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Inflation – turning up the heat

The Russia-Ukraine crisis evolution: an exacerbating factor for inflation

In the case of inflation, time is not on our side. The longer a bout of inflation lasts and the more volatile it is, the more likely it is to become ingrained into society's collective psyche raising the risk of stagflation[1] setting in. Heading into 2022, we viewed stagflation as a relatively low risk given the strong growth momentum seen across much of the world. However, the ongoing conflict and the subsequent sanctions have led to further upwards pressure on commodity prices. The resulting mix of higher inflation and lower growth have raised the risk of stagflation for the medium term, although it is far from our base case of lower yet positive global economic growth and inflation peaking later and at higher levels.[2]

It is, however, a risk that grows with time, especially if hostilities and the resulting inflationary impulse last into 2023: it will require careful attention given how damaging it can be to investment portfolios.

Kindling

Inflation fuel began kindling in the mid-2010s as globalization was increasingly questioned, and the US-China "trade wars" come to mind. More capital discipline after the shale bubble in the early 2010s led to more limited US energy production relative to possible supply. Furthermore, growing environmental legislation increased the cost of energy production and consumption, in some countries more than in others. Unconventional monetary policy became acceptable and fiscal discipline became increasingly unfashionable in the western world.

The spark

The spark that helped fuel inflation came in 2020 when governments across the world damaged supply by encouraging or forcing large parts of their population to stay at home for extended periods of time in an attempt to mitigate the impact of COVID-19. This lowered labor supply and disrupted supply chains which in turn reduced overall economic output. Demand on the other hand, at least for goods, was supported through stimulus checks and other forms of assistance that were brought into existence by fiscal authorities with the support of central banks that monetized the debt.

[1] We define stagflation as a secular period of weak growth and high inflation.

[2] Conflict and Inflation - Global Dynamic Asset Allocation Update - March 2022

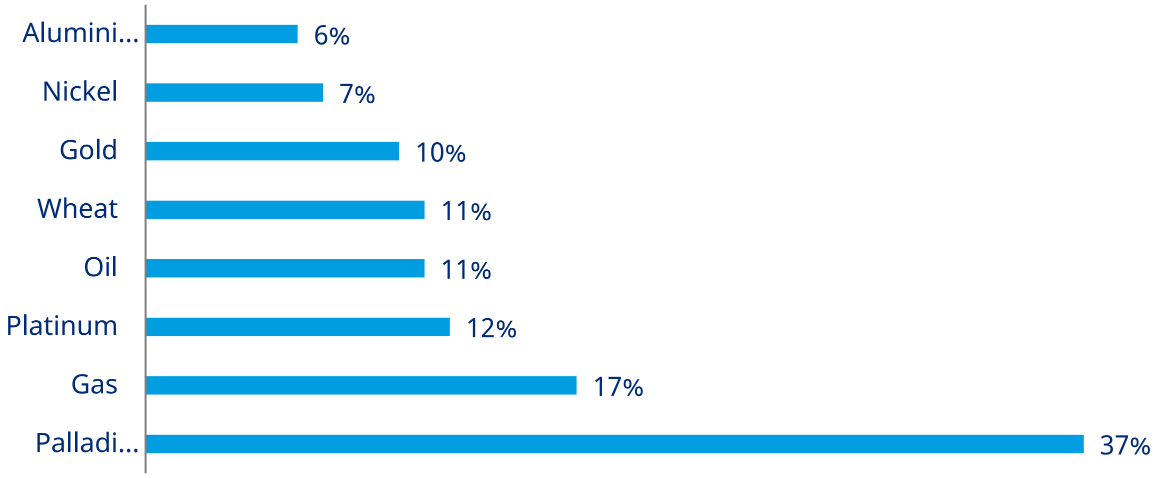
It is getting hot

The combination of supply chain disruptions and excessive stimulus led to a strong rebound in growth and spending but also inflation, which reached a 40-year high in early 2022.[3] While there were certainly supply issues to contend with, we can view this inflation as at least being in part growth or business cycle related. The central bank policy response to this type of inflation is well understood by markets and, indeed, expectations of central bank tightening ramped up in January 2022. This was testing for portfolios, for both fixed income and risk assets, but represented traditional, business cycle-related patterns well understood by market participants. Our own expectation was for inflation to fall over time to close to but remaining modestly above central bank targets. This would in turn provide a form of light financial repression policymakers seem to have deemed necessary, given the debts accrued during COVID-19.

