Is inflation making a comeback?

Fullerton Investment Views

March 2021

Executive summary

- With commodity prices surging, investors are concerned that inflation could shock on the upside. Meanwhile, bond yields have increased rapidly and equities have fallen.
- Investors may worry that their real returns could suffer, and the prospect of tighter monetary conditions could threaten equities.
- Investors' best protection is a diversified portfolio as most risk assets may potentially provide solid inflation protection with returns much higher than global CPI inflation.
- The bigger test, over the next few years, is whether developed economies can continue to grow strongly with higher real yields.
- We believe economies should be able to navigate toward higher interest rates due to credible commitments by global policymakers to give more support if growth slumps; furthermore, economic activity post-COVID seems more resilient without having to heal itself from the painful debt deleveraging of the last 2008-09 crisis.

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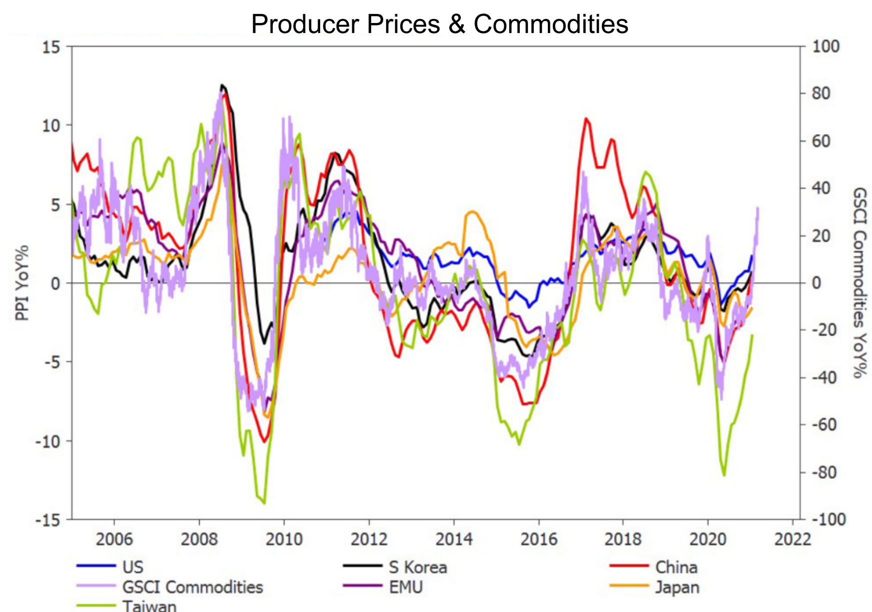
Inflation fears are being driven by commodity prices

Investors have become more concerned about the strong rebound in commodity prices, and the pressures that may be building into producer and CPI inflation - especially across some of the key manufacturing economies (see Figure 1).

