# Nowhere to hide if stagflation arrives

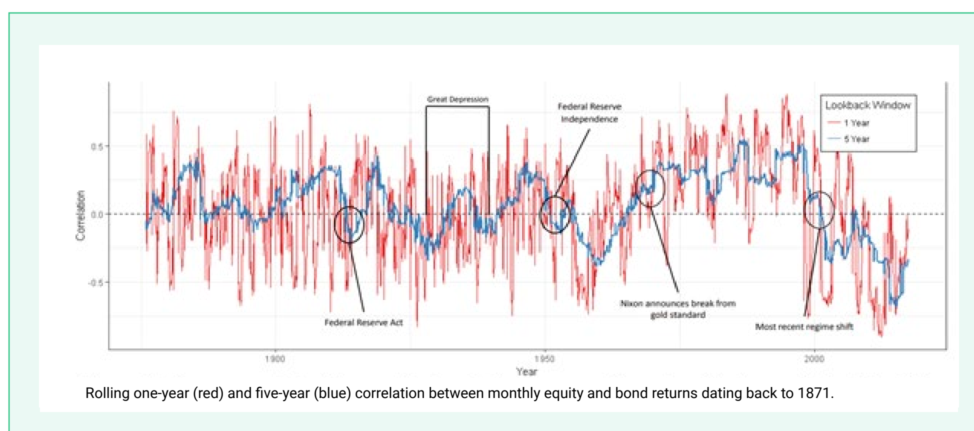
## With the prospect of lower growth and persistent higher inflation looming over the markets, are we seeing a return to 1970s stagflation?

Ebru Smith
Senior Investment Strategist

While equity markets continue their rally, and we begin to hear more about tapering in quantitative easing (QE) – even if this may turn out to be a policy error by central banks – bond markets seem to be ignoring the possibility of persistent and rising inflation.

Why? Although market dynamics have changed over the last few decades, and especially so since the Covid-19 pandemic, this time around, it seems, things really are different.

## What's different now?




Rolling one-year (red) and five-year (blue) correlation between monthly equity and bond returns dating back to 1871.

Chart by Grahamcapital.com

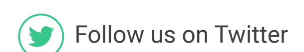
For over 40 years equity-bond correlations were positive until they started to turn negative in the 1990s and have been converging towards zero more recently. Historically, during periods of monetary tightening, the correlation has been positive (see above chart, where correlations peaked in 1997 and remained positive until 2000), while in

www.collidr.com

hello@collidr.com

(+44) 0808 281 2900

Connect on LinkedIn


Follow us on Twitter

periods of low inflation and loose monetary policy, the correlation is generally negative (it has been negative since 2000). The convergence towards zero can be interpreted as an expectation of a tightening of monetary policy which now seems sooner rather than later[1].

What this convergence to zero demonstrates is that the market is aware that a change to the loose monetary policy we have become accustomed to is a foot.

It is obvious to everyone that the Fed cannot continue an asset purchase programme (in the magnitude of $120B per month) for good. In their recent FOMC discussions, they were careful to caveat with the phrase 'if appropriate' when referring to suitable economic conditions and the improving state of the US economy (July 2021 Minutes of the FOMC Meeting).

The domestic data is equally stark (see table below): UK CPI inflation is currently at 2.5% per annum, above the Bank of England's target rate of 2.0%, with yields on 10-year gilts are 0.56% and interest rates at 0.1%; while in the US, inflation, yields on 10-year Treasuries, and interest rates are at 5.4%, 1.24% and 0.24% respectively. Remember when interest rates, yields and inflation all moved predictably and were even hovering around the same levels together? At one point, post the 2008 financial crisis, in the UK at least, they were all c.3% levels.

| | US | UK | EU | China | Japan |
|---|---|---|---|---|---|
| Inflation CPI | 5.4 | 2.5 | 1.9 | 1.1 | 0.2 |
| Interest rates | 0.24 | 0.1 | 0.0 | 3.85 | -0.1 |
| 10-Yr Govt Bond Yields | 1.24 | 0.56 | -0.45 | 2.92 | 0.02 |

Data by tradingeconomics.com

There is little left in Central Bank toolboxes. According to Gertjan Vlieghe, the outgoing external member of the Monetary Policy Committee, even with negative rates added in 2019, and the possibility of cutting the Bank rate to -0.5% or even -0.75% for the next monetary stimulus, "the policy space is still limited relative to pre-crisis years".

