The Investment Podcast

Episode 14: The Investment Podcast: Inflation – is it beyond transitory and now structural?
16 February 2022

[music]

David: The investment podcast, brought to you by M&G.

Disclaimer: This podcast is for investment professionals only. The value of investments will fluctuate, which will cause prices to fall as well as rise, and investors may not get back the original amount be invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice, or forecast.

David Parsons: Hello, and welcome to the M&G Investment Podcast. In the current bond environment, we're seeing a number of developing themes: the gradual reduction of QE bond purchases, sharply rising inflation, and an expectation of higher interest rates in developed markets. Throw into the mix a healthy dose of geopolitical risk in the Ukraine, a potential energy crisis, and rising oil prices, and it's fair to say that the major economies are facing headwinds that could reasonably be described as gale force. To discuss these issues, I'm joined today by Miles Tym, senior portfolio manager covering government bond markets, and Richard Ryan, senior portfolio manager on multi-asset credit strategies. Welcome to both of you.

Miles Tym: Hello.

Richard Ryan: Hi, there. Good to be here.

David: If I may, I'd like to start with you, Miles, and focus on what sits at the core of many of the issues investors are grappling with at the moment – inflation. It does continue to surprise on the upside, yet most forecasters continue to regard the spike as temporary. Is this justified? Have we moved beyond transitory to structural inflation? What are your thoughts?

Miles: It's still perfectly possible, and indeed not unlikely that it proves to be transitory. It's certainly the case of the current CPI and RPI prints you're seeing at the moment, are definitely exaggerated and you're not going to see inflation proceeding at the pace it is at the moment. Having said that, this temporary spike keeps going higher and higher than expected and persisting for longer and longer. If you look at inflation forecasts, now they have got a longer time period to return to what would have been the more average inflation rates that you saw before this spike.

There's increasing concerns that perhaps it's not going to be as temporary as was certainly initially assumed when inflation started to rise. There's only so long you can keep making the temporary excuse for it. Temporary for a few months is all very well, but if you start stretching to a second year of really elevated inflation, I think you're really starting to stretch the temporary definition, which indeed was something that the Fed chairman, Jerome Powell was drawing attention to in the more recent press conferences that the Fed [US Federal Reserve] has given.

Certainly that there's only so long we can use this temporary phrase for before we need to do something about it. The Fed has clearly decided that actually they've seen enough of the temporary and they do in fact need to start doing something about it. Albeit, I think it's still not unreasonable to think that the current spike in inflation is an exaggeration, and it will dissipate through time but that's getting less and less certain by the month.

David: Do you think that there is a different path to inflation developing between the eurozone and perhaps the UK and the US?

Miles: To a certain extent, yes. I think we've spoken about this before and indeed, the theme has continued. In that, there's a global inflationary theme, there's a global problem with certain supply chains. You've had a massive global shift in consumption patterns away from experiences to actually buying physical goods over the last couple of years. That has put a lot of strain on supply chains, which is, to a certain extent, a global problem.

There's also no doubt about the fact that different countries are experiencing very different inflation rates. It does seem to be a more pronounced problem in the UK and the US than it does in Europe at the moment. I think it's a global theme but

perhaps with slightly different emphasis in different countries. I think it's an issue that all central banks either are grappling with already or are certainly going to need to grapple with in the coming months.

David: Perhaps thinking a little bit about the pace of any interest rate movements that might evolve in the various major economies, it does look like the US Fed and the UK are ahead of the game perhaps a little bit relative to Europe. Do you feel they've moved too far too soon? Is it just right? How does the pacing of the evolving central bank policy look to you?

Miles: I think at the moment it's okay. There isn't an issue with going too fast, I don't think. The difference in the central bank approaches is very much a mirror image of the varying inflation rates that we've just spoken about. Inflation is much more pronounced due to more rapid economic bounce back in the US. It shouldn't really surprise us that the US Federal Reserve is lining up to move before the ECB [European Central Bank].

I think the pace is right. It's right that those expectations have been pulled forward because again that's a reflection of the fact that central banks are taking their mandate seriously.

Clearly, I don't think there's anything wrong with that. I think where you may get, and you're going to start to risk policy error, where you're going to enter the realms of policy error debate, is once you've had a few rate hikes, do you want to see any more? How much of a gap should the central banks that are going to move first – the Fed and the Bank of England – leave in between tightening to see how the dust settles and how much scope have they got to do that?

The fact that these central banks have started, in the Bank of England's case, or have clearly made us very aware of the fact that they're about to start in case of the US Federal Reserve, I think that's fine. The danger points are going to come in a few months' time when they've delivered two or three hikes, do they need to deliver more? Do they need to pause for a bit, and how's the economy going to take that? For the time being, the pace is fine, the more testing times are going to come a few months down the track.