Figure 1

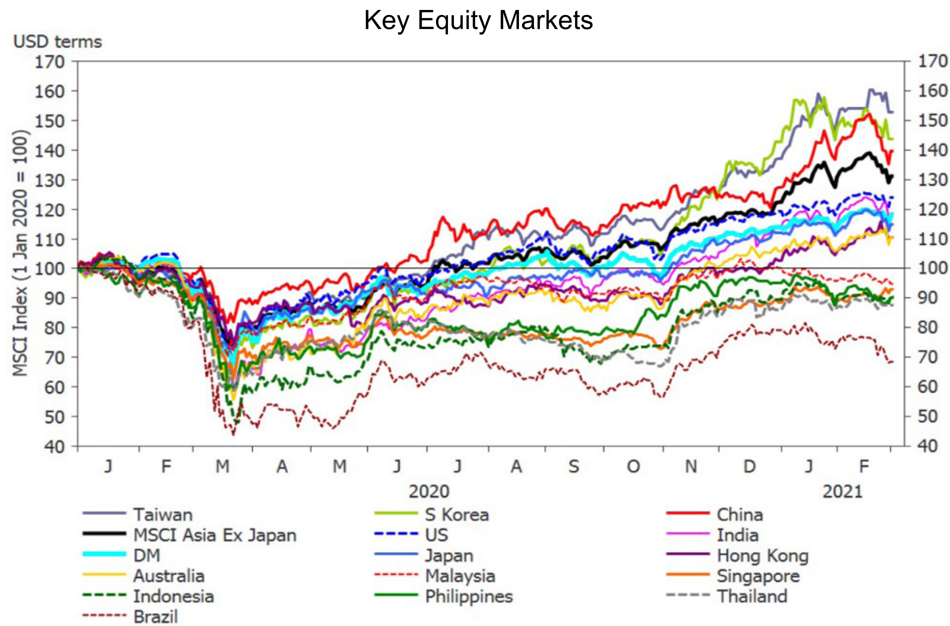


Source: Refinitiv Datastream, 3 Mar 2021

The current surge in commodity prices is driven by supply-chain restocking since the COVID-19 driven recession, strong demand rebounds from Emerging Markets (EM), and supply-side tightness. So far in 2021, aggregate commodity prices are increasing 28% YoY (Figure 1), with industrial metal prices at 42% YoY; agriculture prices are increasing 35% YoY, and Brent oil prices are running at 24% YoY (having recovered from $15 US/bbl on 1 April 2020 to $65 US/bbl currently)[1].

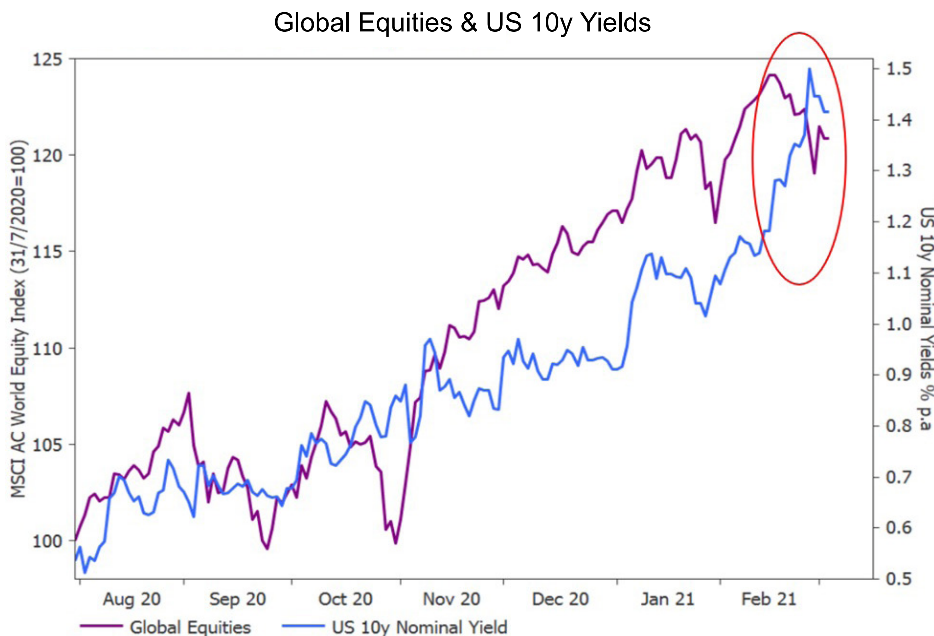
If inflation surprises significantly and moves well above its historic average, it could affect investors' desired real returns from their portfolios. A greater cause for concern is that significant overshoots in inflation could push interest rates higher, especially longer-term yields, which can impact equities adversely. So far this year, we have seen a significant increase in Developed Market (DM) yields, especially in the US, and a fall in equities across most countries (see Figures 2 and 3).