Adding more fuel

This was disrupted, however, by Russia's invasion of Ukraine and the subsequent sanctions imposed on Russia by the Western world, as we have explained in more detail in separate papers.[4] While Russia does not have an outsized presence in financial markets, it is a key exporter of several commodities, as shown in Figure 1 below. Adding in Ukraine, a major producer of wheat, only exacerbates the situation.

Figure 1. Russia share of global commodity production



Source: Morgan Stanley research, Goldman Sachs, JP Morgan, Haver, Woodmac. As of 2020.

Ukraine's share in global supply for wheat and corn is 7% and 22% respectively (Morgan Stanley, IHS Markit, Goldman Sachs).

[3] As measured by the Consumer Price Index for all urban consumer: all items in US city average. St Louis Federal Reserve and U.S. Bureau of Labor Statistics (Accessed on March 18, 2022).

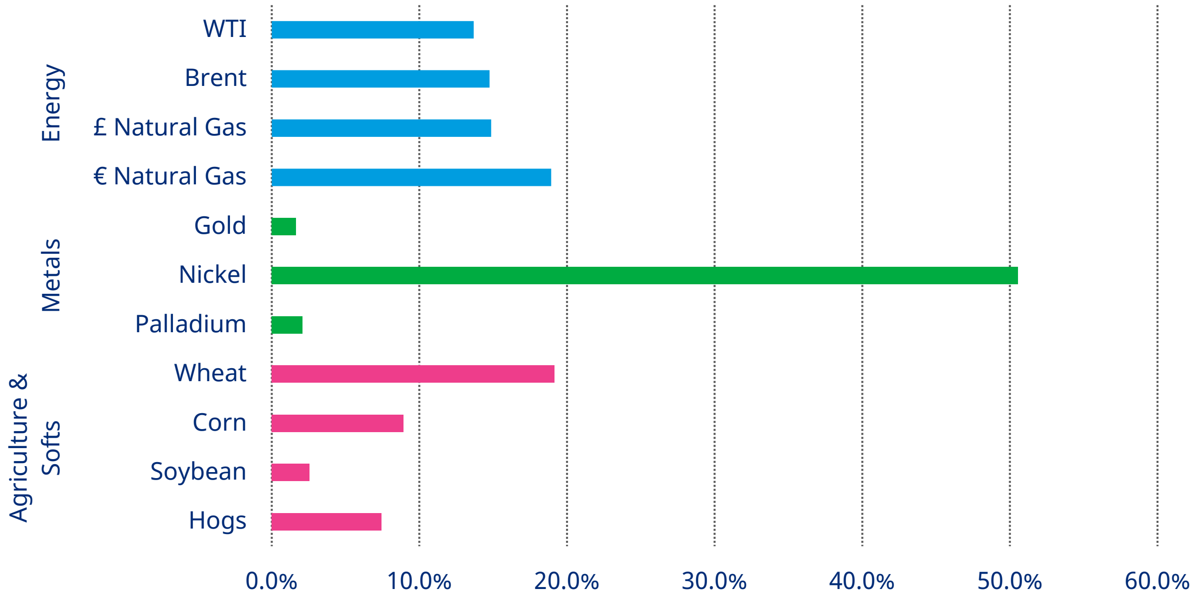
[4] Peering through the fog - Examining prior examples of the impact of geopolitics on financial markets in light of current market events

Offloading Russia - Investment implication of Russia being removed from indices

Conflict and Inflation - Global Dynamic Asset Allocation Update - March 2022

Sanctions and conflict itself are now threatening some, if not all, of this commodity supply. This comes at a time when global supply chains are still trying to recover from the pandemic fallout and still face regular setbacks.[5] The result on commodity pricing so far can be seen in Figure 2. This kind of commodity shock is “bad” inflation from the perspective of consumers and commodity importing countries and raises the spectre of stagflation.

Figure 2: Commodity price changes since the onset of hostilities



Source: Refinitiv, Bloomberg. Performance between February 23, 2022 and March 18, 2022.

Rising commodity prices have both direct and indirect impacts on consumers and the broader economy. Using energy as an example, higher gasoline prices do not only affect us directly at the pump but also indirectly as they increase what farmers pay to bring in the harvest or the cost of delivering online orders to our doorsteps. The result shifts an economy’s supply-demand curve towards lower production and higher prices.

