The Investment Podcast

Episode 12: The Investment Podcast: Is the inflation genie out of the bottle?
22 November 2021

Announcer 1: *The Investment Podcast,* brought to you by M&G.

Announcer 2: 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.

David: Welcome to another instalment of our *Investment Podcast* series. My name is David Parsons, and I'm joined today by Miles Tym, our senior portfolio manager for government bonds in the institutional and public debt team. Welcome Miles. Thank you for joining us.

Miles: Hello.

David: For almost 30 years, the long-term trend in government bond markets has been towards ever-lower rates driven by globalisation, technology, and accommodative central bank policies. However, since the Covid crisis, we've seen a quantitative easing-driven explosion in government indebtedness and a massive expansion of central bank balance sheets. As we emerge from the crisis, transitory inflation has become even stickier amid supply chain problems and sharply higher raw material costs. Indeed US inflation recently printed at 6.2%, its highest level in 30 years, while in the UK, the Bank of England forecast inflation will peak at 4.4% next year. Against this backdrop, have central banks lost control of policy, is inflation here to stay? Miles, your thoughts?

Miles: I think firstly, there's no doubt that the current supply chain difficulties are exacerbating inflation problems. The spot prints that we're seeing, particularly in the US and the UK probably overstate the danger of inflation going forwards. That being said, they're very lofty numbers. The 6% numbers in the US and numbers heading up into the 4% and 5% levels in the UK are obviously a long way above target.

For me, the key element as to whether investors are becoming concerned that central banks are maybe letting the inflation genie out of the bottle, is not so much where it's pricing inflation in the next year or two, because that's high and potentially transitory. It's more, when you look forward, perhaps where they pricing inflation 10 years into the future, because that tells you what investors are thinking about in terms of more longer-term structural inflation.

There's quite a difference between the different countries. In Europe, it's not really a problem. They've got 10-year inflation in 10 years' time priced pretty much around 2, so around the central bank's target. That's slightly higher than it has been historically, but it's not that elevated. In the US, a bit more so. Then you've got 10-year forward inflation priced at around 2.35%, 2.4% there, so higher than the 2% mandate that the Fed has been operating to and, in fact, 2% realised inflation that we've seen in the US over the last 10 or 20 years.

The UK is where you've had the really elevated pricing of inflation expectations. You've got those 10-year forward rates up around a 3.5% level in the UK. Clearly the UK market is pricing in somewhat higher inflation in future decades than we've had over the last 10 or 20 years. There's some evidence that investors are becoming a bit concerned about inflation, albeit the current numbers do exaggerate any rise in inflation you're likely to see because some of the factors are undoubtedly temporary.

David: The inflation environment is definitely changing, but it's often been said that hope is not a strategy, yet this seems to be increasingly reflective of the central bankers' approach to the issue of stickier-than-expected inflation. For example, is the Bank of England's decision to maintain interest rates at current levels a symptom of a wider malaise, or should we expect all the central banks to be overly accommodative in the face of rising inflation?

Miles: I think the central banks would argue they're not being overly accommodative, but when you say they're hoping, I think they probably claim that they're being a bit more scientific than hoping that inflation will come down, but nevertheless, they are assuming that it will be. They're definitely assuming that quite a lot of the inflation or almost all the inflationary spike we're seeing at the moment will prove to be transitory and will fall out in the coming months or next year or so. Definitely, that is the expectation of central banks.

The Bank of England, in their latest forecast, was suggesting that they would only need some very modest tweaks in base rates to bring inflation back down to trend in two, three years' time. Certainly, that is the assumption of central banks. I think the danger will be that it…that may well be correct. I'm not necessarily arguing that it is not, but I think there's a danger to it because if it turns out that that isn't correct, the central banks will be behind the curve because you're certainly…they don't look like they feel the need to leap into action aggressively and squeeze inflation out of the system within the next few months. That could well be the right strategy, probably will be the right strategy, but there's a danger attached to it because if it's not, you could have several more months of strong inflation prints, and they will be behind the curve if it turns out inflation isn't transitory.

David: Taking your points about the Bank of England there though, given the interrelated nature of markets, should the actions of individual central banks be seen in isolation, or are we seeing a more concerted effort on their part to collectively lag the market's expectations of higher rates? Inflation seems to be becoming a global issue, but the responses are very localised. We may have already seen the first crack in the dam with the Reserve Bank of Australia raising rates and abandoning its attempts to manage the yield curve. Where now?

Miles: I think there's no doubt that the higher inflation is a global phenomenon, and we're seeing it across the world in pretty much most of the countries. That being said, the extent of inflation pickup is very different in different countries. I think it's probably fair enough that you do have a localised approach to it because, for example, in Europe, the ECB at the moment dealing with much less of an inflation spike than the Fed or the Bank of England is. I think it's fair enough that we do have a localised approach to it, just because the extent of the inflation spikes are different in different countries.

I'm not so sure that the central banks have got together to act in concert so much. I think there are certain central banks, the Bank of England being one of them, that would not feel entirely comfortable going before the Federal Reserve. I think, yes, as you flag the Australian Central Bank has decided that it's sufficiently independent from the situation in the US, and they've got a sufficient spike in inflation that they need to take their own actions. The Bank of England may well feel that it needs to do that eventually, but I think that the very close interlinking between the US and the UK economies leaves the Bank of England reluctant to embark on a tightening cycle before the Fed has at least indicated it's ready to follow very hotly on their heels.