Figure 2: The recent fall in equity prices across key markets



Source: Refinitiv Datastream, 2 Mar 2021

Figure 3



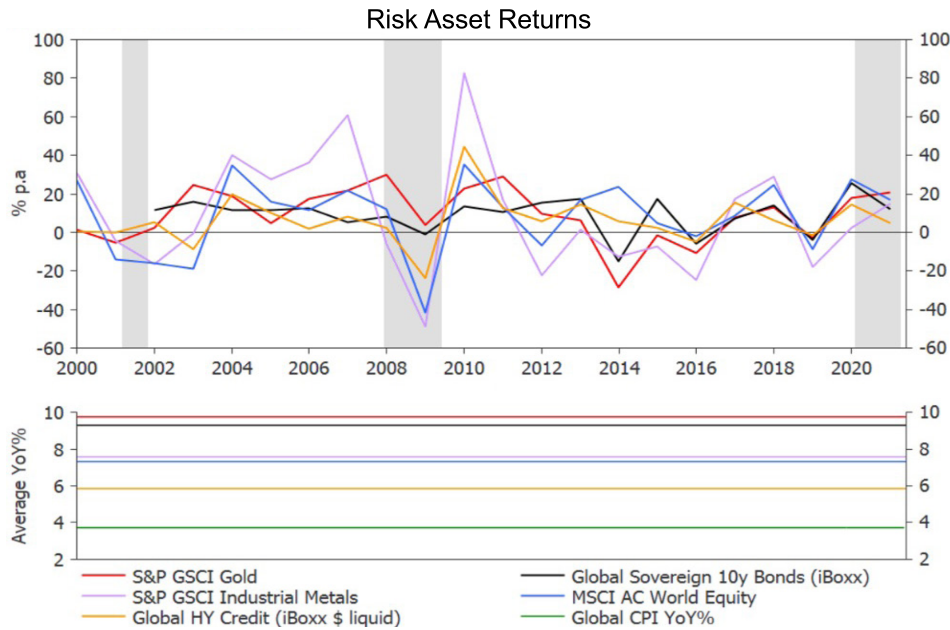
Source: Refinitiv Datastream, 3 Mar 2021

[1] Source: Refinitiv - as at 3 March 2021 - S&P GSCI Commodity spot index is 28% YoY, S&P GSCI Industrial Metals spot index is 42% YoY, S&P GSCI Agriculture spot index is 35% YoY, and Brent oil prices Spot FOB is $65 US/bbl and 24% YoY.

Investors should not worry too much because most risk assets can give significant inflation protection

Since 2000, most risk assets have generated returns that are significantly stronger than global inflation which has averaged just under 4% p.a. (See Figure 4).

Figure 4: Returns from risk assets since 2000



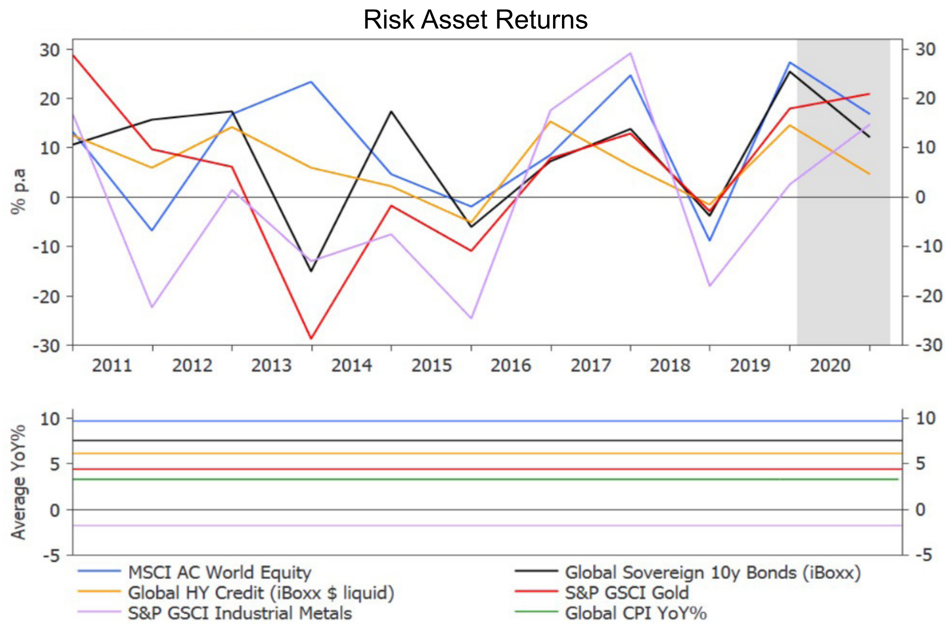
Source: Refinitiv Datastream, 2 Mar 2021

Gold price returns were especially strong on average (almost 10% p.a.)[2], boosted by crisis events like the GFC (2008-09) and significant 'printing of money' policy stimulus as the deleveraging process unfolded. Government bond returns were also strong as rate cuts offered recession protection, and interest rates tended to trend lower over the 2000s as inflation was well contained.