David: If the pacing is fine, how far do you think central banks will actually have to go in tightening, and what might be the combination between perhaps, official interest rates and quantitative tightening? For example, will the ECB rely solely on reducing its bond purchases or should we expect a rate increase in the eurozone too?

Miles: Taking the last question first, it's not unreasonable you will eventually see rate hikes for the ECB. I think it's not on the agenda for the time being, I think they're at the very initial stages of it all. Obviously, one step at a time and ending any bond purchases first. If you look at some government forward rates, in German government bonds, for example, we tend to look at forward rates because they strip out where you are right now, looking at the markets looking a year ahead. It's sort of a front end barometer for perhaps where the German government bond market is seeing things as the one-year rate one year forward.

That rate, although it's still in negative territory, the market is still priced for slightly negative interest rates even a year into the future in Europe, it's less negative than it was. It's risen by about 50 or 60 basis points over the last few months. Although still mildly negative, it's actually the highest it's been for five years. I wouldn't really have any argument with that market pricing.

The market is clearly entertaining the idea that perhaps European interest rates will be rising gradually in 12 months' time or so. I think that's not an unreasonable assumption. Bear in mind they are coming from a negative area. I certainly wouldn't rule out a rise in interest rates from the ECB, but not just yet. That's still several months at the earliest and possibly at least a year away.

Going back to the first question with the combination of interest rate rises and quantitative tightening. The markets so far have priced it to be much more of an official interest rate rising tightening rather than a meaningful quantitative tightening I think. The reason I say that is because of the dramatic flattening we've had in the yield curve in the US in recent months. You've had a big rise in the expectations for near-term interest rates, but the longer-dated rates on longer-dated bonds on those, the forward rate that implies for many years into the future, haven't really budged up very much, and are in fact still a long way below.

If you look at the 10-year average before Covid struck, they're still a long way below that. Bear in mind that's a period when inflation was generally very well behaved/ subdued in the wake of the financial crisis. The fact that longer-dated treasuries and longer-dated gilts are still not pricing in anything like those higher rates in future years, would suggest that markets are very much focused on rises in official interest rates being the tool, certainly initially, rather than any form of quantitative tightening.

That's a dangerous assumption. In terms of where we're seeing things in portfolios, the bonds that are perhaps now most vulnerable to further repricing are the longer-dated nominal bonds in particular because they haven't really reacted that much to this change in signalling from central banks. The first phase of this, yes, will be an initial tightening in official interest rates but as we get further down the line and if more tightening is required, not only do I think, but central banks have started to signal to us that actually they would very much like it to be a combination of the two, and I think markets are vulnerable to that. Certainly to the quantitative tightening element of things, if and when that becomes a tool the central banks do use, which I think will be on the agenda a few months down the line.

David: Fair to say then that your view would perhaps be summarised as slightly negative on bonds at the moment for the government sector, and with steeper curves evolving over the course of the next few months?

Miles: I think certainly the cautious and slightly negative view and a fear that the US may head higher, that's definitely true. What we would observe is that they're very aggressively flattening, almost suggesting it's a policy error, can only go so far. If you get a further sell-off from here it's possible that shorter date yields continue to go quite a lot higher as well so the curve might not steepen that dramatically, but certainly we think if there's more pain in bond market and more repricing in yields, then it's time for longer bonds to play their part in that as well because they've been fairly well protected from the significant repricing in bond markets we've seen over the last few months. We don't think that can continue. If bond markets need to reprice further, we think all yields need to head higher.

David: Given this evolving policy environment that Miles has been describing, Richard, I wonder if you could perhaps elaborate on how this might actually impact in a wider range of bond assets. Specifically your thoughts on how the corporate bond market might respond to this developing policy environment.

Richard: I think the rise in inflation and the prospect to the change in monetary policy really bears down on credit markets in two separate ways. The first is on general risk appetite. Credit is a risk asset and investors need to be compensated for the risks that they bear. I think coming into this year, investors really were faced with a market place with very tight spreads.

If we parallel that back to a previous occasion, if we look back to 2018, the Federal Reserve was pushing rates higher at that time and risk appetite was low. Investors really stood aside from the market place and we saw a slow but steady widening in credit spreads. Spreads move by roughly 90 to 100 basis points, almost a whole percentage point wider. On a market with a five-year duration, you're looking at a 5% capital price loss from that.

Clearly, if it takes all year then your interest rate and your coupon income off that which would reduce it. Nonetheless, if that's the environment, if the parallel is 2018, we would expect investors to stand aside from this market place and allow spreads to generally widen out over that period. Credit investors may be looking at yet another year of negative returns and that prospect, I think, does hold investors on the sideline. Alongside this debate as Miles said, the moment it's mostly focused on inflation and the change in monetary policy, but if in the months ahead we begin looking at a change from quantitative easing to potentially quantitative tightening, whether that's through central banks stopping the investment coupons or actually beginning to dispose of chunks of their balance sheet, that's a significant loss of positive inflows into the marketplace. I think that would be felt.