We can already see this in economists’ forecasts and market prices: consensus economic forecasts for the first half of 2022 have already been downgraded by some economists, the brunt being borne by Europe and Russia, while inflation expectations have been on the rise. It does not appear that we are in stagflation just yet as economic growth is still expected to remain positive for 2022 according to most forecasters, thanks to strong momentum heading into the year, but it can no longer be dismissed as an unlikely tail risk. The longer hostilities run and commodity prices remain elevated, the greater the likelihood of stagflation.

Examining financial market performance year-to-date, we also see some stagflation risk being priced in. Gold has risen by around 6%, the Bloomberg Commodities index is up

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[5] When this paper was published, China was shutting down the large manufacturing hubs Shenzhen and Changchun which could impact semi-conductor, automobile and other supply chains around the world.

24% and the S&P Global Natural Resources index[6] is up 12%. Most equities such as the MSCI All Country World Index are still deep in the red, if not correction territory as in the case for NASDAQ. Global nominal government bonds are down by almost 3% and global credit is down by 4%.[7]

As a reminder, the last time a geopolitical event had such a massive, sudden impact on commodity markets was during the Arab oil embargo in 1973. We have already seen the biggest weekly gain for commodity prices ever recorded during the first week of March and the three-month rolling performance is edging ever closer to the record set in the summer of 1973.[8] However, we are not advocating for naively extrapolating from the 1970s. The flow-through mechanisms are different. Indexation of wages – both formal and informal – is far from standard, at least at the moment in major developed countries. Although inflation expectations have risen recently, they were lower and more stable going into the current shock than they were in 1973. At the same time, energy intensity has declined.[9] The creation of the US Strategic Petroleum Reserve in 1975 provides an additional cushion.[10] Those factors could mitigate the inflationary impact on the economy.

On the other hand, looking at markets, the 1973 oil price shock was not accompanied by risk assets at multi-decade highs and rates at multi-decade lows. Even after the drawdown seen in the first quarter of 2022, equity valuations as measured by the CAPE ratio are still at the second highest level ever recorded.[11]

Hope for but don’t count on a bucket of cold water

If peace between Ukraine and Russia were to be agreed, then markets would likely blow off recent events as just another short-term geopolitical blip even if they have had a devastating humanitarian impact. Unfortunately, we cannot afford to be so complacent. Even if the conflict ultimately ends – which we hope will happen quickly – the prospect of sanctions on Russia being lifted soon thereafter and its commodities fully returning to world markets would be remote. Of course, this does not mean commodity and oil prices will have to automatically increase a lot from here but it is a possibility.[12]

Exploring this less benign scenario of commodity prices remaining high or going higher, central banks would be faced with two unattractive options:

A. Raise rates/tighten financial conditions sharply, resulting in a sharp recession in a bid to fend off stagflation; or

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[6] S&P Global Natural Resources index includes 90 of the largest publicly-traded companies in natural resources and commodities. Companies are in three primary commodity-related sectors: agribusiness, energy, and metals & mining (as of March 18, 2021).

[7] Refinitiv, year to date as of close of March 17, 2022

[8] Deutsche Bank

[9] According to a note from Deutsche Bank published on February 25, 2022, in 2020, the amount of energy for each units of GDP was 37% of its level in 1970. There are similar findings for the EU (going back to 1995).

[10] Whilst this predominantly cushions the blow for the US economy, we would expect a global spillover effect if oil supply increases in the world’s largest economy. There are also other countries that have strategic petroleum reserves including the UK, China, Japan, India and South Korea (accessed March 18, 2022).

[11] See Robert Shiller’s CAPE dataset (accessed on March 18, 2022).

[12] After peaking at $130 (USD) in early March, oil prices fell back to ~ $100 (USD) in mid-March on the back of hopes for a ceasefire, potential for additional supply from Venezuela, Iran and US shale and lower demand after China locked down major cities. WTI Oil futures are pricing oil to stay around $90 (USD) per barrel through 2022 and fall to $80 (USD) per barrel by the end of 2023 (as at close of business March 18, 2022).

