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TRANSCRIPT

Believe the Hype Around the Fed's Inflation Announcement?

*Featuring**: Chenlu Zhou,** Executive Director, MSCI Research*

Adam Bass (00:04):

This is MSCI Perspectives, your source for weekly research insights as investors respond to the COVID-19 pandemic. I'm your host Adam Bass, and today is September 3rd, 2020. This week, a look at the Fed's newly stated approach to inflation and the impact it could have for fixed income and equity investors alike. For details, we spoke with Chenlu Zhou, Executive Director on MSCI's multi-asset class factor research team. Chenlu, thanks for joining us.

Chenlu Zhou (00:37):

Thanks for having me, Adam. Glad to be here.

Adam Bass (00:40):

There's been a lot of news coverage the last week around the Fed's annual Jackson Hole Conference, and that's what we've asked you here to speak about. But before we get to the conference, which like so much else this year took place virtually, I wonder, how have you been dealing with so much of work and life taking place online?

Chenlu Zhou (01:01):

Definitely. For my part, just by all the challenges that we're all facing with staying at home, working remotely, I've been really trying to take advantage of it by spending more time in the nature. I live really close to Berkeley Hills. I'm trying to go on daily little hikes there more frequently and that's being very helpful for my sanity.

Adam Bass (01:25):

So important to maintain that space and maintain your sanity. Now, as we said, there was no face to face in Jackson Hole this year, but there were some real world effects nonetheless, high level Chenlu, what was the Fed's announcement?

Chenlu Zhou (01:42):

Of course. So with this announcement, what Fed has seems to be suggesting is that they will allow inflation to run a little bit hotter for a little longer, and that they won't rush to raise interest rates without a clear evidence that inflation has achieved the long run target.

Adam Bass (02:02):

That sounds like a pretty dramatic change, no?

Chenlu Zhou (02:05):

It does sound like a big shift on the surface. However, we should note that even back in early 2019, before all the COVID crisis had hit said, Fed had actually stopped raising rates quite abruptly back then. So I would say, this announcement, what it does do is to make this strategy more formal and is sending a signal to the market that it will maintain a low interest rate, but it's not completely surprising to the investors.

Adam Bass (02:36):

So it's in essence putting a formal stamp on a practice that investors have already grown used to?

Chenlu Zhou (02:44):

I would say so. Yeah.

Adam Bass (02:46):

So given that, how has the market reacted? What's it telling us about what's on investors' minds?

Chenlu Zhou (02:52):

Right. So in terms of the market reaction, first of all, the 10 year breakeven inflation had recovered from a very low point of only 50 basis point back in March, and now it's as high as the beginning of the year. And secondly, the equity market had responded quite positively and they'd been setting some all time highs as we've seen in the past week or so. So I would say overall, the market's confidence, investors' confidence, have been reinforced by this announcement. In terms of what are on the minds of the investors, I actually attended a conference last week where a lot of the largest asset owners and asset managers in the country are there. And I would say there were a couple of themes that stood out to me. The first theme was with interest rates being so low at the moment and also expected to stay quite low for a while, investors are thinking about how to reach their return targets and they are searching for yield.

Chenlu Zhou (03:59):

The second theme is with all the talks about the loosening of monetary policy, some people are I think, quite reasonably worried about what if the inflation rises in the future, in the longer run, and what implication it might have on the financial market.

Adam Bass (04:21):

So let's take each of those in turn. Starting with the search for yield. It's certainly not a new concern, but as you mentioned, it's one that folks may have to contend with for longer now. What have you seen there in terms of investors who were looking for a steady stream of income?

Chenlu Zhou (04:40):

Yeah. So I think there are two thoughts come to mind. First of all, from the perspective of large asset owners, for example, pension funds who really rely on a steady stream of income and who historically have had a significant allocation to Treasury's tips, now they are taking a harder look at other assets that may offer higher income because rates are so low, and those assets may also come with higher risk. Relatedly from the perspective of the fixed income managers, they are seeing a potential spill over effect of all these liquidity that's being injected into the market. So they see that all this liquidity might go into higher risk categories, such as high yield corporates, emerging market, or even private fixed income assets. So a lot of interesting trends to watch there for sure.

