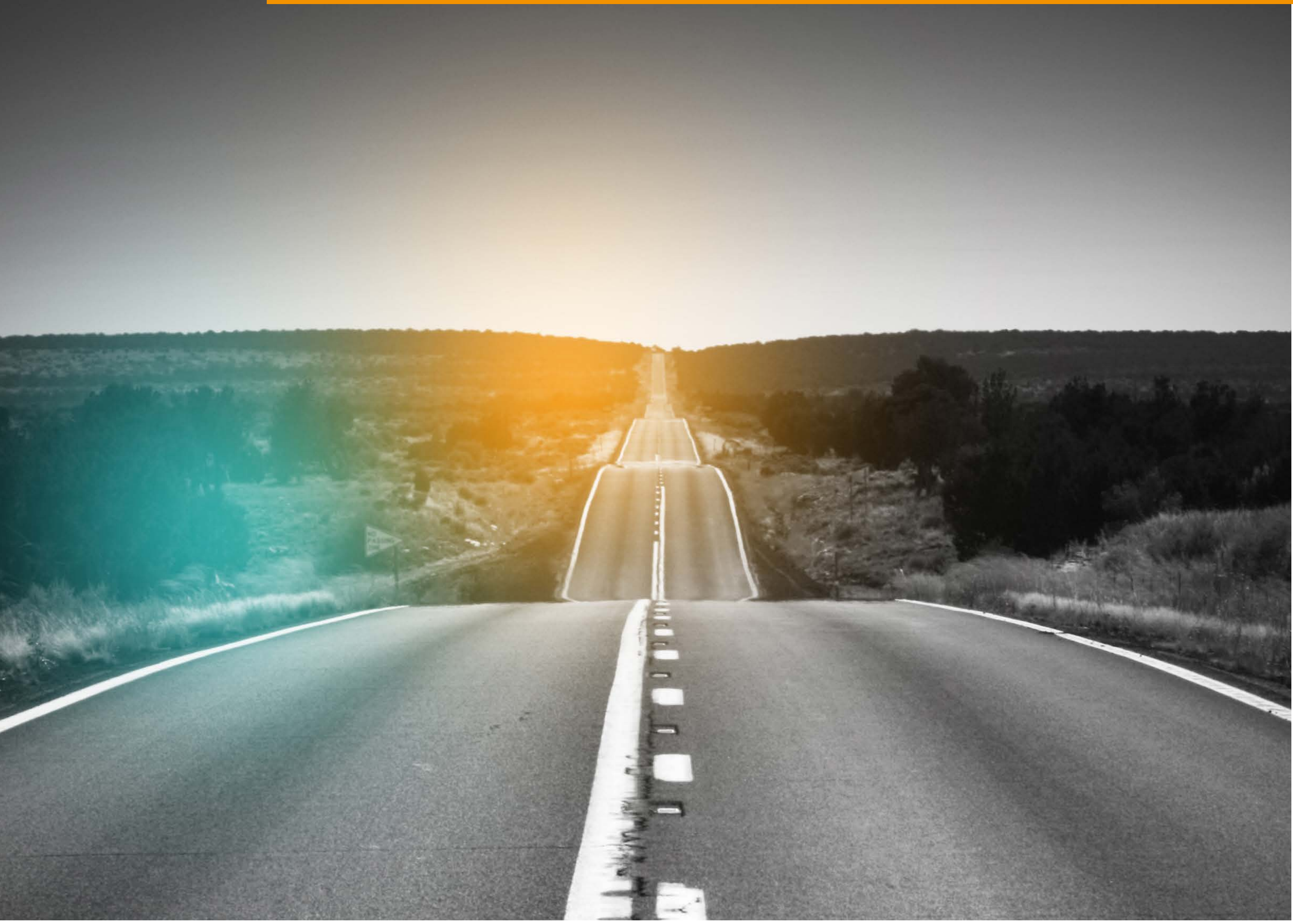
Navigating Uncertainty

CARDANO'S VIEW ON INFLATION RISK PREMIA IN THE POST-PANDEMIC ECONOMY



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Key Points

- Pandemics are generally disinflationary, whilst wars are not.
- There are aspects of the Covid-19 pandemic that do not fit the historical pattern, making its aftermath look similar to a 'post-war' environment.
- Uncertainty over future inflation outcomes is set to rise.
- Inflation risk premia are good value in the US and in Europe, but not in the UK.