Returns from global equities, corporate credit, and industrial metals were also solid and correlated together with robust global GDP growth over the period. Alternative risk assets, like real estate, are also popular inflation hedges as they can potentially give returns significantly above inflation and also offer investors the prospect of capital gains and rental income.

[2] Source: Refinitiv. Risk asset returns since 31/12/1999 (until 2 March 2021), as depicted in Figure 4, are S&P GSCI Gold total return index, Iboxx $ Sovereigns 10y total return, S&P GSCI Industrial metals total return, MSCI AC World US$ total return index, and Iboxx $ liquid HY index total return. The same indices are used in Figure 5 but over a shorter time period (i.e 31/12/2010 until 2 March 2021).

Figure 5: Returns from risk assets over the last 10 years



Source: Refinitiv Datastream, 2 Mar 2021

As seen over longer time horizons, most risk assets have delivered average returns that were well above global inflation over the last 10 years (see Figure 5). In some respects, relative risk asset performance over the last 10 years was a bit more typical, with the strongest returns on average from equities because there were no significant recessionary shocks during the period. However, even though global growth was strong on average, returns from industrial metals were very poor as prices were often depressed by over-supply. Therefore, sometimes commodities do not always provide the inflation hedge investors hope for, as returns will be heavily impacted by the relative demand and supply balance.

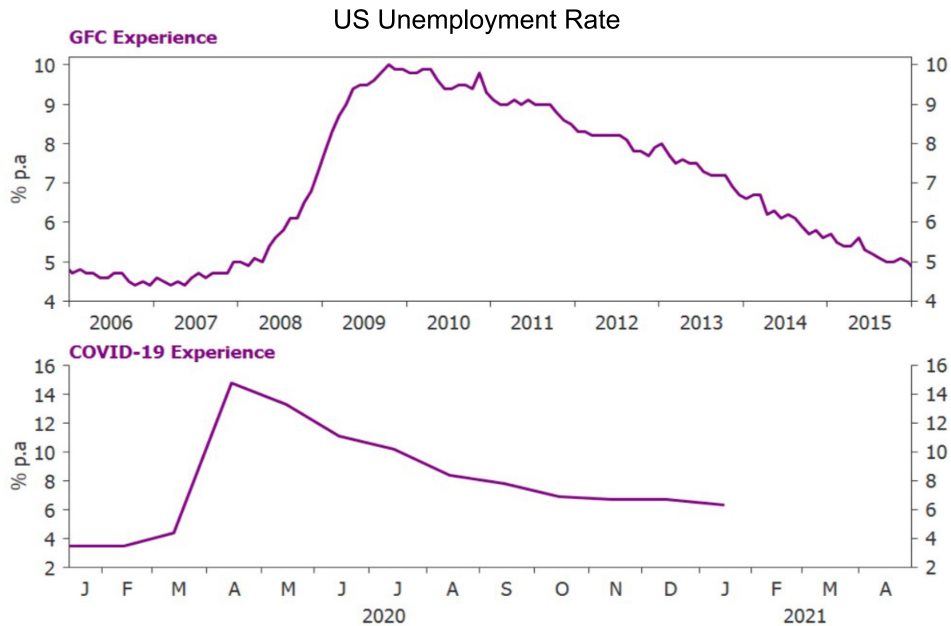
With so much spare capacity, inflation fears from surging commodity prices could be overblown

Sharp rises in commodity prices may not drive large overshoots in selling prices because there can be other off-sets for costs across industries, especially from new technologies and innovations. During COVID-19 lockdowns, many firms undertook significant cost rationalisations to help protect their earnings. Margins were then given a further boost with strong demand rebounds as the recession ended. So as this year progresses, many firms should be well-positioned to navigate higher costs.

Across Asia, the appreciation of China's currency is another factor that could limit the pass-through price pressures from higher commodity prices into selling prices.

