The Investment Podcast

M&G Investments

Episode 16: The Investment Podcast: Weathering the inflation storm
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David Parsons: Welcome to the latest Fixed Income podcast. My name is David Parsons, and I'm joined today once again by David Lloyd, Deputy Chief Investment Officer of Public Fixed Income at M&G. Welcome, David.

David Lloyd: Thank you.

Parsons: Obviously, recent events in Ukraine have dominated the news cycle and the Russian aggression and accompanying humanitarian disaster have been widely discussed and documented. Our thoughts are very much with the people of Ukraine in this darkest hour, and we hope that a peaceful resolution to the crisis can be arrived at as soon as possible.

In addition to the human cost, the implications for the major developed economies of this unfolding crisis in Ukraine are also likely to be substantial and with the intended sanctions, supply chain disruption, and economic impact coming on the heels of an evolving inflationary environment which has proved anything but transitory.

With that in mind, we hope today to look past the immediate conflict and to think about and examine some of those deeper economic issues that will remain once a peaceful settlement has hopefully been achieved. David, to coin a phrase, what are the key things that we know already and what we can observe at this point in time from an economic perspective?

Lloyd: Thanks, David. I think the inescapable thing right in central focus on a purely economic perspective is inflation. We've talked many times before, and we've been observing markets and economies for a good many years and the current increase in inflation is something that bears no resemblance to anything that we've seen, really, for decades. In previous podcasts, we talked about the "great moderation", which included amongst other things, moderation in inflation, and that it seems, sadly, has very much come to an end.

Parsons: Is it fair to say then that with the end of the "great moderation", that spills over into some of the other beneficial areas of the "great moderation" that would have been, for example, low inflation, low-interest rates and increased globalisation?

Lloyd: It almost seems the burden, an inflexion point, or at least we're at a point where things that we've taken for granted almost for years, perhaps we shouldn't have done but we've taken for granted for years, has to be questioned once again. When you think about what the policymakers have been up to for a good few years now, we have been fighting multiple crises, starting, of course, with the global financial crisis, and we have the Euro sovereign debt crisis, we've had Covid, [and] in the case of the UK, we've had Brexit, which regardless of whether you think it's a good idea or not, the facts are that there is a period of adjustment.

Now, of course, we've got the crisis in Ukraine, but where this is different is that if you look at the crises that have gone before, the policy response has been around supporting the financial system and supporting growth. One of the things that the authorities never had to worry about or certainly the data would suggest they didn't have to worry about, was the impact on inflation, so they could take really extreme fiscal and monetary policy measures, apply them to these crises, be it the global financial crisis or subsequent ones that are more macroeconomic nature and not really have to worry about inflation. That, obviously, has profoundly changed.

Parsons: Is it fair to say that what we're seeing at the moment is the wrong kind of inflation?

Lloyd: It's interesting, isn't it, that the inflation, as far as I can see, is if we wind the tape back a few months because certainly, the markets were beginning to get focused on it before the Ukraine crisis began, that you had almost a perfect storm which you had a very, very sharp recovery in economic activity, a very sharp recovery in demand as economies and the individuals within them came out of Covid-related lockdowns.

You have this vast acceleration in economic activity coming up against a supply-side which was inelastic if you like. It was suffering from constraints which were themselves caused by the Covid crisis and other factors too. I think it's interesting that we've got a situation now where, and of course, we can add to that the impact on commodity prices, food prices, oil prices, etc. that accrue directly from the Ukraine crisis.

When you think about what the levers are that the policymakers have, you could, I suppose, term it as the wrong kind of inflation, in this sense, which is many aspects of this inflationary problem are supply side. The only tools really that the policymakers have got to manage demand, and to say the least, is a little bit premature to start trying to choke off demand when it is only just recovering, and that is, of course, something that is entirely desirable, is only just recovering from the falls that you saw as a result of Covid.

