MSCI

TRANSCRIPT

What’s Up with Inflation?

*Featuring: **Andy Sparks**, Managing Director, MSCI Research, **Dimitris Melas**, Global Head of Core Equity Research*

Adam Bass (00:03):

This is MSCI Perspectives. Your source for insights, for global investors and access to research and expertise from across the investment industry. I'm your host Adam Bass and today is April 29th, 2021. Today we welcome back two old friends of the program, Andy Sparks, MSCI's head of Portfolio Management Research and Dimitris Melas, MSCI's head of core equity research. Dimitris, you may recall joined us in the very early days of the pandemic. The pandemic had shut down his local pub.

Dimitris Melas (00:38):

Ye Olde Fighting Cocks.

Adam Bass (00:40):

Which had survived for 1200 years, but was closed by the UK government possibly for good he thought. Well, it took more than a year but when we spoke with Dimitris earlier this week, he had some good news.

Dimitris Melas (00:55):

Some tentative signs here in the UK that we are returning to normal. The MSCI offices in London has reopened from April 12th. Some of the shops here in the UK are open and importantly pubs in general in my local pub here in Central Banks has reopened. So I have been able to go back and enjoy the pint in the sunshine a week ago.

Adam Bass (01:19):

I share this story, not only to let you know the latest about England's oldest pub, but because it relates directly to our topic today, inflation. Despite concerns throughout 2020, that large stimulus packages and Central Bank actions around the world would cause inflation to spike.

It has been a while since it proved a true concern. Now, as vaccines flow, restrictions lift and economies re-emerged from their long slumber. Some feel this time, it might be different.

Dimitris Melas (01:50):

There's obviously pent-up demand as all of us have been locked inside for most of the last year. And as economies reopen, I think the consumer will take advantage of the new opportunities to spend companies will take advantage of the better environment to invest. So we're likely to see better economic growth and this is likely to lead to somewhat higher inflation in the coming several quarters. So that's really the concern in markets at the moment, even this extremely strong stimulus that we've had in the economy. And as we reopen with vaccines, an economic activity returns back to normal could prices rise and we see inflation going up.

Adam Bass (02:34):

Andy continued to thought

Andy Sparks (02:36):

We've had major pieces of legislation driving more fiscal stimulus. This goes back to the Trump administration. There was a major piece of legislation passed in adding significant new fiscal stimulus. Now the Biden administration had its fiscal stimulus bill, which passed congress. And now we're working on a third piece of legislation for infrastructure. So this all adds up to very, very significant fiscal stimulus at the same time that we've had major monetary policy aggressiveness and exactly the same time that the rate of vaccination has been such that a fairly large part of the population in the United States and in other developed market countries has become vaccinated and the lockdowns are easing.

Andy Sparks (03:31):

And even in the absence of the fiscal policy and the monetary policy, just the good news generally on the health front probably would have led to the burst in economic activity and good news on the economy. And on top of that, you put in the stimulus and the monetary policy and we are in uncharted waters. And the question is whether that could lead to a big burst of inflation. That's not just temporary, but could persist. That's one of the core issues in the bond market right now.

Adam Bass (04:05):

We dug into this a little bit more with Andy, specifically falling up on research. He and his team had published last month. In late March, about a month ago, as we record this, you wrote in summary, if inflation picks up to levels suggested by market implied pricing, cash investments or short maturity investments may experience some of their worst inflation adjusted returns of the past two decades. As we speak today, what are you seeing in the markets when it comes to expectations about inflation?

Andy Sparks (04:40):

It's very similar to what we've [inaudible 00:04:42] about a few weeks ago. I think there is a lot of concerned about inflation there. And so as reflected in market implied pricing markets are expecting a short burst of inflation in coming months followed by a slowly moderating level of inflation spanning many years. And so long run inflation expectations are very close to the Fed's 2% target. And this is just another way of saying that markets have confidence in the fed and the Fed's ability to control inflation. But the reality is that inflation expectations have risen. And they're definitely quite a few market participants who think that the market may be understating inflation going forward. And there are definitely some beneficiaries of inflation, but on the other side, there are also losers from inflation and specifically investors in bonds receiving a study flow of fixed coupons on their fixed income investments, those coupons and the principal received on their bond investments will purchase fewer goods and services in the future, in the presence of inflation.

Andy Sparks (05:57):

So this is the reason why that the voices of the so-called bond market vigilantes are becoming louder now, as they call out rising inflation risk. So the savers and the bond holders, it could be a significant losers of, of future inflation.

Adam Bass (06:14):

That begs the question about why anyone would invest in bonds right now.