Even with much higher commodity prices, we are unlikely to suffer any sustained overshoot in CPI inflation because negative output gaps and above average unemployment, especially across DM countries, will exert significant downward pressures on inflation (see Figure 6). It will still take several years for these disinflationary forces to fade and for unemployment to normalise.

Figure 6



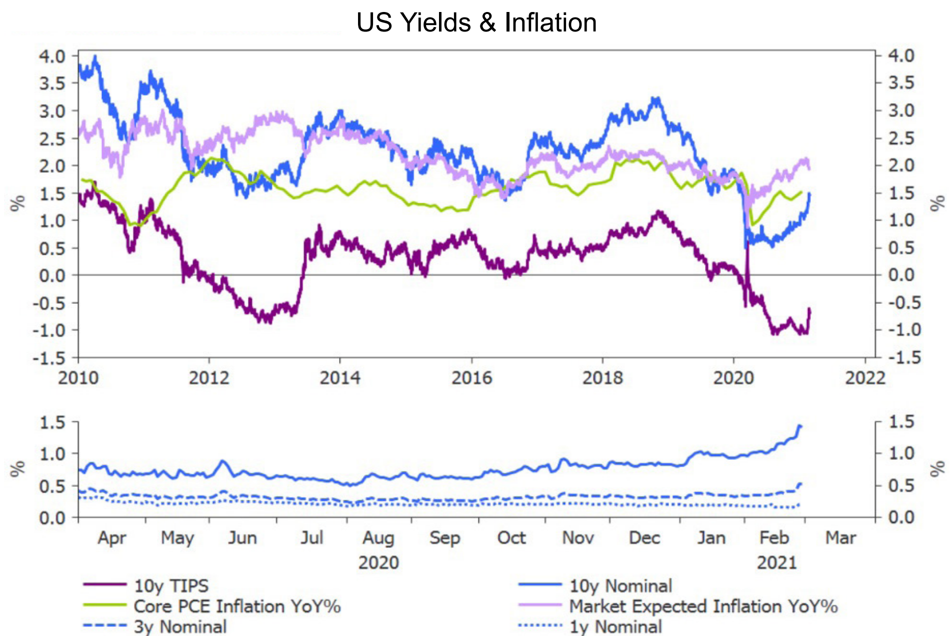
Source: Refinitiv Datastream, 3 Mar 2021

Investors have suffered a sharp rise in yields and a fall in equities

What has been painful to investors, and concerning to DM policymakers, has been the speed at which yields have increased this year. It has not been surprising that the Fed has been quick to reassure markets that yields should not rise too fast, because the Fed will keep monetary conditions very accommodative.

What has been encouraging with this bond sell-off is that US inflation expectations priced-in by the market have actually held steady around 2% (see Figure 7). This remains a key signpost to monitor to gauge inflation fears. Fed's quantitative easing (QE) policy has also remained credible as shorter-end yields – 1-year and 3-year durations – have not increased too much (see Figure 7).