Parsons: Taking that one step further, it puts the central banks in a very challenging position of not necessarily being able to directly address the issues that are facing the developed market economies. We have central banks with differing mandates in terms of where they should be putting their emphasis, be that to either support growth in the economy at the same time as keeping inflation under control or having a purely inflation-fighting remit, for example, the ECB. How do you see the implications of this supply-constrained inflation feeding through into policy and what are the risks around that?

Lloyd: You rightly point out that central bank mandates differ, certainly, in terms of the way that they are formally set out. Of course, the impact of what we're seeing at the moment differs from country to country, for example, depending on whether it is or isn't a net importer of energy or commodities related to the generation of energy. In that regard, the United States will be in a different situation from Europe. Continental Europe is in a slightly different situation from the UK, although, of course, most of these commodities, they're globally priced anyway.

I've been doing a fair amount of reading around what central banks, not only are doing but actually what they're saying. I think there's a fairly clear recognition that many aspects of the inflation that we're seeing at the moment is just not something that they can control. Of course, the Bank of England mandate, to take an example, openly accepts that inflation may drift away from its target, and in times of crisis, may indeed do so quite significantly and for a protracted period of time.

I think it's fair to say that the exchanges, whether they be in letters between the Chancellor and the Governor of the Bank of England – and I think these themes read across to the other central banks too – is an acceptance that there is only limited capacity for the central banks to control what's going now on the inflationary side. They will trust to that inflation coming down over time, as for example, commodities stop going up.

I think, still, if you're thinking that the central banks are in something of a bind, do they support growth or do they try and tame inflation? I think on balance, they're still very much in the camp of supporting growth.

Parsons: That's very interesting. Their continued willingness to do that perhaps contrasts with the government's limited opportunities to do so given the extent to which government deficits have been accelerating during the Covid crisis and are now at levels that would have been, quite frankly, unheard of in anything other than the deepest depths of the Second World War. Given the restraints on government support for that, can central banks address these issues single-handedly? Are they in a position to do so, do you think?

Lloyd: No, in all probability, they're not. Certainly, the fact is quantitative easing is being paid back, interest rates are beginning to go up, so it isn't that the central banks have taken their eye off the ball completely. Of course, they haven't. It would be ludicrous to suggest otherwise. Certainly, if you look at what's going on in the Federal Reserve (Fed) and the backup in yields in the US interest rate markets and the expectation of what the Fed will do going forward, of course, there is an expectation that interest rates will continue to go up.

I think the observation I made a moment ago, I think it's important to place that in the context of where real yields are or real interest rates are, that is nominal rates adjusted for inflation. If you look at either officially administered interest rates in Europe, the UK, United States, adjusted for inflation, whether you're looking at administered interest rates or government bond yields, we are in deeply, deeply negative territory.

As we've said before, inflation in the US is as high as it's been for 40 years, in Europe, in the UK, as high as it's been in 30 years. A similar observation and perhaps probably a more extreme observation could be made in terms of when we last saw real interest rates in such deeply negative territory.

I think my sense going forward is this: real interest rates are unsustainably negative and of course, there are only two mechanisms for that to unwind. One is for inflation to fall or the other is for interest rates to rise starting of course with administered interest rates by virtue of central bank action by extension perhaps government bond yields going up with them.

My sense at the moment is that the likely normalisation of real interest rates into something at least resembling sensible territory because we are not there at the moment, that will unfold over time as inflation begins to moderate largely of its own accord rather than really aggressive action on behalf of the central banks, which of course would be the very threat to growth that I'm sure they wish to avoid.

Parsons: We've talked in the past about the risk of central bank policy errors occurring. Are we in a position where the error has already occurred?

Lloyd: That's a really tricky one, I think. If we go back a bit and look at some of the monetary policies that were implemented in direct response to the global financial crisis, we saw the widespread effective printing of money, which prior to the global financial crisis, we normally associated with dysfunctional economic regimes, Zimbabwe to pick one out of the air, which would end in ruinous inflation.

However, what has certainly happened is that we've seen a vast expansion of central bank balance sheets, which is a function of this monetary creation. In the popular consciousness, at least, has not produced inflation, but of course, it has. It has produced inflation in those areas that have been directly affected by this money printing, which is causing asset prices. Elsewhere in what I think people would normally think of inflation in goods and services.