Andy Sparks (06:18):

I would say that investments in bonds can be considered as insurance against equity market, volatility and excessive equity valuations. Those negative on the bond market might say that this is very expensive insurance. Supporters on the other hand may argue that the sell off in the bond market that we've seen since last November has improved valuations and made the sector much more attractive.

Adam Bass (06:48):

Now that we've heard the news from Bonn City, let's set over to equity Heights.

Andy Sparks (06:52):

When we take a look at global equity markets year to date, for example, we've seen strong overall performance, double digit returns in many markets. And then when you go under the surface, we've seen a substantial rotation within equity markets into the more cyclical factors, factors, and strategies. So for example, we've seen value strategies, outperform growth. In the last few months, we've seen a small capitalization companies outperform large cap stocks, and generally we've seen cyclicals outperform defensive.

Andy Sparks (07:28):

And we've seen that at the industry level as well. If you look at how different industries global equities have performed this year, for example, or the last six months, you'll notice that the materials industrials, financials and energy have done well. How about the form, the market, while on the other hand, what we would call defensive industries, utilities, healthcare, consumer staples, those have lagged behind still delivering positive returns, but certainly underperforming compared to these other sectors that I mentioned.

Andy Sparks (08:00):

There's one notable exception from a regional perspective from a country perspective as the cycle picks up, but normally you would expect the emerging markets to power ahead and outperform developed markets, but we haven't seen that.

Andy Sparks (08:15):

And I think there's a combination of reasons why this is the case. Clearly we have lagging COVID defects in emerging markets. They are now experiencing a second wave of infections while in some of the developed markets, especially the US the UK, for example, we seem to be coming out of the second wave. And also the strength in the U S dollar is another headwind for emerging markets.

Andy Sparks (08:40):

But with the exception of this EM versus DM relationship, which is not playing out in the way that you would expect it at this point in the cycle, I think there's definitely a lot of evidence that the higher inflation expectations are being reflected in equity markets. And we've seen a substantial rotation into cyclical sectors and factors as well. We've done several blogs looking at inflation and equities. There are different inflation scenarios that could come to pass. A scenario that would be bad generally for the capital markets is a real stagflation environment where you have low or even negative economic growth and high inflation. And we have some experience with that and the late seventies and early eighties in the United States. So now there are other more benign types of inflation that maybe less, less harmful to equities.

Adam Bass (09:38):

Remember that reference to the 70's and 80's we'll get back there, but for now, let's keep going with this idea about different scenarios.

Dimitris Melas (09:47):

Broadly speaking I think we can see four scenarios for inflation going forward. The most likely scenario is moderate inflation. We may see higher inflation, and then there are two more extreme scenarios on one hand on one extreme, you have stagflation very high inflation while growth is muted or even negative.

Dimitris Melas (10:09):

And then deflation. So moderate inflation in the rate of let's say two to 3% may actually be a very positive sign that the global economy is growing again. And that economic activities becoming more normalized after the pandemic. So I think government bond markets, as Andy mentioned in his comments are generally pricing in this scenario for the medium and long-term. And as a result may be little affected by it. And this could also, moderate inflation in the range of 2 to 3% would also be a very benign background for equity markets in general.

Dimitris Melas (10:43):

However, if we see inflation overshooting, this range. I think both equities and fixed income could potentially suffer. And I guess going beyond that, the worst scenario for equity markets of course would be deflation or stagflation. Those are the two extremes that we mentioned. However, given a current condition, I think current conditions, I think deflation and stagflation, we can probably discount the most theoretically possible, but hopefully unlikely to play out in the near future.

Adam Bass (11:15):

One point to remember as investors consider these different scenarios, is how to interpret and think about acting on growth and inflation numbers. For one thing, as Andy pointed out

Andy Sparks (11:27):

We get inflation monthly, we get GDP quarterly.

Adam Bass (11:32):

So it may be wise to take a breath or two before reacting.

Andy Sparks (11:36):

The market is going to be of course, very focused on economic reports. And the first few reads and in coming months are going to be a little, potentially a little deceptive because prices were at relatively lower levels at a year ago, right at the beginning of the pandemic.

Dimitris Melas (11:54):

It is true that the report that the economic numbers actually lag markets and markets already discount these so-called base effect, we call them base effects. So for example, of course, we had the collapse in economic activity and prices fairly a year ago when the pandemic hit as a result, this will lead to higher reported inflation in the coming months because the comparison is with the prices a year ago, and we will observe similar base effects in terms of economic growth. We had the depressed economic activity a year ago, so it's not going to be surprising to investors and market participants. When we see some strong here on here, growth numbers reported in the next next few months.

Adam Bass (12:39):

Both Dimitris and Andy were very clear however. There's more to this than the year over year. It's not just the turning of the cycle and economic activity picking up after a more depressed period, investors are interested in the add on effect of the stimulus or rather the level of the stimulus.