Figure 7

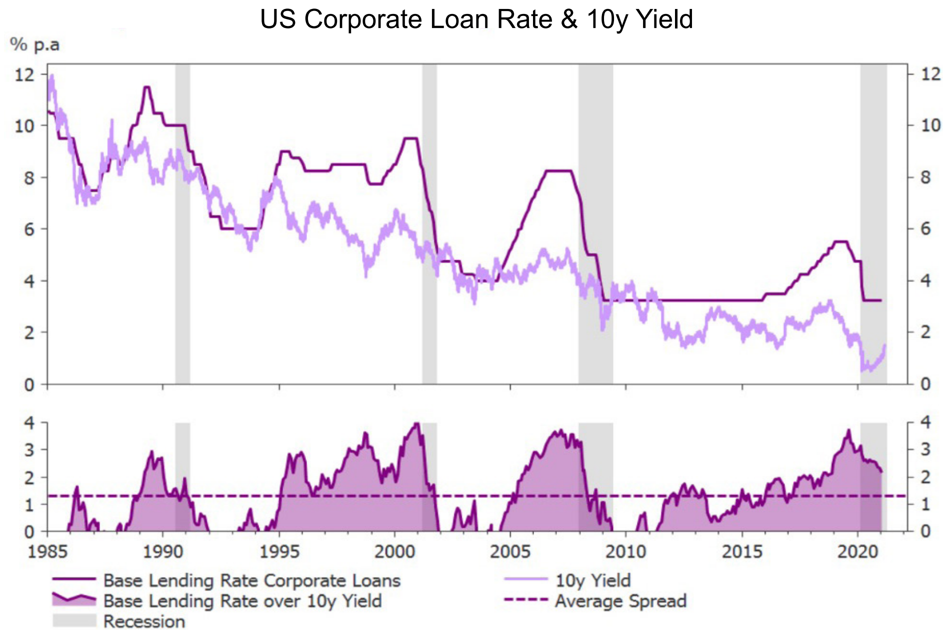


Source: Refinitiv Datastream, 3 Mar 2021

In many aspects, what we are seeing is the start of a ‘good’ yield normalisation process – on expectations that stronger GDP growth will be sustained and there is no significant inflation risk. If higher commodity prices ultimately signal stronger demand and growth, then higher yields can be a healthy response and a sign of stronger earnings growth to come.

The normalising of US nominal yields back towards 2% should not add significant stress to US corporate borrowing costs as loan interest rates have already been above that level for a while, and the lending margin over Treasuries is above average. (See Figure 8).

Figure 8

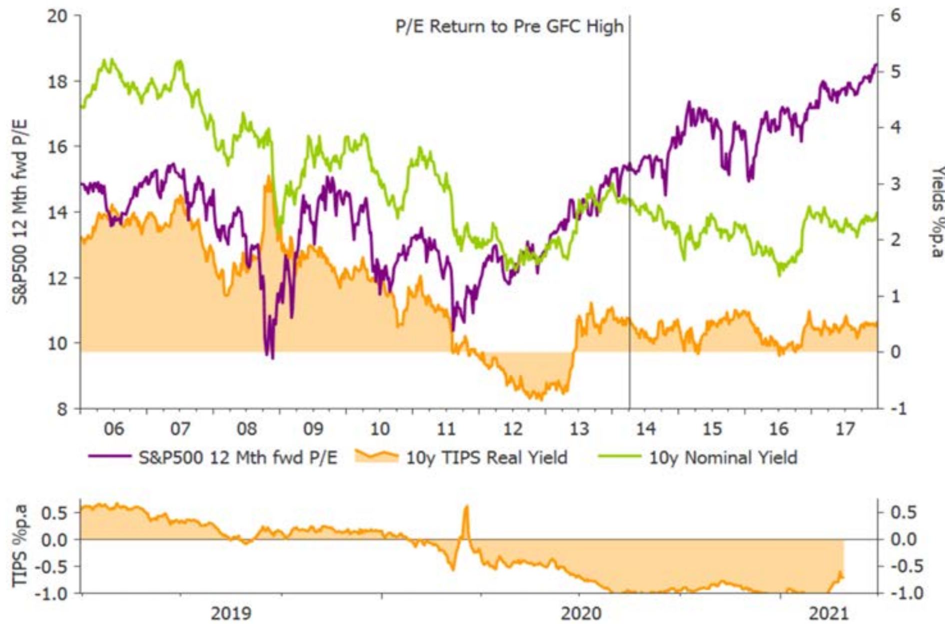


Source: Refinitiv Datastream, 2 Mar 2021

The bigger test for investors is likely to be shifts to higher real yields

The big test for many DM economies is whether economic activity can grow solidly with the return of positive real 10-year yields, and this is likely to play-out over the next few years. The US experience from late 2013 demonstrated that the economy could cope as equities continued to trend higher even with the significant shift from negative to positive real yields, i.e. from around -1% to around +0.75% (See Figure 9).

Figure 9: US share market P/E ratio and yields



Source: Refinitiv Datastream, 2 Mar 2021

Policymakers today will want to make sure that the rise in real yields to pre-COVID-19 norms is not too abrupt, so as not to stress GDP growth by too much. Because of credible commitments by global policymakers, we believe that investors should remain confident that risk asset returns can continue to be favourable as economies transition to a higher real interest rate environment.

In many respects, economic activity is more resilient today having emerged from the COVID-19 driven recession without the pain of a sharp deleveraging process that happened in the years after the GFC (2008-09).

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