Investors have been poor at quickly recognising the signs of those deteriorating technicals within the marketplace and have mostly begun to price those in with hindsight. I think there's a general loss of risk appetite – that's already evident in market places. Then inflation hits in a different way, which is it hits directly onto the balance sheet for some companies. We are seeing the ravages of the pandemic and a period of subsequent inflation hits on balance sheets particularly hard.

We've seen labour cost rises in some parts of the economy and in some segments we've seen difficulty in obtaining labour – maybe it's the leisure sector or certain parts of the industrial value chain where companies are struggling to replenish their workforce. We've seen the cost of that workforce increase. Then we're seeing inflation feed through in terms of input prices. That hits credit markets in different ways. Perhaps the investment rate is more resilient to this with more branded goods and more pricing power from these individual companies.

How your manufacturers who might be producing white label products who don't have that branding with which to push through those new costs are finding their margins squeezed and balance sheets are deteriorating. That's requiring skilled management to work hard to keep these businesses running at full steam. On one side, you've got demand has been stoked with low interest rates by central banks and supply chains have been disrupted by both inflation and the Covid pandemic. That again we're seeing the rise of individual company, I'll almost use the term distress. We're seeing in the current market, a number of issuers get hit quite hard in terms of market pricing. They get hit quite hard as a result of these deteriorating margins which come through from the facts that Miles has described.

David: Within that environment, do you see any brighter spots in the market place which still look investable? Even allowing for the inflation environment and the pressure on cost, supply chain and labour?

Richard: Yes. We take the view that the market place is filled with opportunity. We start by asking the question, even on these more distressed companies, it's whether or not they have the balance sheet, or they have the liquidity, or the management expertise to see their way through these changing market conditions. Do they have a sales structure, maybe with contracts, that renew on a frequent enough basis? Do they have the ability to push through price rises onto their customer base? Do they have the ability within the business to restructure, to squeeze out cost pressures elsewhere, and therefore rebuild those margins? Ultimately do they survive and how long can they survive in these difficult situations?

We shouldn't be afraid of these assets when they fall heavily in price. We need to do the work and think carefully about those risks and then come back to this question, which whether or not we get paid to take that risk at that point in time. Beyond that, I don't think that all balance sheets suffer in the same way. I think that if you are a high-quality investment-grade issuer, perhaps in the consumer sector but you have a valuable brand, you have the ability to push those price hikes through. Therefore you're not having to absorb that on margins. Then again you can see your way going through these types of environments.

David: Very interesting. What you're really suggesting then is that there are pockets of value out there but you really need to do your homework before you get too involved in buying names at this part of the cycle so you've really got a full understanding of what the risks are that you can actually can contrast that with the market pricing in order to really make that proper value judgment. Richard, for many years conventional wisdom essentially promoted by the market, has been to look to buy the dips. Should we be exercising more patience here? What do you feel is the best strategy for the uncertain world we face in 2022?

Richard: Well, David, as you know we've always valued patience as being a critical element of any investment strategy. I think what you're referring to is this belief that investors should always buy the dip. With central banks being acutely aware of market distress but willing, and with the playbook, to come out and defend market valuations, that any episode of weakness will be met by central bank intervention and therefore, as investors, we should take risk ahead of that into that short-term weakness.

What Miles has talked about right at the outset is if in the coming months or quarters central banks begin to withdraw their immediate liquidity injections into the market place, so even if it's just a cessation of the reinvestment of coupons and ultimately later on, the beginnings of a disposal of balance sheet, in that environment it's clear that central banks would be prioritising a larger macro feature like inflation in their thinking than necessarily the health or, dare I say, the P&L of investors' books.

I think at the moment, certainly, that we should have more patience in the face of an underlying shift in monetary policy that slowly withdraws the immediate support from that marketplace. Rather than buying the dip, we go back to an environment in which investors once again need to be well compensated for the risk they're taking. That to me, again, points a little bit towards a 2018-type scenario where we should expect to see spreads meaningfully wider, not just a little bit wider before we act.

David: It's quite interesting in this environment as well that with the withdrawal of support of quantitative easing gradually happening over the course of the next few months, we will actually see whether indeed the market reprices to cheaper levels, or whether or not the momentum that has been engendered over the last 18 months continues a little bit further even as official interest rates start to rise. I think it's an interesting environment for all of us investors. Thank you both very much for your thoughts and insights today, and look forward to the next podcast with you both.

[music]

Richard: Thank you.

Miles: Thank you very much, David.

Host: This podcast is for investment professionals only. For further information, please view the notes which accompany this episode.