I think it puts the Bank of England in an uncomfortable position. I think they would rather not have to tighten rates in any meaningful way before the Federal Reserve do, but it's a global problem the inflation, but the extent of it is different. We may well see localised and different approaches in different countries, and I think that could well be justified.

David: At the risk of putting you on the spot, if you were tomorrow promoted to chairman of the US Federal Reserve, what do you think would be the most appropriate policy response following the recent inflation data, which has been the highest in 30 years?

Miles: I think notwithstanding the dangers that I flagged just a couple of minutes ago, the Federal Reserve is probably broadly along the right lines here in that they are starting to tighten policy gradually, they're tapering down their purchases, and they've continued…They've been reasonably consistent in that message over the last few weeks and how they've delivered it and they've just carried a little further down that track preparing the market that by the middle of next year, they'll have finished purchasing any bonds and might actually be starting to embark, certainly as we get into the later half of next year, on a gradual tightening in the federal funds rates. That seems to be the path that they're taking us down at the moment, and they're considering to deliver that gradual message.

That being said, as we've discussed, there is the assumption in there, certainly by the spring, the inflation spike will have rolled over and be on a reasonably sharp downward trajectory. If it's not, they are going to have to shift tact and start to both indicate and act in a far more aggressive manner in terms of the monetary tightening. I think they have probably just about got the leeway to do it at the moment, but it's very much a watch this space, make sure that the inflation data isn't starting to feed through into wage bargaining, for example.

David: Would your answer differ if you were governor of the Bank of England say, or perhaps president of the ECB?

Miles: Yes. I think the ECB out of all these central banks has the most time on its hands because inflation isn't really much of a problem in Europe at the moment. Inflation and the forward price degree inflation has risen by a lot less in Europe than it has elsewhere. The ECB definitely has got plenty of time on its hands. The Bank of England, I think is in the most uncomfortable position here, in the inflation expectations. There's not so much necessarily spot inflation as yet, that's actually risen slightly more in the US than the UK, but inflation expectations and the pricing of forward inflation in future years has risen far more in the UK than it has in other countries.

That does put the Bank of England in a bit of a tight spot. They haven't got that much leeway before they run the risk of letting inflation expectations get out of control. They can just about wait for the time being, but they, out of all these central banks, I think are in the hardest place here.

David: In the current environment then, the risk of a central bank policy error does seem certainly significant. If they do the right thing and raise rates, say in the face of inflationary pressures and in doing so, put the brakes on a global recovery, are they doing their job? Would that constitute to policy error or is this a case of they are damned if they do and damned if they don't?

Miles: I think the current generation of central bankers must be looking very jealously at the previous generation of central bankers because I do think they have a much harder task in that it does look as though the trade-off between growth and inflation everywhere really has deteriorated in recent years and certainly will not be as favourable in the coming decades as it has been over the previous two, perhaps.

Whereas in the past central bankers only really had to tighten policy to stave off rapid growth when it looked like economies were overheating, it does look as though this current generation, if we're going to continue to operate with inflation targets as the centrepiece of central bank's mandates, it does look as though the current generation of central bankers may well have to act to rein in inflation, even if growth is pretty lacklustre.

In the sense that they've got to administer probably some more unpleasant medicine than previous central bankers, I do think they are possibly in a position of being slightly damned whichever way they go. I just think they've got a harder job. When you're inflation targeting and your mix between growth and inflation, that mix between that trade-off deteriorates, as it seems to have done, it just puts you in a harder position. Yes, they've got a harder job up to do than central bankers did 10 and 20 years ago.

David: Finally, and perhaps controversially, one could argue that with current levels of government debt inflating it away, in real terms, may be the politicians' preferred choice. Do you think today's generation X will be generation public debt?

Miles: I think something has to give. It may well not be an expressly stated preference for politicians to inflate away and governments to inflate away the amount of debt they have at the moment, but the issue is debt is rising. The demographics everywhere in the developed world are not favourable in terms of having a dwindling working-age population to actually help you pay off this debt.

I do struggle to see how the current levels of debt and the levels of debt that we are moving towards will be paid off in money that has this broadly the same spending power as it has today. In order to do that, that's going to require some austerity at some point in the future, which current electorates just don't seem to have the stomach for. I think it's almost, although higher won't necessarily be a specifically chosen policy objective, it could be where we end up simply as a path of least resistance because if you're going to repay debt in currency that's worth roughly what it's worth at the moment, you're going to have to implement some austerity at some point. The current intellectual preferences have moved a long way from that. Unless that changes, it may well be where we end up just as a path of least resistance in the long-term.

David: Well, thank you once again, Miles. I think we are definitely entering one of the most interesting government bond environments that we've seen for many years. How it plays out will be very difficult to predict and I think you're right. I think central bankers are effectively walking a policy tight rope across shark-infested inflationary waters in the months and years ahead. We'll continue to monitor it, and thank you very much, Miles for giving us the benefit of your thoughts today and we look forward to the next podcast.

Miles: You're very welcome. I look forward to it myself.

Announcer 2: This podcast is for investment professionals only for further information. Please view the notes, which accompany this episode.

[00:13:37] [END OF AUDIO]