The Bank of England is renowned for having some of the longest economic data series in existence. This was evidenced on 15th July with the publication of MPC member Tenreyro's speech[1] regarding the effects of COVID-19 upon the UK economy. The transcript of Tenreyro's speech includes a history of UK CPI starting in 1250 and charts, through the subsequent 770 years; 5 plagues, 2 cholera outbreaks and 3 flu epidemics. She observes that, through each of these 10 public health crises, the immediate effects upon the economy were typically inflationary. Then, over the 8 years subsequent to the onset of each episode, the aftermath tended to be disinflationary.

Why?

While no two of the pandemics were alike, taking place at different junctures across centuries within very different economic conditions and societal structures, they do share one common element. A pandemic, unmitigated by modern healthcare and public health management, will destroy more human capital than physical capital in the economy. This leads initially to labour shortages – the sick and dying not going to work – and thus an immediate upward pressure on wages and inflation, followed in later years by an oversupply of productive capacity as the public health environment stabilizes with a lower but, on average, healthier population.

Wars are different. Despite the societal upheaval and human tragedy, in economic terms, it is the destruction of physical capital that is most significant. As peace resumes, reconstruction initiatives increase aggregate demand in a 'post-war' economy that is initially undersupplied. This sets the scene for a more sustained inflationary environment until the supply / demand balance returns to more normal conditions.

Historically, pandemics have tended to conclude in conditions where potential supply outstrips demand, whilst wars have generally concluded in conditions where demand outstrips potential supply. Hence, the longer-term effects of pandemics are generally disinflationary, whilst wars typically give rise to inflationary pressures.

So what lies in store for the future?

The current public health crisis has neither the full characteristics of a historical pandemic nor a war. This time around, both supply and demand reduced together as economies locked down. Policy initiatives to maintain equilibrium have been bold. So far, fiscal expansion has acted towards preserving both productive capacity ***and*** labour income and therefore mitigated against the destruction of both potential supply and demand.

Modern healthcare, and a scientific approach to the understanding of the public health environment, has mitigated the loss of life to a fraction of the levels experienced in the pandemics of previous centuries.

[1]https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/covid-19-and-the-economy-speech-silvana-tenreyro.pdf