## What now from Central Banks?

Central Banks will be reluctant to raise rates for several reasons. When the US announced that they would taper down their QE in 2013 and raise rates, global markets panicked, and US Treasuries yields spiked. Stock markets fell across the world, with emerging markets suffering specifically (as they were, and still are, overburdened with US dollar denominated debt). Investors are addicted to central banks pumping money to fuel growth, while keeping risk assets elevated.

Any sense of retreat or a change in policy could pose a significant threat to global financial market stability, investor confidence and sentiment. Especially as we are

[1] Equity-Bond Correlation, Graham Research_2017.pdf (grahamcapital.com)

still being battered by the economic consequences of the pandemic. Investors have become accustomed to low interest rates, which has left any attempt by central banks to 'normalise' their rates policy fraught with difficulty. The pace and timing of tapering is of paramount importance, and with inflation rising it is all the more difficult to prescribe.

In addition, QE distorts bond markets and the nature of the yield curve, with investors becoming immune or oblivious to this.

## What are bond markets telling us?

The yield curve is one indicator for the expectations of future growth, with the shape of the curve for rates from '1 month' to '30-year' (at the long end) reflecting this. An inverted yield curve as demonstrated below with the UK 10 Year gilt – the green line – or the flattening US 10-year Treasuries – in blue – shows that long-term expectations are below 1% for the UK and below 2% for the US. If rates were to rise as a means to manage inflation, the yield curves would flatten more, a 'bear flattener', which is seen as a harbinger of economic contraction and monetary tightening.

