M&G Public Fixed Income

Inflation, Central Banks and the Markets

Bond Vigilantes

November 2021

The magnitude of the rise in inflation has taken some fixed income market participants by surprise, contributing to heightened volatility across global bond markets. Will inflation become a permanent feature of the post-COVID world? Will central banks be able to tame it, or will they find themselves behind the curve? And, what are the best ways to navigate the potential turbulence ahead? Our fixed income experts tried to answer these questions, and more, in the recent Bond Vigilantes forum, a summary of which is below.

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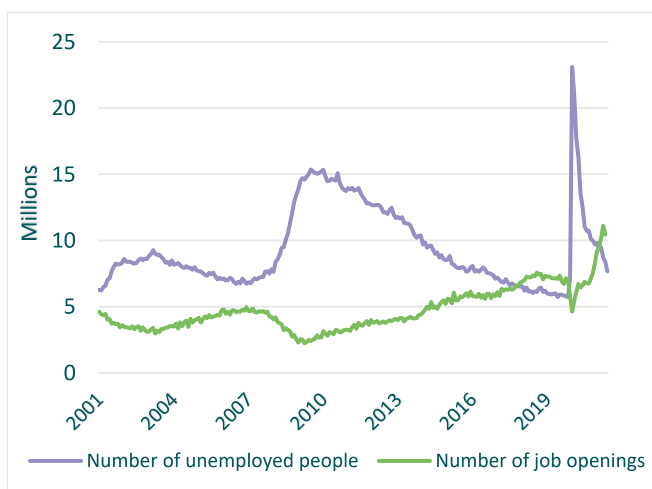
Inflation assessment and outlook

Stefan Isaacs, fund manager: If we go back to the 1960s, when the so-called 'misery index' was created, it showed unemployment and inflation as two of the driving factors that have a serious impact on people's wellbeing and economic comfort. This index is currently sitting at levels that we haven't seen outside recessions over the past couple of decades.

Whether those inflation factors are transitory will be hugely important. If inflation falls back, sentiment should improve somewhat. But if inflation persists, this will create some challenges, not least for central banks. It could be a problem in politics as well as we look ahead to the US mid-term elections. A key factor that lost President Ford the election in 1976 was this misery index and the debate about inflation and unemployment.

Richard Woolnough, fund manager: In the job market in the US currently, there are more job openings than people looking for work. There is more demand for labour than labour supply and I think going forward that condition will continue, and that is inflationary.

Figure 1. US job openings vs unemployed people



Source: Bloomberg, 30 September 2021

Another unusual thing that happened during this recession is that households' net worth has gone through the roof. In the previous recession, net worth as a percentage of GDP collapsed. This means you can consume, you can bring retirement forward, you don't necessarily have to work, because you are wealthier.

This has been a big, big change from the pattern of previous recessions: the consumer is very, very healthy and has pent-up demand. Consumers have money to spend, partly from fiscal transfers from the government, and partly because they've not been able to spend it on things such as travel, hotels or leisure. That money when it gets spent, will drive the price of goods and services up.

One other big change has been the shock to the oil price. OPEC's effectiveness as a cartel is being enhanced by our desire to move towards clean fuel, so there's a bit of a battle going on: you have the oil & gas producing countries wanting to maximise their revenue, and the importers wanting them to increase supply to reduce pressure on prices.

Richard Ryan, fund manager: The main question is, will inflation be transitory or not? Central banks seem to believe that with stumbling blocks due to constraints on supply chains and various types of activity removed after the pandemic, inflation will start to ease in a couple of years.

What markets are telling you is that there is a division: what central banks believe might be right, but there are some features of inflation that are more permanent, and not necessarily the result of the last few years of activity. We've got logistical problems, we've got trade barriers that have been put up, and that's led to cost pressures that companies are feeling.

We've got two very firmly held views that are splitting the market down the middle, and I think it's going to be fascinating to see which way it falls out. But from my perspective, the question is: can we position ourselves in such a way as to take advantage once we have clarity?

Claudia Calich, fund manager: Inflation has also a political component; for example, in Argentina populist policies have led to higher inflation and the current government, which is more populist, has lost a lot of seats in recent elections. Ironically, Argentina will potentially get a more market-friendly government in two years' time, because people don't want to see more inflation.