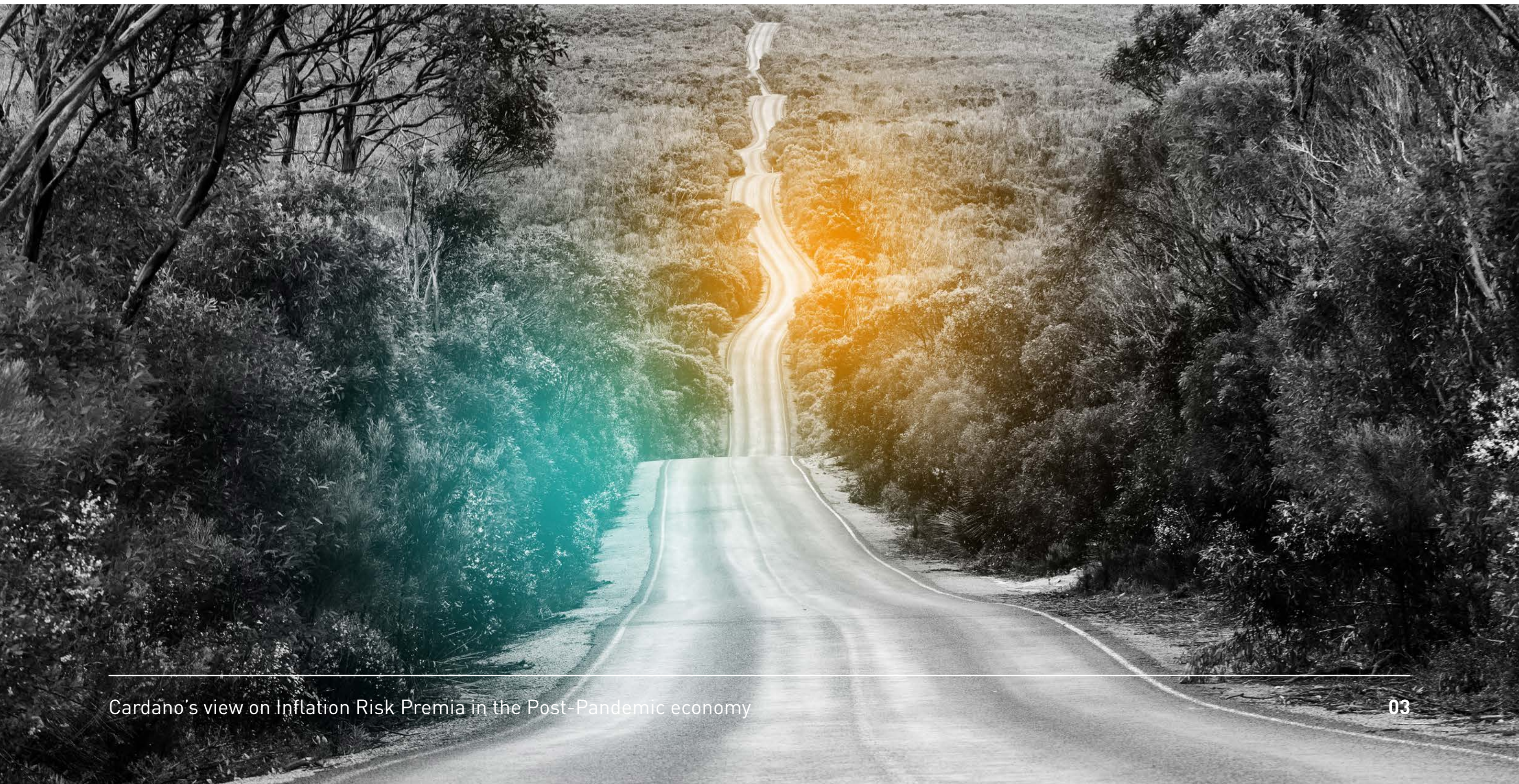
It remains uncertain how the delicate process of restarting normal economic activity will proceed. But we can be sure that the range of possible outcomes is wider in the post-COVID global economy than it was in the pre-COVID one. For instance, at the extreme ends of the spectrum we see credible scenarios whereby:

1. **INFLATION accelerates: Demand remains robust whilst supply catches up.**

   - Monetary and fiscal policy remain plentiful and well-coordinated. Demand is well supported, and central banks remain accommodative of higher inflation outcomes.
   - In developed economies, corporations shorten supply-chains and move away from 'just-in-time' inventory management, reshoring production capacity as they go. This raises operating costs and shifts demand for labour from the emerging to the developed world.
   - The pace at which low labour costs can be assimilated into corporations' business plans wanes but corporations generally retain pricing power in a very strong demand environment.
   - Inflation rises with feedback loops into wage demands and inflation expectations.
   - The structural shift to a higher inflation environment is facilitated by easy Monetary policy and high credit availability.