[00:21:10] [END OF AUDIO]

For Investment Professionals only. Not for onward distribution. No other persons should rely on any information contained within. This guide reflects M&G's present opinions reflecting current market conditions. They are subject to change without notice and involve a number of assumptions which may not prove valid. The distribution of this guide does not constitute an offer of, or solicitation for, a purchase or sale of any investment product or class of investment products, or to provide discretionary investment management services. These materials are not, and under no circumstances are to be construed as, an advertisement or a public offering of any securities or a solicitation of any offer to buy securities. It has been written for informational and educational purposes only and should not be considered as investment advice, a forecast or guarantee of future results, or as a recommendation of any security, strategy or investment product. Reference in this document to individual companies is included solely for the purpose of illustration and should not be construed as a recommendation to buy or sell the same. Information is derived from proprietary and non-proprietary sources which have not been independently verified for accuracy or completeness. While M&G Investments believes the information to be accurate and reliable, we do not claim or have responsibility for its completeness, accuracy, or reliability. Statements of future expectations, estimates, projections, and other forward-looking statements are based on available information and management's view as of the time of these statements. Accordingly, such statements are inherently speculative as they are based on assumptions which may involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such statements. All forms of investments carry risks. Such investments may not be suitable for everyone. **United States**: M&G Investment Management Limited is registered as an investment adviser with the Securities and Exchange Commission of the United States of America under US laws, which differ from UK and FCA laws. **Canada:** upon receipt of these materials, each Canadian recipient will be deemed to have represented to M&G Investment Management Limited, that the investor is a 'permitted client' as such term is defined in National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations. **Australia:** M&G Investment Management Limited (MAGIM) and M&G Alternatives Investment Management Limited (MAGAIM) have received notification from the Australian Securities & Investments Commission that they can rely on the ASIC Class Order [CO 03/1099] exemption and are therefore permitted to market their investment strategies (including the offering and provision of discretionary investment management services) to wholesale clients in Australia without the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Cth). MAGIM and MAGAIM are authorised and regulated by the Financial Conduct Authority under laws of the United Kingdom, which differ from Australian laws. **Singapore:** For Institutional Investors and Accredited Investors only**.** In Singapore, this financial promotion is issued by M&G Real Estate Asia Pte. Ltd. (Co. Reg. No. 200610218G) and/or M&G Investments (Singapore) Pte. Ltd. (Co. Reg. No. 201131425R), both regulated by the Monetary Authority of Singapore. **Hong Kong:** For Professional Investors only. In Hong Kong, this financial promotion is issued by M&G Investments (Hong Kong) Limited. Office: Unit 1002, LHT Tower, 31 Queen's Road Central, Hong Kong. **South Korea:** For Qualified Professional Investors. **China**: on a cross-border basis only. **Japan: M&G Investments Japan Co., Ltd., Investment Management Business Operator, Investment Advisory and Agency Business Operator, Type II Financial Instruments Business Operator, Director-General of the Kanto Local Finance Bureau (Kinsho) No. 2942, Membership to Associations: Japan Investment Advisers Association, Type II Financial Instruments Firms Association. T**his document is provided to you for the purpose of providing information with respect to investment management by Company's offshore group affiliates and neither provided for the purpose of solicitation of any securities nor intended for such solicitation of any securities. Pursuant to such the registrations above, the Company may: (1) provide agency and intermediary services for clients to enter into a discretionary investment management agreement or investment advisory agreement with any of the Offshore Group Affiliates; (2) directly enter into a discretionary investment management agreement with clients; or (3) solicit clients for investment into offshore collective investment scheme(s) managed by the Offshore Group Affiliate. Please refer to materials separately provided to you for specific risks and any fees relating to the discretionary investment management agreement and the investment into the offshore collective investment scheme(s). The Company will not charge any fees to clients with respect to '(1) and '(3) above. M&G Investments is a direct subsidiary of M&G plc, a company incorporated in the United Kingdom. M&G plc and its affiliated companies are not affiliated in any manner with Prudential Financial, Inc, a company whose principal place of business is in the United States of America or Prudential Plc, an international group incorporated in the United Kingdom. This financial promotion is issued by M&G International Investments S.A. in the EU and M&G Investment Management Limited elswhere (unless otherwise stated). The registered office of M&G International Investments S.A. is 16, boulevard Royal, L-2449, Luxembourg.M&G Investment Management Limited is registered in England and Wales under number 936683, registered office 10 Fenchurch Avenue, London EC3M 5AG. M&G Investment Management Limited is authorised and regulated by the Financial Conduct Authority. M&G Real Estate Limited is registered in England and Wales under number 3852763 and is not authorised or regulated by the Financial Conduct Authority. M&G Real Estate Limited forms part of the M&G Group of companies.