Dimitris Melas (12:59):

Much of the debate in financial markets is focusing on the question of to what extent the stimulus has been the right size, have government done enough, or have they possibly done too much and will this feed into higher prices and higher inflation going forward.

Adam Bass (13:19):

The right role of government, both on the fiscal and monetary policy side. That's not a question we're going to be able to answer here. To be honest, even time may not settle this debate. But as we search for answers about the right path and what investors might expect from a period of sustained even moderate inflation, it can be helpful to look back at what's come before. And while

Andy Sparks (13:44):

From an inflation perspective you could argue the past 20 years has been almost a Goldilocks scenario. Inflation has been relatively stable.

Adam Bass (13:53):

There was a time not too long ago when inflation was anything but stable. And investors' portfolios, well they were looking at anything but groovy.

Andy Sparks (14:03):

The 70's and 80's is the nightmare in the minds of current bond market investors. We had a situation where the US economy experienced exceptionally high and variable inflation, which at times touched over 10% after inflation returns were negative for extended periods of time. We had a situation where oil and food shocks were accompanied by very accommodative monetary policy. And it was really not until Paul Forker became chairman at the fed in 1979, that the fed adopted a policy to really reign in inflation. And they did this by significantly tightening monetary policy. The result was a dramatic increase in short term interest rates, which coincided with a sharp increase in the employment rates. So by the mid 1980's rates were falling, the economy was rebounding, but the medicine the economy took to get to that point, some, some would argue was very severe and too much, but in general, the bond markets greeted that tightening but ultimately they greeted it very warmly.

Dimitris Melas (15:19):

And then moving forward late 80's early 90's and throughout the 90's, we had other structural trends such as globalization deregulation that created benign market conditions. So we enjoyed the very long bull market actually in from the mid 80's, all the way to the early 2000's in both equities and fixed income, both global equity markets and fixed income markets perform quite well. And during these three decades, the 90's and 2000, 2010 when you had a crisis, equities would suffer but then central banks would step in cut interest rates and bonds would perform well.

Dimitris Melas (16:02):

So equities and bonds had this negative correlation and therefore they provided the good hedge for each other. And as a result strategies such as 60/40 in long-short portfolio's or risk parity, for example, in long-short portfolio's provided effective diversification bonds and equities were a good hedge for each other.

Dimitris Melas (16:24):

Now, if we see inflation rising in the future, the question is, will this relationship persists or will equities and bonds start to move more in tandem. In the moderate inflation I think it's likely that the negative correlation could persist but in higher inflation environments, it could break down. And we may see some of these traditional strategies that have provided diversification such as 60/40. They actually perform less well in a high inflation environment.

Andy Sparks (16:55):

And as we, as investors consider going forward, I think of a very important question is can history repeat itself?

Adam Bass (17:05):

So that's what people are trying to figure out.

Andy Sparks (17:05):

If we had a situation where in the early phases of the pandemic, we had significant rallies in US Treasury but the equity market sold off. So there was that insurance value of bonds and particularly US Treasury.

Andy Sparks (17:20):

And then we had another phase where we had generally in recently, I should say, we've had a situation where we've had generally very good news on the economic front and equities have rallied very significantly at the same time that bonds have sold off. And so that's a little bit of the unwind of the insurance value of bonds that it wasn't needed. But again, you had that negative co-relation, but bonds are oftentimes thought by asset allocators to be a defensive play in the anchor in a portfolio when that portfolio and when the markets particularly the equity markets are going through stormy waters.

Dimitris Melas (18:08):

I would say the last year, we've also seen that bond do provide to some extent the head for equities. But you know, the question is looking forward and if we see inflation overshooting, we got relationship persist or will it change. I think there is a chance that it might change.

Adam Bass (18:26):

There are other factors at play here as well, differences between the 70's and today. Besides polyester leisure shoots that is. Sorry. Couldn't resist getting in one more.

Andy Sparks (18:37):

I do think the Fed has tried very hard to learn lessons from the experience of the 70's and 80's. That includes effective communication and transparency of policy and very strict adherence to it's dual mandate of maximum employment and stable prices. And so that's the hallmark of the modern Fed. So the Fed back in, particularly in the 70's it was accused at times of not being having enough independence from policymakers critics that the Fed would say that they were too accommodating to the political powers. At that time, there was no inflation target up until Chairman Bernanke's reign at the Fed. He introduced inflation targets in 2012, but the Fed even before that had been acting I'd say as if there were some new miracle inflation targets. And there were also meetings during the summer during the what's known as the Jackson Hole meetings where they changed some of their policy. And again, but in a very transparent way.

