# The Investment Podcast

**Episode 7: Inflation – is it real?**
5 August 2021

**David P** [00:00:33] Welcome to another instalment of our investment podcast series. My name is David Parsons and I'm joined today by David Lloyd who is M&G's Deputy Chief Investment Officer of Public Fixed Income and Head of the Institutional Public Debt Fund Management Team. Welcome, David. It's fair to say that we've both been doing this for a while, David. If you had to briefly summarise our collective 80 years in the markets, how would you do so?

**David L** [00:00:59] Well, I would probably start off by saying how old you've just made me feel. I think the main takeaway is that hindsight is a truly wonderful thing. We can look back now, and things seem quite clear. But of course, at the time, they were very much less so. But with that benefit of hindsight, given that you have asked me to be brief, I'd say probably the first 25 years or so was spent in the period often referred to as the Great Moderation, which was then in 2008 very rudely interrupted by the global financial crisis and its aftermath. And, in the period since the global financial crisis, we've seen a number of subsequent ones. The most recent, of course, being last year and the ongoing COVID crisis.

**David P** [00:01:55] Yes, the Great Moderation. I remember it well. However, I think perhaps some of our younger listeners may not have had the benefit of being able to look back that far. How would you characterise the Great Moderation and what can we learn from that period?

**David L** [00:02:11] Okay, so firstly, it was a long period starting in the 80s and one of positive economic growth, low inflation and pretty importantly, reduced volatility in both growth and inflation. There were also some very totemic events during this period, which I think collectively serve to make us all feel good about things. For example, the end of the Cold War and the collapse of the Soviet Union and things of that nature. As it unfolded, there was increased faith in the soundness of economic policy and in the competence of governments and central banks. This confidence, translated into lower interest rates and into a virtuous circle of falling inflation, economic stability, and greater prosperity. I think it's quite interesting and because of the apparent success of all of this, I think it was sometimes referred to as the Goldilocks period. Central bankers achieved almost sort of rock star status as having their hands perfectly on the tiller of economic affairs and everything was and was always going to be alright. But it's worth remembering that the Federal Reserve governor, Ben Bernanke, attributed the Great Moderation not only to improve economic policy but, also to structural changes in economies and also to good luck. So he was, if you like, claiming only partial credit and he was recognising some factors were completely outside of the central banks insurance and that some policy success was actually fortuitous. But anyway, in any event, the Great Moderation played out over a long period of time, and it changed the investment landscape. People felt that they could invest with confidence and that their savings and investments wouldn't any longer be ravaged by inflation. I'm old enough to remember from childhood, in the 1970s, inflation had exceeded 25% in the UK and even in the early 80s peaked at over 20%.

**David P** [00:04:36] So Bernanke's structural changes that he referred to, how do you think they really fit into the inflation picture?

**David L** [00:04:44] You could group these structural changes into three main headings. So, technology and of course we have witnessed an unimaginable technological change in the last 20, 30 years. Some of the stuff that we use every day, my parents would regard as pure science fiction, such as satnavs, smartphones, etc., So, the extent and pace of technological change has been enormous. Deregulation, particularly of labour and goods markets, has obviously been a big part of the story, as has globalisation, where companies have adopted a much more globalised model. When looking at those in some kind of order, technology, has obviously delivered not only efficient production through automation and things of that nature but, also via the Internet, there have been remarkable levels of price transparency for consumers. Also, there is an ensuing competition because people know the lowest price that they can get and this competition has led to drive prices down. As far as deregulation is concerned, we can see large impacts from companies seeking out the lowest cost production through locating in countries where labour costs are a fraction of those in developed economies. And of course, global product markets offer producers vast economies of scale. So, again, you bring all these together and the result is a period of persistent economic growth, reduced asset volatility and booming markets.

**David P** [00:06:34] Very much, it's interesting just to look back over my own career and think that when I first started out, there was no Internet, there were no mobile phones, and a Bloomberg screen was just a little tiny black screen with very limited functionality and green characters that sat in the corner. If you were lucky enough to have access to it, it was the latest in cutting edge technology at the time. So, I think we've certainly come a long way in terms of the investment side of the market as well as access to technology and the wider implications of that. I guess, over time this has been felt through all

aspects of the industry and the service sector and investment markets. You did mention, though, that volatility was crucial. What did you mean by that?