Adam Bass (05:41):

Have we seen any of this money shift into higher risk fixed income assets so far?

Chenlu Zhou (05:48):

I think that's what people are starting to see, but I think that's something we will have a clearer understanding in the longer run.

Adam Bass (05:57):

Fair enough. So secondly, inflation, always on investors' minds. Inflation has been relatively stable for the last 20 years or so. What kind of effect has that stability had on the market? Let's start there.

Chenlu Zhou (06:12):

Yeah, you're absolutely right. The inflation rate in the US has been very stable for the past two decades. One of the most important outcome of these two decades of stable inflation is that the rates and equity market tend to move together. And in the past two decades, they have a positive correlation of about 40%. So when economy is doing well, equity market would price in a higher earnings, pushing the price higher, and Central Bank tends to raise interest rate in the economic expansion as well. Because of this correlation, bonds and equity have been very good hedges to each other. And a lot of investors really rely on that feature to diversify their portfolio. One strategy is the strategy of risk parity, and it's really taking advantage of this correlation. So if people worried about this correlation to go away, then that could hurt such strategies.

Adam Bass (07:18):

Have we seen this effect during other times of rising inflation?

Chenlu Zhou (07:25):

That's actually a relatively recent phenomenon, this correlation. However, back in the late seventies and early eighties, when in the US and much else in the world, inflation was very high, we saw the rates equity correlation being in opposite signs of what it has been recently. So I think it's not unreasonable concern. If inflation does become more unpredictable, this diversification effect may be no longer or weaker.

Adam Bass (07:56):

So like fixed income investors, those on the equity side will need to rethink their portfolios. One of the articles that I mentioned at the top was actually an opinion piece by John Authers on Bloomberg. I want to read you a quote from that. It said, "While the Fed has demonstrated immense power to move markets and asset prices over the last decade, it has shown no similar power over the economy." Now his point was that the Fed supposedly allowing inflation to rise doesn't mean inflation will, and that the

Fed has not seemed to be able to make it rise in fact. But when I read this, what I thought about was the disconnect between the economic data and the markets, which continue to set records. Can you talk a bit about that and what you've seen in the models?

Chenlu Zhou (08:47):

Yeah, I think that's a really great question. Definitely something on my mind and on a lot of people's mind, this dislocation between Wall Street and main street as they call it. So let me take one step back first. Back in March around the time when the market was at the bottom, we, using our macro-economic model did a reverse stress test. So the idea was we try to understand what scenarios, what economic scenarios had been priced in, in the equity market back at that time. We found that one explanation could be there will be a big blow to the short term growth, there might be little or moderate longterm shock to the GDP, and a lot of fear for the uncertainty. And that could have explained that draw-down back then. So given all the news in the market, the new highs, I've been taking another look at the same test this week to see how things have changed, where they are today.

Chenlu Zhou (09:56):

And one thing I found really fascinating was even if I use the same assumption about the economy, basically even if the outlook on the economy hasn't really improved, we could actually explain the majority of the rebound by two things. One is there is a sharp decline in real interest rate, and I would say that is mostly thanks to the Fed's action. And the second thing is a complete reversal of the fear that I mentioned earlier, meaning that investors seems to have regained confidence in the outlook of the market, if not the economy, but they're so confident that said, we'll keep supporting the market and they're no longer afraid. So that's been really fascinating to me.

Adam Bass (10:52):

Very interesting. I'm curious again, going back to history, have we seen this type of dislocation between the data and market performance before?

Chenlu Zhou (11:02):

In the data that I have studied, I think this is probably one of the starkest contrast I've seen.

Adam Bass (11:10):

Well, thank you very much for joining us Chenlu. It's been a pleasure.

Chenlu Zhou (11:15):

Thank you. Good talking to you.

Adam Bass (11:17):

That's all for this week. Thanks to Chenlu and to all of you for joining us, be sure to tune in next week when we'll speak with Brian Reed, about the impact of missed rents on real estate portfolios. Remember, it takes just a moment to subscribe to the podcast, leave a comment or share with a friend. Until next week, I'm your host Adam Bass, and this is MSCI Perspectives. Stay safe everyone.

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