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Where next for inflation?

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The outlook for inflation has been the key influence on markets recently and rarely have there been such divergent views on the subject and such a broad range of forecasts.

Many of those predicting a sharp inflation uptick are pointing to two main catalysts: a spending boom funded by the release of household savings accumulated during lockdowns and, second, the impact of the stimulus packages from governments and central banks.

The numbers attached to each of these factors are, undeniably, extraordinary.

Looking at savings rates first, the average UK household saved over 6% more than normal last year and this number is closer to 8% in the US. This may not sound that dramatic but in fact far exceeds what one would expect to see in a 'typical' recession.

But therein lies the issue – this has very much not been a 'normal' recession and, as a result, views now differ very substantially as to how quickly, and to what extent, spending will pick up. Some argue that this increase in savings ratio is heavily focused on older, wealthier people whose generally more conservative spending habits will not fuel a rapid surge in demand. Others, however, argue that much of the slowdown in spending has been imposed on people by lockdowns, rather than being the active decision one would see in a 'normal' recession, and see this as a reason to believe that most of this cash will quickly find its way back into the economy as soon as there is the opportunity.

Turning to the stimulus we are, again, in somewhat uncharted territory in terms of the scale, speed and nature of the packages that continue to be rolled out. In July last year alone, the US Federal Reserve created more new US dollars than the US government had borrowed in the previous 200 years, and vastly more than it created during the global financial crisis in 2008. Again, looking at the US, much of the stimulus has been made immediately available – households have received sizeable payments directly into their pockets – and President Joe Biden continues to put forward further multi-trillion dollar plans despite the fact the economy is already recovering.

Given all this it is perhaps not surprising that markets are struggling to get an accurate handle on the likely extent of an inflation pick up, or on where this inflation will be most focused.

While a pick-up in inflation seems inevitable, we continue to believe that it will be a largely temporary phenomenon and we expect inflation rates to fall back within, or close to, target ranges into next year. This is partly because much of it is being driven simply by an initial surge in pent up demand as restrictions are lifted and by a general rebound in some of the inflation dampeners created by the pandemic, such as lower commodity prices. We note that the rise in core inflation, which strips out some of the more covid-sensitive areas of the economy, has so far been much less significant.

In addition, the economic impact of the virus has led to some disruptive bottlenecks and shortages in economies which, when added to an increase in demand, is also pushing prices higher in some areas. These imbalances should iron out in time as workforce and supply chain disruption diminishes and shorter-term demand pressures ease and normalise.

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So, what does this all mean for equity and bond markets?

All this uncertainty in inflation expectations is likely to lead to a continuation in the recent volatility we have seen in bond markets. Our view that we are looking at a temporary spike in inflation, rather than a step change to much higher levels, means that we are still comfortable having some exposure to interest rates in portfolios as an equity hedge. Crucially the US Federal Reserve and the European Central Bank have been vocal in stating their intention to look through 'temporary' and 'transient' spikes in inflation and not react to them. It is also fair to say that many governments will welcome some inflation to ease the burden of repaying massive levels of accumulated debt.

In our latest Investment Committee meeting we have, however, decided to decrease the sensitivity to interest rates (duration) in portfolios in acknowledgement of the fact that the downside risk in government bonds has certainly increased, at least in the shorter term.

Within equity markets we will likely continue to see short-term rotations between more cyclical and interest rate sensitive (typically 'value') stocks and sectors and their generally less rate sensitive 'growth' counterparts. We see opportunities in both areas and therefore continue to favour a blend of value and growth investment styles in portfolios.

What all this doesn't change is our overall positive view on risk assets, which we think remain supported by the prospect of a broad-based economic recovery, a continued period of ultra-low interest rates and ongoing support from central banks not ready as yet to withdraw stimulus packages. As a result, we are maintaining equity exposure at the upper end of strategic ranges, albeit this is complemented by diversified exposure to fixed income and alternative assets for medium and lower-risk mandates.

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