B. Be more cautious in raising rates and risk stagflation taking hold.

Starting with Scenario 1, in a monetary policy driven recession with an inflation kicker, both risk assets and bond duration would be expected to suffer initially as rates are hiked beyond what is priced in already. Duration would be expected to eventually recover to a degree, as inflation might fall, but the recovery for risk assets would be expected to be slower as rates are unlikely to be as supportive as in past recessions. Not many assets would be expected to do well in a scenario of rising real rates and slowing growth. Gold comes to mind as one which might – as the ultimate fear asset it can be negatively correlated with equities and could mitigate the shock to a growth asset portfolio, to a degree, in a policy-driven recession. However, gold prices are also sensitive to real rates and thus vulnerable if central banks are too "successful", as rising nominal rates and falling inflation would put upwards pressure on real rates. Holding cash would be another option: it would not give real returns but likely hold its own and would become a source of liquidity for when opportunities begin to arise. Short duration or floating rate credit as well as tail hedge strategies could also be considered.

Moving to Scenario 2, stagflation, what had been long viewed as a tail risk scenario has now turned into a more tangible risk scenario. If central banks choose to follow wage inflation and "look past" the spike in commodity prices, inflation could eventually spiral out of control as central banks chase a lagging indicator. In practice this is a two-part scenario – central banks being too cautious at first[13], worried about pushing the economy into recession, allowing stagflation to take hold and then doubling down as described above in a Paul Volcker[14] style extinguishing of the inflation fire at a huge economic cost. When testifying in early March[15], Federal Reserve chairman Jerome Powell explicitly confirmed that he might follow Volcker's example.

There are few asset classes that do well in a stagflationary scenario. Growth assets such as equities as a whole tend to do poorly in such an environment. Of course, some sectors and styles may do better than others – equities tied to the energy sector, for example, could be a major beneficiary as we have already seen year-to-date.[16] Nominal fixed income assets obviously suffer in inflationary regimes as their cash flows are eroded. Inflation-linked bonds may do better if real yields fall, which is not always a given as central banks may hike rates to break inflation expectations.[17] Even real assets such as property may not do that well, at least in the short term, as rents cannot be revalued instantly and discount rates will rise to allow for higher inflation expectations.

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[13] After the Federal Reserve increased short dated rates on March 16 for the first time since 2018, an aggressive pace of further rate hikes is currently being expected by Fed officials and priced in by markets but may still not be enough to fend off inflation in an extreme scenario.

[14] Paul Volcker was the chairman of the Federal Reserve from 1975 through to 1987. Inflation had reached double digit levels when he took office. During his tenure, inflation was brought down through a 'shock' treatment of steep discount rate increases even if it came at the at the initial cost of lower economic growth and rising unemployment.

[15] https://www.wsj.com/articles/feds-powell-set-to-discuss-rate-rise-plans-with-senate-lawmakers-11646303401 (accessed March 15, 2022)

[16] MSCI ACWI Sector Energy has returned ~16% to year-to-date to March 17 when the MSCWI ACWI as a whole has returned ~-8% (Refinitiv).

[17] Outlined in more detail in our paper: 'Inflation-Linked bonds: a real dilemma'. There are also regional differences in inflation-linked bond markets.

The only asset classes we believe would be expected to do well in stagflation are gold and potentially inflation-linked bonds, but performance for both asset classes is subject to real rates not rising too much in the late stages of a stagflationary shock. Commodities usually do well both when inflation comes with growth and when stagflation is driven by a major geopolitical shock, as is happening at the moment.

Diversify across a range of inflation-sensitive assets, hedge stagflation risk

The key take-away in our inflation protection paper[18] was to broadly position portfolios via inflation sensitive assets towards a number of different inflationary scenarios to improve portfolio robustness. That advice remains the same today with a greater emphasis to position for stagflation risk, one of the scenarios traditional portfolios were least prepared for. We would not encourage investors to reshuffle portfolios towards geopolitical events as they are already unfolding and note that the initial spike in commodities and gold has been missed. However, we believe stagflation remains a real risk beyond the immediate fall-out of the Ukraine conflict.

As we potentially move into a more multi-polar, chaotic world, we move into a world more fragile to future geopolitical or climate-related events. With it, the risk of outsized moves in commodity markets or other crucial inputs such as semiconductors makes it likely that stagflation will remain more than just a tail risk. Portfolio construction needs to factor this in via a strategic allocation to gold and a commodity allocation which could be implemented via developed market natural resource equity strategies, commodity trend strategies or commodity futures[19]. Investors who do not already have these allocations need to be mindful that both gold and commodities/natural resource equities have considerably increased in value year-to-date and may have priced in elevated stagflation risk at least to some degree. Dips in the near future may present opportunities for those investors to gradually hedge against stagflation risk in their portfolio for the long term.

[18] Inflation protection – building robust portfolios

[19] See our paper Commodities in an inflation-aware portfolio for more details.

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