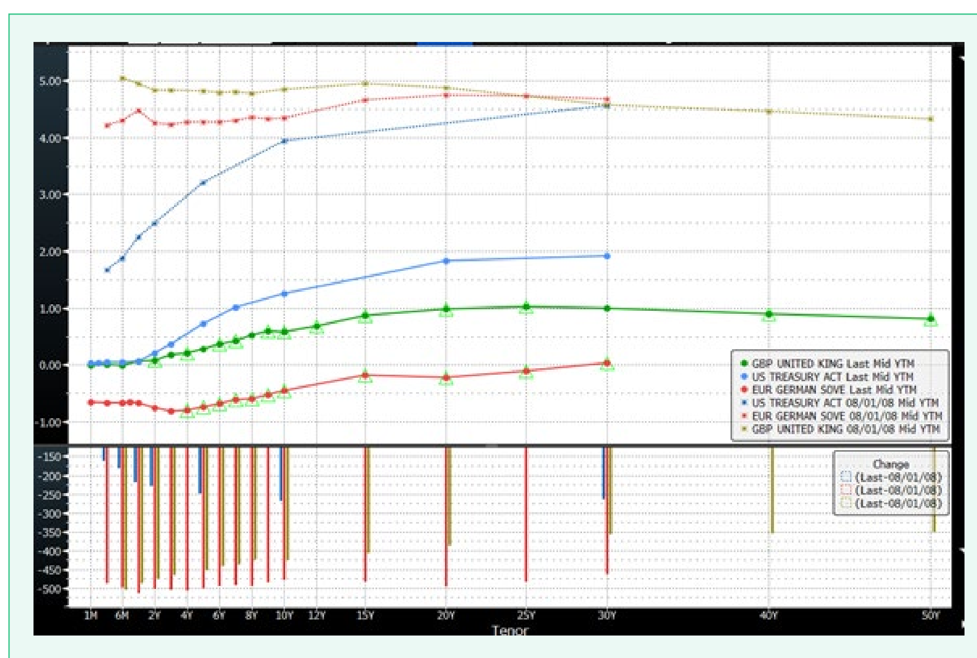



Chart: Bloomberg, as at 28 July 2021

To start with, any increase in yields would also increase debt service costs. While some inflation would allow the debt mountain to be inflated away, the UK faces the additional constraint of rising inflation adding to the costs of servicing index-linked gilts. From the aspect of debt service costs, yields would need to remain low for the foreseeable future.

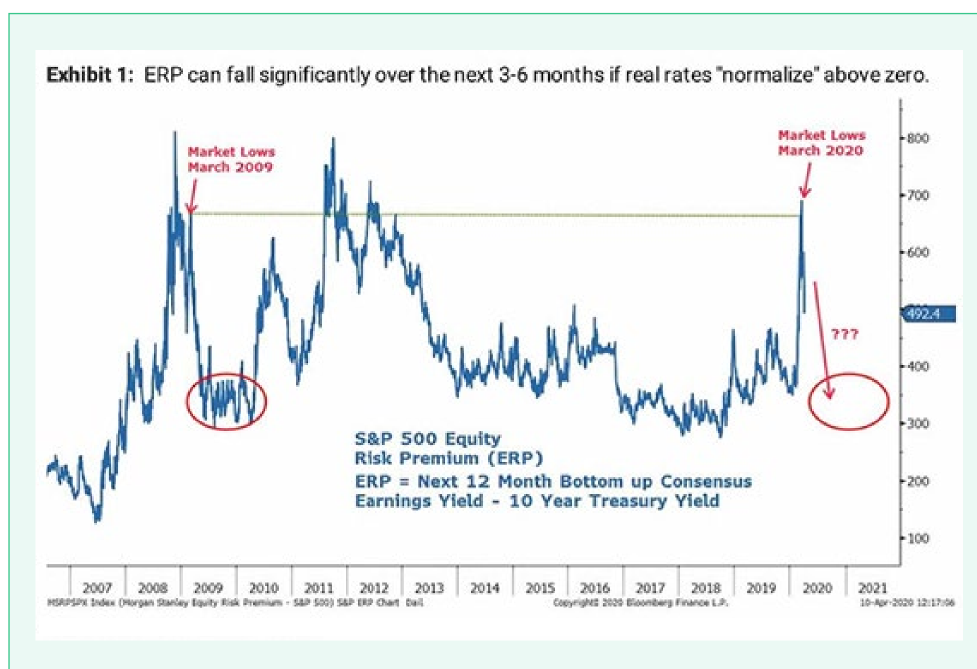
## What happens if inflation is not transitory?

Whilst central banks would like us to believe that inflation is transitory – driven by the extreme conditions of the Covid-19 pandemic – perhaps to calm investor nerves, it would be rather misguided, not to mention imprudent, if we do not analyse the underlying headline number.

While the reopening of restaurants and bars, partial return to the office and uptick in summer holidays may have trigged a rise in clothing and footwear prices, and the material shortages affecting the production of cars has resulted in a never-before-seen price rises in used cars, other larger components of CPI, such as commodities and housing costs, look set to stay elevated.

Any rise in inflation will have an impact on economic growth. As consumers feel a squeeze on their living standards, if wages struggle to keep up, and companies face margin pressure from rising costs, bond yields may eventually react to the return of dreaded 'stagflation' in view of other economic indicators. For instance, there is increased talk of slowing economic growth in China and the US. For even though the US economy grew at an annual rate of 6.5% in June, it was lower than the expected 8.5% as a result of Covid-related supply chain shortages and disruptions. And when combined with other macro headwinds globally, including a tougher corporate borrowing environment and increasing regulatory risks on shadow financing in China, makes the outlook for equities challenging.