Central banks and monetary policy

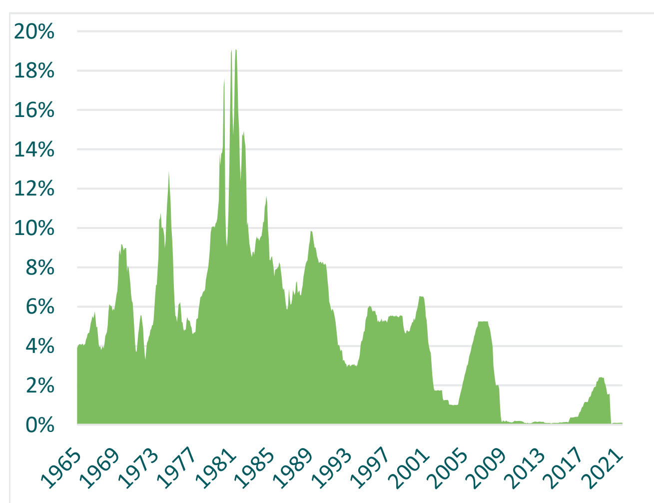
Stefan Isaacs: For central banks there's been a lot of difficult press in the past weeks. We need to watch this space very closely and be hopeful that central banks don't lose their credibility with higher inflation and policy rates that remain effectively at zero and huge asset-purchasing programmes.

Richard Woolnough: Central banks have moved and changed their targets. The European Central Bank (ECB) now wants to see 2.0% or more inflation as opposed to "close to but below 2.0%". The US central bank is going to put rates up only when inflation is a problem, not before. All these things combine into a very, very pro-growth policy.

The problem central banks face is that everybody's assuming that putting interest rates up slows the economy, but what if it doesn't? What if there's a "black swan" event? Central bank interest rate policy takes two years to work. Currently, central banks have their foot on the accelerator. When they hit the brake, will those brakes work? Will they be braking on Formula 1 tyres on tarmac, or will they be braking on black ice?

Figure 2. Central banks: need to escape the zero bound

Federal reserve interest rates



Source: Bloomberg, 30 June 2021

Claudia Calich: Within emerging market central banks, some of those (Russia, Brazil, Chile) thought it is better to pre-empt the Fed and start hiking interest rates. So we've seen large moves, a couple of hundred basis points in some cases. I think those countries would be in a much worse situation if they were trying to be behind the curve or even doing the wrong thing. Some emerging market central banks have seen this before, in the '70s and '80s, and don't want to go through that whole experience again.

At the other side of the spectrum, you have central banks who believe this is transitory and give more weight to the economy and don't want to hike rates. Or some of them are simply doing the wrong thing, for example Turkey. They are cutting interest rates, inflation is rising and that is feeding through into inflation expectations and the loss of confidence, which in this case is translated in the weakening of the lira. So the cycle never ends.

It's a whole gamut, but from an investor's perspective this is good, because it gives us quite a bit of different flavours. We are watching this very carefully, and positioning accordingly.

Richard Ryan: Since the financial crisis, governments and companies have piled on debt. One of the ways to get out of that debt, sneakily, is to inflate it away. I think behind this, markets are also thinking that maybe central banks don't want to be as harsh on inflation and control it the same way they did pre-financial crisis.

The markets' confidence in central banks is hard won. But do you lose that confidence quickly? I think no. I think you need to see central banks on the back foot, allowing inflation to run ahead for an extended period of time, before we begin to question whether central banks are fighting it as much as they have done in the past.

Market outlook and investment strategy

Richard Woolnough: If we look at bond yields, which on German bunds for example are still negative, we have a situation in which the economy is really, really hot but the market is priced for low interest rates. It's a dichotomy and we find it very, very hard to take duration risk, because the risk/reward is limited. The upside is limited, the downside is large, and our view is that central bankers are behind the curve and might have to do more in what regards raising interest rates.

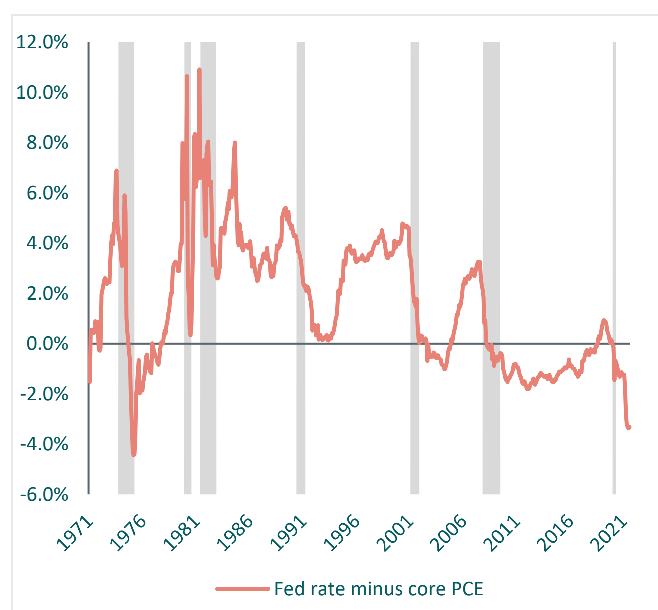
On credit, if monetary policy is easy, if it's cheap to borrow, it's easy to pay it back. Inflation is the debtor's friend. So I think growth will be good going forward and default rates will be low going forward. In investment grade you are still getting paid for taking the default risk, which is very small, and that is something that we like.