2. **DISINFLATIONARY forces persist: Weak demand endures, supply slowly catches-down to the new environment.**

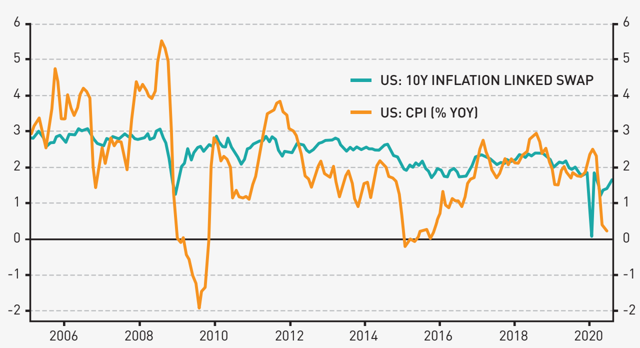
   - Policymakers on both the monetary and fiscal front do not or cannot do enough to preserve demand in the economy.
   - As furlough schemes are wound down, temporary layoffs turn into longer-term unemployment and further downward pressure on labour income and final demand results.
   - Where fiscal support is retained, it tends to favour businesses rather than consumers, which acts to preserve elements of production capacity in the economy that would otherwise be uneconomical to retain.
   - Output gaps widen amidst weak demand conditions and plentiful potential supply.
   - Producers slowly withdraw capacity from the market only as they discover new lower clearing prices for their output. Stagnation / recessionary conditions continue until balance is restored.



Scenario 1 is analogous with a 'post-war' economy, Scenario 2 is closer to the environment that Tenreyro describes as 'post-pandemic' in her speech. It is impossible to know now which scenario best describes the future. However, it is exactly this kind of scenario analysis that helps us judge prevailing market conditions in the context of all the uncertainties.

Measured against these scenarios, we observe that the market currently prices inflation[2] at a level that is much more consistent with Scenario 2 than Scenario 1.

Chart 1: When US inflation is above 2% (orange line), inflation expectations (blue line) often exceed 2.5% as a leading indicator of further rises.



Source: Refinitiv Datastream

However, there are distinct signs that policymakers around the world are setting the scene for Scenario 1 to be possible; movement towards Eurozone fiscal unity, governments avowing parochialism and deglobalisation, trade disputes and central banks weakening their commitment to inflation targeting etc. Most importantly, the powerful stimulus provided by coordinated monetary and fiscal policy is unprecedented. And, of course, not to forget that the rise of populism in Western democracies that already have highly indebted economies serves as motivation to policymakers to be more welcoming of higher inflation outcomes. All this is occurring in the aftermath of the current global economic hiatus; a period which has seen inflation fall, thereby providing a pretext for a powerful base effect in the event of a rebound.

Implications for Clients' portfolios

Unsurprisingly, our thinking is framed by a very important portfolio construction angle. With equity markets having already broadly priced in a V-shape recovery, and government bond yields making new lows, a critical risk is that bonds and equities now underperform at the same time i.e. equities sell-off as bond yields move higher. Should this occur, we would expect it to coincide with an upward repricing of inflation expectations.

"We see an opportunity in the growth orientated part of clients' portfolios to add exposure via inflation swaps"

Whilst many investment strategies depend upon bonds offsetting the losses suffered by equities during downturns (and vice versa during upswings), at Cardano, we aim to maintain a much broader economic balance in our clients' portfolios so that we are not narrowly dependent on this naïve and somewhat binary equity / bond relationship – a relationship that we know does not work well during periods of rising inflation.

To provide this economic balance, we see an opportunity in the growth orientated part of clients' portfolios to add exposure via inflation swaps, benefiting portfolios if inflation expectations move higher.

Our preferred markets are in the US and Europe, where the broadest exposure to the global trends identified in Scenario 1 are to be seen and market levels are most favourable. We have a more negative view on the UK, where inflation that is priced into current market levels is already elevated, the effects of Brexit present additional risks and RPI reform will likely exert a downward pressure on breakeven pricing in due course.

[2] We reference the breakeven swaps market here as the most liquid source of exposure to a pure investment view on inflation, albeit one that is more sensitive to future changes in inflation expectations than realized actual inflation.

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