The Investment Podcast

M&G Investments

Episode 19: The Investment Podcast: Spiralling inflation…this wasn't supposed to happen
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David Parsons: Welcome to the latest fixed income podcast. My name's David Parsons, and I'm joined once again by David Lloyd, Deputy Chief Investment Officer of Public Fixed Income at M&G. Welcome, David.

David Lloyd: Thank you.

David Parsons: Obviously while recent events in Ukraine have dominated the news cycle, today, we thought we'd take a look at some of the deeper economic issues that are developing – and what the implications might be for markets. Since the global financial crisis, whenever the volatility in the market has risen significantly and the financial markets have gone into freefall, central banks have responded with ever greater degrees of largesse. A comfortable coalition, if you like, has existed between central bankers and politicians to keep the good times rolling. However, the belief that central banks have successfully delivered low inflation is being tested in today's environment. Is this a classic case of correlation being mistaken for causation?

David Lloyd: Certainly, up until quite recently, the perceived wisdom seems to be in the central banks, the heads of which have enjoyed almost godlike status, have engineered a really benign environment in which inflation has been conquered and in which so-called quantitative easing, which as we all know is basically just printing money, has been successfully rolled out in waves to support economies, to support the financial system and to support asset prices. As that has unfolded since the response to the global financial crisis, there's been quite a lot of comment and debate around these issues.

For example, focusing on the rise of asset prices and the consequent impact on wealth inequality, housing affordability, and that kind of stuff. At the other end, at the less cautious end of the debate, we've seen monetary creation heralded by some as a magic bullet, which can be employed pretty much without limit. What has really been conspicuous by its absence in many of these debates around this unconventional monetary policy was a focus on the threat to inflation in goods and services outside of the asset price story, everyday inflation, if you like, because I think the widespread belief was that beast had been slain.

With the sudden arrival of high inflation now, it's probably fair to say that there's been an unrealistic trust placed in the central banks. I think with that trust came significant complacency around inflation. To my eye, at least, the Covid pandemic, and now the conflict in Ukraine has reminded us of a fairly simple but important truth, which is this, that central banks can albeit in a pretty imperfect way influence demand. I think it's also shown that they're almost powerless to deal with supply-side shocks, and those supply-side shocks are a very significant component of the current resurgence in inflation.

Just to be clear, this isn't a question, the competence of central banks, although pre-pandemic, there were big questions around why monetary policy had been so loose for so long. As I said, not to necessarily question the competence, it's more to recognise the limitations of what they can and can't do. Of course, that hasn't stopped criticism from politicians now that inflation has become a live political issue, and we'll have seen comments of the, you only had one job variety.

David Parsons: Where does that leave us today do you think?

David Lloyd: Well, it's tricky. We've got inflation in the major economies that is approaching double figures. It's setting 30, 40-year highs in a number of countries. I think an interesting place to look is the Eurozone. The most recent inflation print is just over 8%, 8.1%, but that disguises a really wide range of inflation outcomes at the country level. For example, in Malta, the most recent print is 5.6%, and in Estonia is 20.1%.

I think this huge spread of inflation outcomes has exposed the limitations of monetary policy, because in the UK or the US, it's quite tempting to look at policy settings, quite simplistically and infer that there's a causal link between the stance of monetary policy and the delivered rate of inflation. You can look at the rate of inflation and look through the telescope on the other end and say, "Well, it is that policy setting that led to this rate of inflation." Then, of course, that could inform the basis of a critique of the policy setting, where we can see within the Eurozone with that massive range of outcomes that I've just mentioned that it is far, far more complicated than that. The final bit of the answer to the question of where are we now? I think it does need to be said that given the significant passage of time, since we last off inflation at these levels, there's a whole generation of investors who have never had to confront the reality that we see today.

David Parsons: With inflation firmly embedded in markets, the challenge for investors is where to put their money to achieve a positive real return. How would you address that, David?

