A (7) TRILLION-DOLLAR QUESTION: IS INFLATION COMING BACK?

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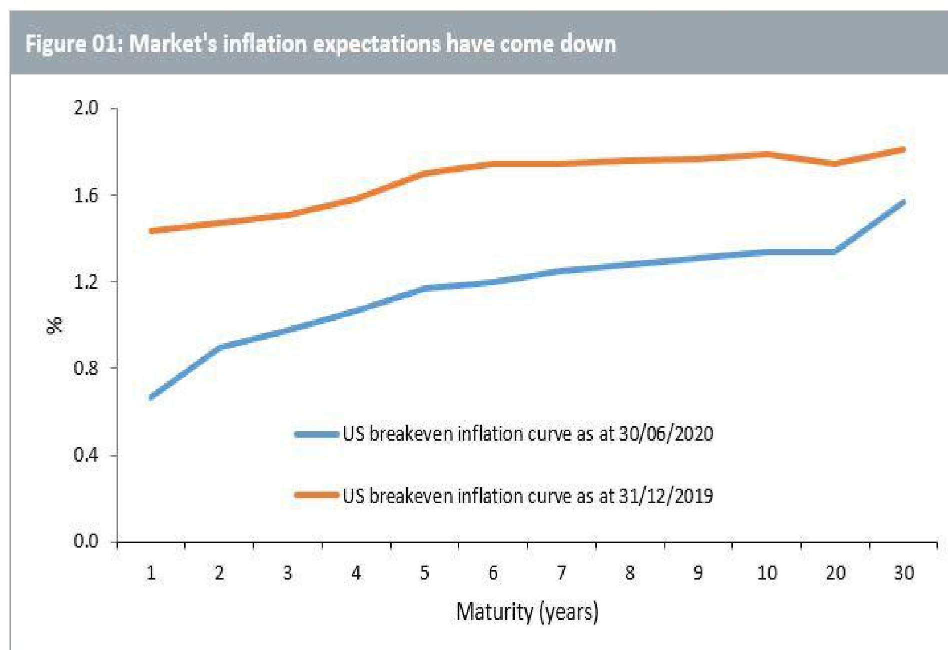
It isn’t always easy to establish what future outcomes are being discounted into asset prices by market participants. Inferring market’s inflation expectations is, however, not so difficult. The breakeven rate of inflation – calculated as the difference between the yield of a nominal bond and an inflation-linked bond of the same maturity – is a reliable measure of gauging the inflation expectations of markets. So, what is the wisdom of crowds telling us?

At present, markets do not expect US inflation to reach the US Federal Reserve’s 2% inflation target in the next 10 years. The US breakeven inflation curve shows the level of inflation priced into US treasuries for different levels of maturity – or years into the future. The crucial insight from Figure 01 is that inflation expectations have come down across the curve since the start of the year. This illustrates the market’s assessment of lasting damage to the US economy from the pandemic.



Source: WisdomTree, Bloomberg. Data as at 30/06/2020.

Historical performance is not an indication of future performance and any investments may go down in value.

Then why is everyone talking about inflation?

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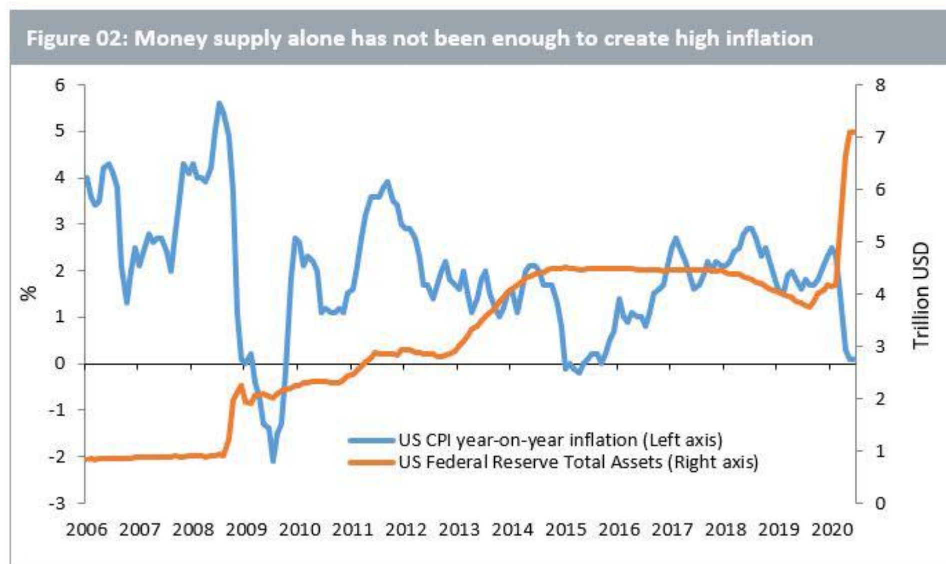
One of the reasons why investors may feel that bond markets have got the inflation outlook wrong is the impact of US Federal Reserve (Fed) policy accommodation. Figure 02 illustrates how sharply the balance sheet of the Fed has grown this year on account of the central bank's sizeable asset purchases. Such aggressive accommodation from the Fed also came during the 2008 global financial crisis. Inflation did return, but only at modest levels. The Fed's attempts at tightening policy in subsequent years were met by 'taper-tantrums' by the market, i.e. collective panic in the market over the potential withdrawal of liquidity.