Equity risk premium (ERP) expectations may need to be reduced to reflect these tricky market conditions. The ERP is the rate that investors demand or charge for an average risk equity over the risk-free rate. In the US, the ERP has averaged around 5.5%[2] over a recent 10-year period and is in line with KPMG's Equity Market Risk Premium study of June 2021. The same goes for the UK and Europe. If rates start to rise, i.e. the risk-free rate, then it would imply lower equity returns, all else being equal.




Source: Bloomberg Morgan Stanley Research

If investor sentiment turns sour, and the consensus presumes a looming slow down, we may have a repeat of the market conditions of the late 1990s and early 2000s when the dot.com bubble burst. The memories of those days – when the Nasdaq Composite index

[2] Average market risk premium in the U.S. 2011-2021 | Statista

rose c.580% from 1995 to 2000, only to fall by 75% in the two years that followed – still creates shivers.

With rates low, debt levels large, QE so entrenched and valuations stretched, Central Banks have little margin for error when it comes to policy. Although recent history has shown that the mistakes were different (lack of regulation in 2008, too lax monetary and fiscal policies in 1988, too much tolerance of inflation in the early 1970's), when it comes to central banks delaying action, the consequences can be severe. On the other hand, if banks raise rates too early, this could have an adverse effect, too.

## How to position your portfolio?

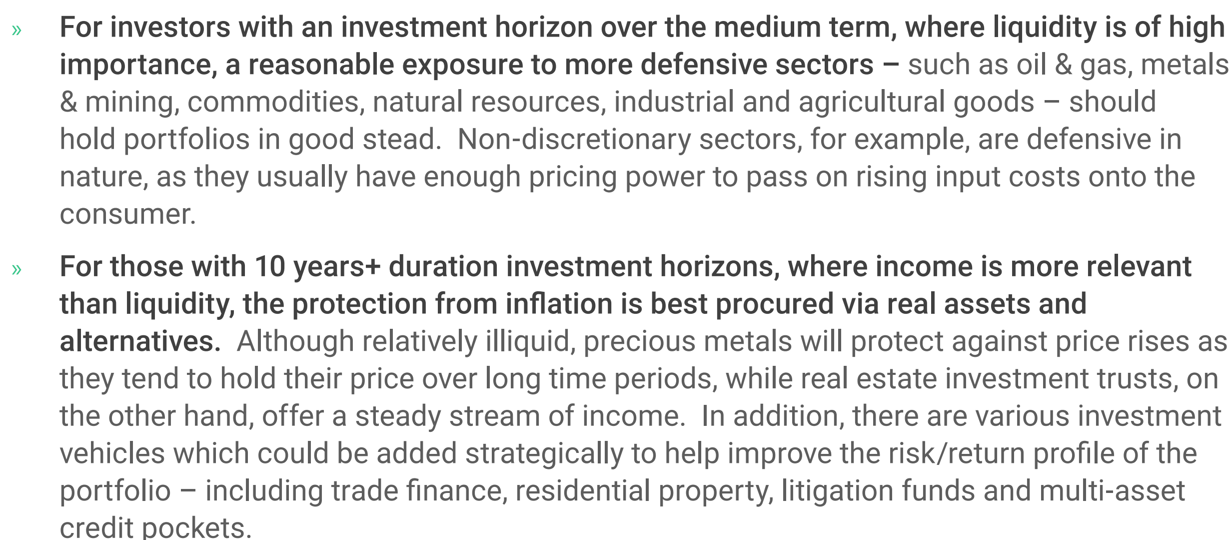
Is stagflation on the horizon? It may be too early to tell, but the warning signs are prevalent. Being aware of risks alone is not enough when the landscape ahead is uncertain, being prepared is key.