David Lloyd: Well, to be honest, I don't think it's possible. Right at this moment, we're in a world of deeply negative real interest rates. Positive real returns are not available without taking fairly speculative positions on the short-term direction of market. If you're not feeling that heroic, painful, though, it is to say there's no safe haven on offer as we look at markets right now. Historically, of course, investors will park their money in cash, and wait until equities or fixed income or whatever, offered a more attractive opportunity but the cost today in real terms of parking your money in cash, is that you're losing 7% or 8% on an annualised basis.

David Parsons: So what should we be doing? Should we be investing differently? Do we have to adjust our mindset or our horizons?

David Lloyd: I think it's a bit of both, to be honest with you, and that they are very much linked. I think the most important quality we need right now is clear-headedness. A really important variable, inflation, has changed really significantly for the first time in decades. That's a nontrivial development. This is a pretty opportune time for investors to revisit, and revalidate, if you like, their approach to investment. What does that mean? I guess, to me, this means being really clear, really clear about a number of things.

First, what's your timeframe? Secondly, what is your understanding of and what is your tolerance for risk, and this is really, really key. As fixed-income investors risk when you boil it right down means the risk of permanent loss. In other words, when a borrower defaults on their obligations, and clearly, that is something to be avoided. We shouldn't confuse risk with volatility, which is sometimes very aggressive ups and downs of market pricing. If we can look through the noise of volatility, whilst of course, always being alive to the possibility of permanent loss.

If we can look through the noise, then the job does become a lot less fraught. Adopting a long-term timeframe is by far and away the easiest and most effective way of proceeding.

David Parsons: Okay, so if we employ that longer-term horizon, where should we look for value or at least to mitigate the punitive cost in real terms of holding cash?

David Lloyd: Yes, good question. I suppose, again, the risk of caveat in the question again, I suppose you probably need to ask yourself the question, are you investing on the basis of looking for opportunities and looking for attractive returns? Are you doing so on the basis of making the best of a bad job for now? That being said, areas of the bond market offer yields which are significantly in excess of cash rates, which isn't a bad starting point. Of course, at the same time, bonds provide a significantly greater degree of certainty of outcome than say, equities do.

Through the fixed income lens, the key question has always been, will I get my money back? This has a wonderful simplicity to it, when you consider the current turmoil around inflation, economic outlook, uncertainty around policy, geopolitics, and all the rest of it, to be able to boil down the prospect of an investment to one simple question. Will I get my money back? I think it's very helpful and it's certainly the case that the outlook for other assets can never be boiled down to such a simple question.

When you take this together with the presence of a maturity date, this provides real clarity to what it is we're considering. We know what income we're going to get. We know when the capital is due to be repaid but we do, of course, need to have a very considered view regarding the risks that the borrower will not be able to meet these obligations. The key, of course, to assessing those risks is research and analysis. There are no shortcuts.

It's more important than ever, of course, to focus on understanding the individual risks in a portfolio and investments to ensure the confidence that you're going to be repaid. That background, that approach, it does allow us to buy increasingly attractive, cheap, if you like, bond assets that we're confident will repay over the life of the bond and focusing on the known maturity of each asset, in effect adopting a hold to maturity mindset, it does see you through the current noise.

Back to the question, positive real returns are very difficult to achieve at the moment. There's no escape from that reality. I'd say the known returns currently offered by bonds and the fact that at the moment, they offer yields that are significantly in excess of cash rates, that mitigates some of the punitive costs of holding cash. So, it remains in our view probably a better home for now, certainly than cash, and possibly other assets too. As we began by saying, this wasn't supposed to happen bearing in mind the trust that hitherto had been placed in central banks, but for now at least it’s the reality.

David Parsons: I think that's right, known flows or coupons versus unknown dividend flows and a recognition that there's no quick fix is probably the new reality. As you say, today's environment requires a longer timeframe and a willingness to look through the noise and perhaps accept short-term volatility in asset prices. Current levels of inflation though mean that the cost of parking in cash has become prohibitive. Fixed income, I think can mitigate the cost of de-risking, but it's not going to eliminate it completely. However, with patience and a clear understanding of the default risks of the companies you invest in, bond investors should live to fight another day. Thank you very much for your time, David, and we look forward to our next podcast.

David Lloyd: Great pleasure.

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Speaker 2: For further information, please view the notes, which accompany this episode. 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 they 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.

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