The Fed, therefore, continued to expand its balance sheet in the years following the crisis. Its balance sheet has grown from under USD 1 trillion in 2008, to over USD 7 trillion in July 2020. Despite the strong liquidity infusion since the global financial crisis, inflation has not reached very high levels. Liquidity alone will probably not be enough to cause high levels of inflation going forward either.



Source: WisdomTree, Bloomberg. Data as at 30/06/2020.

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Let's envisage an inflationary scenario

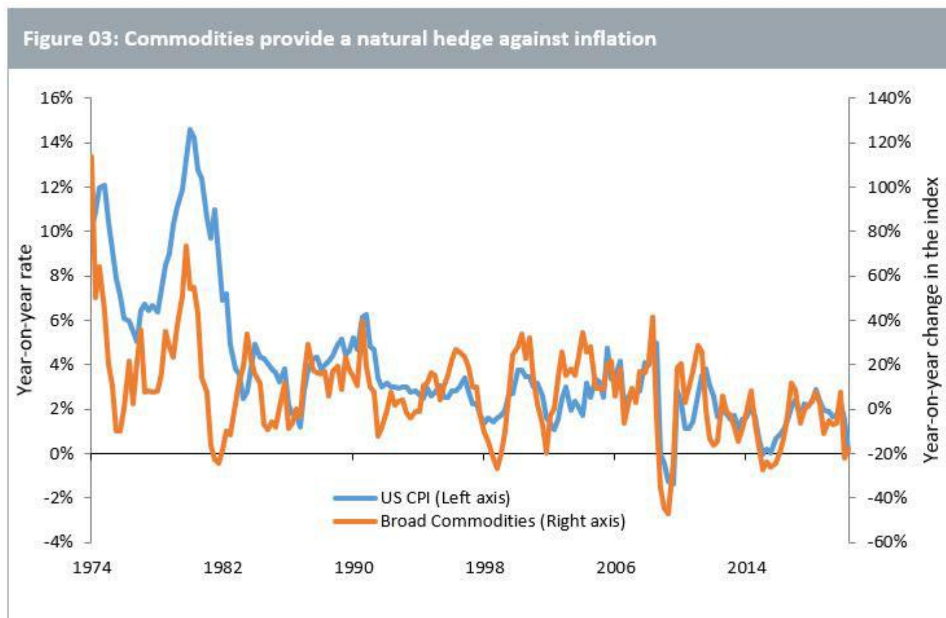
Let us outline one possible combination of factors that could join forces to elevate the level of inflation, probably in 2021. Let's assume a potent vaccine is developed and distributed widely and the pandemic is all but over as we enter the new year. Life returns to the old normal. A large proportion of jobs lost this year are restored. The so-called 'pent-up' demand, i.e., people holding back from spending this year, causes demand-pull inflation next year. An increase in economic activity could cause energy prices to rise back to pre-pandemic levels creating cost-push inflation. Further support may come if governments follow through on their recent pledges to employ infrastructure spending to induce growth.

The above scenario, however, is not our base case. Question marks exist on a number of the aforementioned variables. A vaccine is yet to be developed and energy demand has a long way to go before it pulls oil prices back to pre-pandemic levels. Similarly, with bankruptcies and lasting damage to businesses, unemployment will only decrease gradually, and it will be a while before wage pressures start to pinch again. In our

base case, we expect inflation to rise moderately in 2021 and reach 1.5% for the US around the middle of next year. This is closely aligned with the International Monetary Fund's forecast.

What should investors do?

Is it too soon to be thinking about inflation? We don't think so. Even if inflation rises only to moderate levels, for the US as well as the global economy, it is very likely to increase from where it is today. If investors think in terms of their 'risk budget', they should consider which risks their portfolios are exposed to, and whether they are well-compensated for taking those risks. If investors don't actively want inflation exposure, they should consider hedging some of that risk.
One effective way to hedge against moderate levels of inflation may be to use a broad basket of commodities (See Figure 03). Broad commodities provide a natural hedge when the global economy starts to grow. Cyclical commodities are needed to produce things – even more so when governments introduce infrastructure programs.



Source: WisdomTree, Bloomberg. Quarterly data as at 30/06/2020. US Consumer Price Index (CPI) is the year-on-year rate of inflation in the US CPI Urban Consumers (Seasonally Adjusted) Index. 'Broad commodities' refers to the Bloomberg Commodities Total Return Index.

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Historically, another effective inflation-hedge is gold. Since inflation devalues paper currency, gold is seen by investors as a better 'store of wealth'. Its trade-off with broad commodities is that investors lose the diversity of a basket, but they add a strong downside hedge against a financial market or macroeconomic downturn. It also works better than broad commodities in periods of high inflation – as such a scenario is likely to result from monetary policy errors, again pushing investors away from holding currencies.

With prices up nearly 17% year-to-date2, gold markets appear to be pricing in higher levels of inflation next year compared to US treasuries. Inflation protection is a

relevant and important issue for investors to consider now, as inflation inches up from extremely low levels today to normal levels next year.

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