**David L** [00:07:24] Okay, well, let's start at 101. So, markets need to be appropriately compensated for risk. That is absolutely central to the efficient allocation of capital. If you take a greater risk, you should expect a greater reward. So, the pricing of asset markets contain risk premia, and that is a component of a return that is compensating you for the risk that you're taking. These risk premia are the market's collective attempt to price risk appropriately. Now, when we talk about risk, in essence, we're talking about the range of possible outcomes associated with any particular act, decision or forecast. So, at the most basic level, we expect it to be dry but there is still a risk of rain. We expect to win, but there is a risk that we might draw even loose. Or, more pertinent to this conversation, I'm investing in this stock because I expect it to outperform the market, but there's a risk that it won't. But in the markets, of course, we tend to focus our caution on the bad things that might happen, which come in a variety of shapes and sizes. So, of course, there is this permanent loss when a company fails or if a bond defaults, but there are also gyrations in prices and returns. This is even with a company that is perfectly sound or a bond that is likely to and eventually redeems that power and the investor get their money back. There are still gyrations in the market along the way and when these gyrations, which is basically just volatility, when these generations are high, the market's focus is inevitably drawn to the potential downside of a particular stock. In these conditions investors become risk averse because in their recent experience prices can do up but prices also go down. Therefore, it follows from that, that the more volatile markets are, the greater compensation for risk is required. So, you turn that coin over and you get what happened in the Great Moderation. With the volatility of market drivers, which are growth, inflation and so on, as the volatility of those drivers fell, so did the volatility of markets. As such, the risk premium, the market demands fell, or put another way, the return required to hold an asset fell. So basically, all this adds up to higher equity valuations, lower interest rates, lower bond yields and lower credit spreads.

**David P** [00:10:16] So as well as lower inflation, lower volatility of inflation contributed to a long-term bull market for bonds, do you believe now in the current environment, the opposite might also hold true?

**David L** [00:10:28] I do, yes. Exactly that. If the volatility of inflation were to increase, even if the trend itself was reasonably benign, I believe that there would be consequences for asset prices. Incidentally, I'm not sure how my career would have panned out in a 30-year bear market rather than the 30-year bull market that I've been lucky enough to enjoy.

**David P** [00:10:49] You know what they say, it's better to be lucky than good. OK, so we'll come back to inflation and policy-making in a moment. But it does bring us back to the end of the Great Moderation. How does the global financial crisis of 2008, 2009 fit into the story and how did that change things?

**David L** [00:11:06] Well, first of all, it's worth remembering how scary it was. For a while...

**David P** [00:11:10] Hard to forget.

**David L** [00:11:12] Yeah, it felt apocalyptic. I vividly recall conversations about what our next careers might be and what transferable skills we had, bearing in mind we'd spent most of our lives looking at bond markets. I remember conversations with friends about how our life plans around work, children, homes, pensions would have been destroyed. It really was that serious and not just within the financial sector. The potential fallout looked like it could engulf us all. But anyway, in terms of what actually happened, I think a decent summation of the global financial crisis was caused by misallocation of capital, effectively lending to people who couldn't pay it back. It was by high levels of leverage, and both of those seem to be looking at risk through, if at all, through rose tinted glasses. I think looking back we could certainly question the efficacy of the regulatory regime at the time. I think a number of commentators would say that the GFC was, amongst other things, a failure of regulation. But anyway, the response to policy had to be massive and of course, it was. As well as rescuing the financial system, which, of course was the first and most important objective, policymakers were focused on fighting the risk of deflation once the immediate crisis was contained. And to do so, they unleashed a barrage of policy measures, including quantitative easing, which is essentially printing money. Now to your question, why is that still relevant today? It's these extraordinary policy responses that were put in place to address that emergency that are still very much part of the policymaker's toolkit today. The extraordinary has now become ordinary. Also, the post global financial mindset amongst policymakers was the threat of deflation and the fight against it should be at the forefront of policymakers minds. I think that largely that mindset is still prevalent.

**David P** [00:13:39] So if you put the Great Moderation, followed by the global financial crisis or GFC together, what's the 20,000 foot or the helicopter view, if you like, with regards to inflation, now?