Then, of course, there's been significantly less impact. I think our old friends of deregulation, globalisation, automation, etc. have been very big players in the comparatively sound good behaviour of inflation against the backdrop of policy settings which historically we would've thought would've produced it. I have to be perfectly honest and say, I don't really know the answer to your question, which is, has the effective printing of money, which has been going on since 2008, resulted in the inflation that we are seeing now?

I really don't know, but what I'd say is this, that inflation certainly has occurred as a result of those policy settings and has been clearly evident in asset prices.

In many respects, it doesn't really matter in the sense that the inflationary impact we're now seeing in goods and services, the central banks have got to deal with anyway, regardless of how it's been generated.

Parsons: I suppose you could also argue that from an overindebted government point of view, inflation is actually somewhat helpful in inflating away government debt over the longer term.
Lloyd: Yes, and that's a classic example of be careful what you wish for.

Parsons: Yes, quite.

Lloyd: It's interesting that the central banks have an inflation target and were it easy to keep inflation at or very close to those targets, then I think that would've been achieved more often than not, but of course, it isn't.

For many years we were worrying that inflation was undershooting targets and now of course we're worrying that inflation is overshooting targets. I think the idea that overindebted governments when ministers of finance are looking in the mirror who is there, getting ready for work in the morning and saying: "If only I could engineer the perfect inflation rate to help me slightly inflate away government debt." A, I'm not altogether sure what that perfect inflation rate is, but B, I'm very, very sceptical about any policies makers' ability to achieve it.

Parsons: Thank you, David. I guess the final piece of the jigsaw is to then ask the question from an investment perspective, what should investors be doing at this point in time. Given everything that you've drawn our attention to?

Lloyd: I think the answer inevitably has to be waiting. In any crisis and in any market reaction to that crisis, I think one of the most important things is how you went into it. If you went into it very, very long of risk assets and risk assets suffer, then, of course, you'll be licking your wounds. If you went into a crisis short of risk assets and they read price, then, of course, you are less licking your wounds and more eyeing the opportunity that might lie ahead.

I'd probably sum it up like this, that the situation that we're in at the moment is quite astonishingly difficult to analyse and draw firm conclusions from. It's almost, to me, that the consequences of making a forecast and then your fortunes being a function of whether that forecast is actually it or not, really is, at this moment, is a fool's errand. Not only is the future especially uncertain but I think even if you could map it out reasoned accurately, I'm not altogether sure that you could have a really clear view of what it meant for asset prices.

As it were, think about it in the terms from a value investor which, disclosure alert, I am a value investor, and look at the opportunities that have presented themselves following the repricing of assets. I think I have to say at the moment that I don't believe that we've seen an adjustment in prices of sufficient size or sufficient severity to make me think almost it doesn't really matter what happens going forward, this stuff is just cheap.

I don't think we are behaviourally there yet. I don't think we've had the big blow-off selling of assets that we've seen in previous crises. Also, I think that the value signals are still pretty tepid, bearing in mind the possibility of significant increases in interest rates, which might come through from central banks. At the risk of sounding like it's a bit of a cop-out, I really do believe that extreme caution is warranted. I think waiting is warranted and keeping dry powder, I think is a sensible thing to be doing at this stage.

Parsons: I can certainly see that that would be the best step forward from here, particularly as there's an awful lot of further unknowns around global supply chains. The long-term impact of sanctions, for example, which are almost impossible to estimate at this point in time, not knowing their duration or whether they will continue to be in place or even the extent to which they might bite into the economies of the developed nations.

If I'm hearing you right and certainly this feels like the right strategy, if I had to sum it up it would be that patience is likely to be the best strategy and potentially in the long-term, the best-rewarded strategy.

Lloyd: It's always been the most underrated strategy.

Parsons: Thank you very much, David. Greatly appreciate your time and I look forward to our next podcast.

Lloyd: Thank you, great pleasure.

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