Andy Sparks (19:53):

And so among other things, they said that 2% inflation target should not be viewed as a cap, but as an average. And the Fed also clearly said that they're no longer going to be involved in pre-emptive changes in policy, in anticipation or based on a forecast of what might happen. Instead, they're going to be very outcome oriented. And more recently, as the Fed has been discussing its near term outlook and its policy responses, they've gone out of their way to say that they aren't changing their Asset Purchase Program or their Rates Program the Fed funds rate in this case.

Adam Bass (20:37):

But all the same could that change in policy, be fueling some of the fear that they're going to way too long, let's say to react and almost a self fulfilling prophecy from the markets?

Andy Sparks (20:54):

Absolutely. That is a concern that the Fed there's a concern that the Fed is, would prefer to be late rather than early. And the concern is that they may be too late and a real problem with inflation is when it begins [inaudible 00:21:15] its way into expectations. And so when businesses begin entering into contracts with suppliers or with employees, maybe they'll have a one year contract or a two year contract and in those contracts, the terms may be fixed over the term of that contract. And so if companies and individuals begin to think that inflation is going to rise, they will write into these contracts, changes in fees, changes in prices, changes in wages based on that anticipation. And once that happens, it could begin to affect current inflation, actual inflation.

Adam Bass (21:57):

So what's an investor to do? What are the options?

Andy Sparks (22:02):

But you need to look at it in a broader context from the context of a multi-asset class portfolio. And I would also say within the bond market, I think there are a lot of interesting relative value plays, potential plays. It could be the slope of the curve. Should you buy the long-end, short to short end, should you be overweight in any emerging markets? Private debt is an increasingly interesting asset class that I think investors are looking at.

Dimitris Melas (22:30):

Now under a higher inflation scenario, it's possible that the equities and nominal bonds may suffer declines based on historical analysis. In this type of environment, other asset classes such as in the clean bonds and even commodities could provide better hedging opportunities. Now under a higher inflation scenario, it's possible that the equities and nominal bonds may suffer declines based on historical analysis.

Dimitris Melas (23:02):

In this type of environment other asset classes, such as in the clean bonds and even commodities could provide better hedging opportunities. If we take a step back and look at what's been happening recently, of course we've seen we're feeling the early stages of adoption, but digital assets are gaining more acceptance. Gradually, mainly cryptocurrencies they could over time facilitate transactions, help investors manage inflation and even help preserve wealth over time. But as I said, we're still in the early stages. We need to see a lot more development and transparency into how these digital assets are priced, how they're traded.

Dimitris Melas (23:47):

I personally find it very exciting and we're already starting to do some research to understand the space and support some of our clients. We're trying to answer questions like, well, what is the volatility of these assets compared to more established financial assets? What is their correlation with other asset classes? Can they help to catch a certain risks such as inflation? Could they play a role similar to gold, for example, in the future in terms of helping catch inflation? So there's a whole host of questions and we're just starting to get to grips with those questions, but it's actually a very exciting technological innovation that hopefully will open up new avenues for investors.

Adam Bass (24:29):

What came through loud and clear in our discussions is that fixed income and equity markets seem to be saying inflation is coming. Though, how steep and how long is still up for debate. Now, if these indicators are correct, there are many people working in the industry today for whom sustained inflation is merely historical. Theoretically even. Though a fund manager, let's say they might have decades of experience. Well, it's been decades since this has happened. I asked Dimitris and Andy what they would say to such a fund manager.

Dimitris Melas (25:04):

So look, I can certainly talk about my own personal experience. I started working in financial markets in the late 90's and throughout my career, I saw three major crisis, the technology crisis of 2000, the financial crisis in 2008. And of course the pandemic that we had in 2020, and we're still going through it as we speak. So this experience has taught me that, although there are similarities, every market crisis that I went through as a professional is different.

Dimitris Melas (25:36):

Therefore, I think all of us we should study and try to understand the history of financial markets during periods of stress during periods of crisis, but more importantly I think we should always look into the future and understand the new challenges that we're facing.

Andy Sparks (25:51):

I think looking at the US itself, going back to the 70's and 80's and asking the question of how did inflation reach those very high levels and how was it ultimately reigned in, I think for those younger fund managers that weren't alive in those days, and maybe weren't too aware of what was going on. I think it would definitely be worth their while to look at some of that history. It's not exactly ancient history yet.

Adam Bass (26:21):

That's all for this week. A big thank you from co-producer Joe Cole Lovecchio and me to Andy and Dimitris. And of course, to all of you for listening. For more insights into the effects of inflation on portfolios, visit msci.com. We also invite you to check out our sister podcast ESG Now. We'll be back with a new episode on May 13th until then I'm your host, Adam Bass. And this is MSCI Perspectives. Stay safe, everyone.

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process. To learn more, please visit **www.msci.com**.