**David L** [00:13:51] To be honest, it often feels like we have collectively forgotten about inflation. We've had a benign inflation environment for years and policymakers, as we've said, have been focussed on fighting deflation. They have seen their

extreme policy settings fail to produce any meaningful inflation. That said, I think there's a very significant flaw in this summary. The fact is, we have had inflation, and, in my view, inflation is linked to policy minded interventions. It's just that the money created through QE, effectively through money printing has largely stayed within the financial system. And so, it is asset prices, not prices of goods and services within the real or non-financial economy that have risen significantly. I think because asset prices go up, people say, well, that doesn't count because that's that is feel-good inflation. I like that. I like the fact that I bought a share and it's gone up or I bought a house and it's gone up. But in any case, it strikes me as a perfectly reasonable question to ask, what would be the impact with policy largesse, if you like to be targeted at the real economy?

**David P** [00:15:11] Yeah. So, part of what they've achieved really is to inflate the price of virtually every asset class. But fast forward to today, how do you think things look in hopefully a post-pandemic world?

**David L** [00:15:24] Well, of course, we can't and must never forget the human tragedy of COVID from which it will take a very long time to recover. But thankfully, economies are rebounding and although a lot is unclear about the way ahead, we now have rapid expansion in the United States, in the U.K. and elsewhere. Interest rates are at or around zero and we've got a highly stimulative fiscal policy despite some pretty horrendous deficits. Also, you then have central banks effectively printing money to buy government debt.

**David P** [00:16:04] I think that latter point is actually quite interesting because there is a real-world example of the long-term implications potentially, of central banks printing money to buy government debt. The Japanese experience of the last 30 years is something that I believe should worry investors.

**David L** [00:16:24] Indeed, and I happen to believe it has the potential to be the basis of some future crisis. But it is quite interesting because, of course, there are numerous precedents in which widespread monetary finance, monetary financing of government spending has had a far from a happy ending. You think about what collectively and facetiously a term basket case is like, such as Zimbabwe and some of the countries in South America which have experienced hyperinflation, which is attributable to just printing money. Japan, of course, is a very interesting example of this. The central bank buys pretty much all government debt issuance and has done for years. But of course, we should recognise that a good many people would say that nothing bad has happened as a result of that and not yet at least. With that aside, just parking the threat of weather there are crises lurking in the future as a result of this, I struggle to reconcile the rapid recovery of economies with policy settings that look consistent with trying to tackle a genuine existential emergency. So, it's remarkable to me what has actually become normal policy since the global financial crisis. Pretty much any peacetime period in history, the post global financial policy settings that we've witnessed are off the scale extreme. So given the sharp recovery in economies from the huge shock of covid, what was countercyclical policy, in other words, helping the economy when it needs it can really quickly become procyclical, which is effectively pouring petrol on the fire.

**David P** [00:18:27] I think you're right on that last point. The ECB, for example, continues to purchase great swathes of the euro corporate debt market, even though credit markets are trading today at better levels than they did before the COVID crisis. I guess the worry is that central banks have inflated assets now to a point where just the merest suggestion of a policy change by them or a taper or a reduction in their quantitative easing purchases, I think is likely to send markets tumbling. So, in a land of QE forever, I get that you're concerned that extreme, procyclical policy would eventually stoke inflationary pressure. Doesn't the market trust the authorities to tighten policy appropriately should the inflation threat start to materialise?

**David L** [00:19:15] That in many respects is the key question to which the answer is possibly. So perhaps those who are saying that the current uptick in inflation is temporary, and let's remind ourselves that it's gone to 5% in the US, which is the highest for decades. They may be proved right. It may be temporary and regardless of whether it is or not, some people will have faith in the authorities to move appropriately and quickly. But I'm a little concerned that some authorities, governments rather than central banks in the main, I suspect, have become not only complacent but actually emboldened by the apparent free lunch of debt being effectively financed by printed money. Now, of course, very few would admit that this is what's happening. They would of course, claim that monetary and fiscal policy are acting entirely independently. But it's worth bearing in mind that there are commentators and politicians out there openly espousing ideas such as modern monetary theory, which proposes that there is no practical limit on how much a government can spend using printed money. From an inflation point of view, that construct worries me. It really does. Incidentally, it does amuse me that the acronym for Modern Monetary Theory (MMT) is the same as that for a magic money tree. I think there is perhaps something pertinent to bear in mind there.