A typical investment strategy often used is a balanced portfolio, for example a 60/40 allocation – a split between 'riskier' equities and 'safer' bonds. The belief behind this is that when markets sell-off, bonds and equities will react differently. However, when you consider their current correlations, this may not turn out to be the case. While a traditional 60/40 portfolio may not be the perfect solution, a diversified portfolio remains the best starting point. The challenge is finding the right approach to constructing the portfolio, one that takes into account various factors (such as duration and liquidity) and uses the right mix of asset classes with differing drivers and price sensitivities.

» **Equities – To achieve both long-term investment objectives while managing short-term volatility, a combination of value, growth and defensives is the better option for most risk-return portfolios.** For example, equities with an exposure to real assets (such as precious metals) not only hold their pricing power but can help mitigate inflation erosion and do not tend to default during times of stress. While an allocation to cyclical fast growth sectors such as technology & small caps can offer above market returns and tend to perform well in inflationary environments.

» **Bonds – As we know, the shorter the bond's duration – duration is the sensitivity of the price of a bond to a change in interest rates – the less volatile it is.** For risk-averse investors, who do not wish to take on this increased volatility, shorter duration bonds are the best option. Yet although bonds are considered safer than equities, they cannot hide from inflation per se. Bond coupons are usually fixed so that inflation will erode their value over time, therefore, inflation or index-linked bonds are preferred instruments to cover this asset class. If central banks decide to manage inflation with higher interest rates and monetary tightening, this could result in short-term rates rising faster than the long-term. Short duration bonds in this instance would be more volatile as rising rates would depress prices increasing their yields relative to long-term bonds.

» **Liquid alternatives – There are also ways to counterbalance the effects of inflations negative impact on risk assets, through the use of long-volatility trades, macro and trend following funds.** These should also help manage downside risk and reduce equity sensitivity.



- **For investors with an investment horizon over the medium term, where liquidity is of high importance, a reasonable exposure to more defensive sectors –** such as oil & gas, metals & mining, commodities, natural resources, industrial and agricultural goods – should hold portfolios in good stead. Non-discretionary sectors, for example, are defensive in nature, as they usually have enough pricing power to pass on rising input costs onto the consumer.
- **For those with 10 years+ duration investment horizons, where income is more relevant than liquidity, the protection from inflation is best procured via real assets and alternatives.** Although relatively illiquid, precious metals will protect against price rises as they tend to hold their price over long time periods, while real estate investment trusts, on the other hand, offer a steady stream of income. In addition, there are various investment vehicles which could be added strategically to help improve the risk/return profile of the portfolio – including trade finance, residential property, litigation funds and multi-asset credit pockets.

While stagflation remains a possibility, a well-diversified portfolio of asset types and strategies remains the appropriate approach for now. A dynamic and active approach to monitoring portfolios and different market conditions is also essential, for being ready to act should any of these conditions unfold over the coming months.

Disclaimer: FOR PROFESSIONAL USE ONLY. This report was produced by Collidr Research ("Collidr"). The information contained in this report is for informational purposes only and should not be construed as a solicitation or offer, or recommendation to acquire or dispose of any investment. While Collidr uses reasonable efforts to obtain information from sources which it believes to be reliable, Collidr makes no representation that the information or opinions contained in this report are accurate, reliable or complete. The information and opinions contained in this report are provided by Collidr for professional clients only and are subject to change without notice. You must in any event conduct your own due diligence and investigations rather than relying on any of the information in the report. All figures shown are bid to bid, with income reinvested. As model returns are calculated using the oldest possible share class, based on a monthly rebalancing frequency and all income being reinvested, real portfolio performance may vary from model performance. Portfolio performance histories incorporate longest share class histories but are either removed or substituted to ensure the integrity of the performance profile is met. The value of investments and the income from them can go down as well as up and past performance is not a guide to the future performance. Collidr Research is a trading name of Collidr Technologies Ltd, registered in England and Wales No. 09061794. Registered office: 34 Southwark Bridge Road, London, SE1 9EU, UK.