**David P** [00:20:58] I wish we all had a magic money tree. So, I guess you see policy as a risk if it's not tightened appropriately. But what are the structural disinflationary forces that we were talking about earlier, for example, deregulation and globalisation?

**David L** [00:21:12] That's a fascinating subject. And to be honest...

**David P** [00:21:16] Possibly worthy of another podcast even?

David L [00:21:18] Very, likely. But to be honest, I am unsure. I do wonder whether the pendulum around deregulation and globalisation may be beginning to swing the other way or at least that, we've had most or all of the benefits. As I say, I am really unsure about this. But certainly, the political agenda in large parts of the globe are coalescing around two really large themes. First, inequality, which is held to have massively increased in the post-global financial period because inflated asset prices benefited the already prosperous. The second main theme and probably more important than that is sustainability. In some and probably by no means all but in some respects, any serious attempt to tackle these issues is inimical to the deregulated, globalised model, particularly given that many people, I think, believe that these agendas can only be addressed with interventionist governments playing a much bigger role in the economy through their actions and through laws and regulation. So, the most simplistic way of looking at it, if one believes that deregulation and globalisation have been disinflationary, then it is worth pondering whether increased regulation and localisation might be inflationary.

**David P** [00:23:06] So picking up as ever on that inflationary point, then, what should we be looking at to track this going forward, do you think, to really give us a clue whether this is the direction of travel?

**David L** [00:23:18] I think, most importantly, I'll be watching very closely as to what the central banks do and what they say in response to incoming data. Central bank credibility is central to market confidence, and we need reassurance that the central banks are alive to the inflationary threat and that they will act accordingly should it properly materialise.

**David P** [00:23:39] Around central bank policy, I think the word on inflation that's been used most frequently is that it's expected to be transitory. Perhaps that could be a little bit premature? Labour market costs and supply chain pressures have a habit of starting out transitory and becoming quite sticky and entrenched. I think central banks at the moment seem to be running significant risks around a policy error if they do allow inflation to become entrenched.

**David L** [00:24:08] Indeed and we need to become alert to what we might call leading indicators for inflation. Particularly, I would pick up your point around labour costs, because without feeding through into higher wages, higher prices can't usually be sustained. That's why people often talk in terms of a wage-price spiral. Now, in the near term, people during COVID people have accumulated savings and those, of course, can support consumption and higher prices for a while. But in the end, wages will have to keep up if an inflationary trend can become a persistent thing. We are already seeing labour shortages in the US and the UK, particularly at the lower end of the wage spectrum. Record numbers of people have left the workforce and I've heard plenty of stories in the UK of businesses not being able to open or having to pare back their hours because they can't get the staff and hearing hotel staff being poached from one hotel to the other. This is feeding through into wages and I guess we have to be clear that the numbers at the moment are ticking up. As we said, inflation in the US is exceeding 5% and it's ticked up in the UK too. Inflation has arrived and the question remains whether the central banks can (whether it is more temporary or permanent) and if it is of a stickier nature, whether the central banks can put the genie back in the bottle. I think the final thing which is really key is our collective mindset. Our markets and individual economic decisions and actions are influenced by the expectation of persistently higher inflation. Thus far, the answer to this, we know and as I might have said earlier, inflation expectations are still pretty relaxed, pretty benign. But this is something we should watch really carefully, because if those changes, if people collectively begin to expect higher inflation, then there will be potentially significant consequences for asset valuations.

**David P** [00:26:47] So, bringing it back to where we started, is inflation real? Puns aside, I think we would both agree that we may be heading into a riskier territory for asset markets at present, and bonds, in particular, don't like inflation. This is something that we'll have to watch closely. There are relatively few investors today, though, I think, who have managed assets through inflationary periods, which I think potentially adds a further layer of risk to asset prices as well, should the inflation prove to be non-transitory. For now, though, we're going to watch the data, the central banks and the policy responses and gauge our own responses accordingly. David, thank you very much again for your insights today.

**David L** [00:27:26] My great pleasure.

**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 license 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**. This 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 elsewhere (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.

M&G Investments