As for high yield, there doesn't seem to be as much value, as the global high yield spread versus compensation for taking the risk of default is very low. But we look at this a different way. If central banks are very, very slow at tightening and we have a very loose monetary policy over the next two or three years, default rates will be very low and owning high yield bonds would be attractive.

Luke Coha, fund manager: It would be hard to argue that spreads look appealing at this level, certainly across developed markets. The US for example is back close to year-to-date tight credit spreads. What's interesting is that in the past month or so, we have seen interest rate volatility, but we've still seen spreads compressing.

Figure 4. Real rates over time vs recessions

It is hard to get a recession with negative real rates



Source: Bloomberg (Federal funds target rate – upper bound index and US personal consumption expenditure core price index), 30 September 2021. Information is subject to change and is not a guarantee of future results.

In the US the ability of the high yield market to absorb that rate volatility has borne out the strength of that market. Some of the macroeconomic considerations, and earnings, are positive for many of these high yield companies. High yield has outperformed investment grade year to date, and a lot of that has to do with this capacity to absorb interest rate volatility. So, valuations don't look hugely attractive but I am not concerned about a massive correction if the macroeconomic conditions continue in a fairly benign fashion.

The challenge is in this compressed spread environment, where do you find spread compression if you can't get it from the index? On an individual, issuer-for-issuer basis, looking for upgrade candidates either from B to BB or from BB to investment grade and trying to get spread compression that way.

Chinese real estate has become close to un-investable. The size and the scope is quite large, it is hugely complex, you have massive swings in price volatility based on a policy statement, or an allusion to a policy statement that may or may not come true. There are also matters of accounting credibility. There are issuers that missed payments, but if you had looked at their balance sheets a few weeks prior to that, they appeared to be in good shape.

To expose yourself to the whim of the central government, in terms of what it may or may not do, makes it very difficult to embrace that market even at this kind of valuations, because of how complex the situation is and because you are at the mercy of the central government.

Richard Ryan: We've got spreads at historically tight levels and we wouldn't want to take a long duration credit risk. Given those historically tight spread levels, it's hard to envisage that the market as a whole continues to tighten much from here. I would prefer today to take more credit risk in the shorter end.

There are a lot of companies out there that are absolutely capable of managing their way through the current volatility, whether it's interest rates volatility or supply chain disruption. That to me allows us to defer the decision on where we think markets are going right now, because we can earn a reasonable spread, and then we can react to market movements as they occur.

That does require something that is a little unpalatable: defensive assets, or cash, because in the event you get something that's unforeseen that shakes market confidence, you want to be able to react. From my perspective, being able to react to these market events can be an important factor to help when seeking to generate outperformance.

So, it's almost like a barbell: short-dated high yield, taking that spread that gives some income on one side, and defensive assets on the other side which, in the event volatility comes quicker than expected, allows investors to go out and react to it.

Claudia Calich: There hasn't been much contagion from the troubles in China's property sector, even within China. Once you extrapolate into the rest of the emerging markets corporate debt at the index level, on the investment grade side spreads are similar to pre-COVID tight levels. The same is true for investment grade sovereign debt. This is why we think investment grade bonds are quite expensive given the recession, higher debt levels and wider deficits in the past couple of years.

However, we do think there is still value in high yield, partly on the sovereign side, but even in the corporate space. Once you take out the noise from China, there are still plenty of good, solid BB and B rated companies, in the energy sector for example. The US and the rest of America are booming too, so there are cyclical companies as well.

I also think that next year, once things stabilise, there will be a lot of opportunities in local currency bonds. Right now we're still early, but next year, once we see an inflection point and inflation starts stabilising, hopefully falling in some of these countries, there will be a lot of opportunity in some of these bonds.

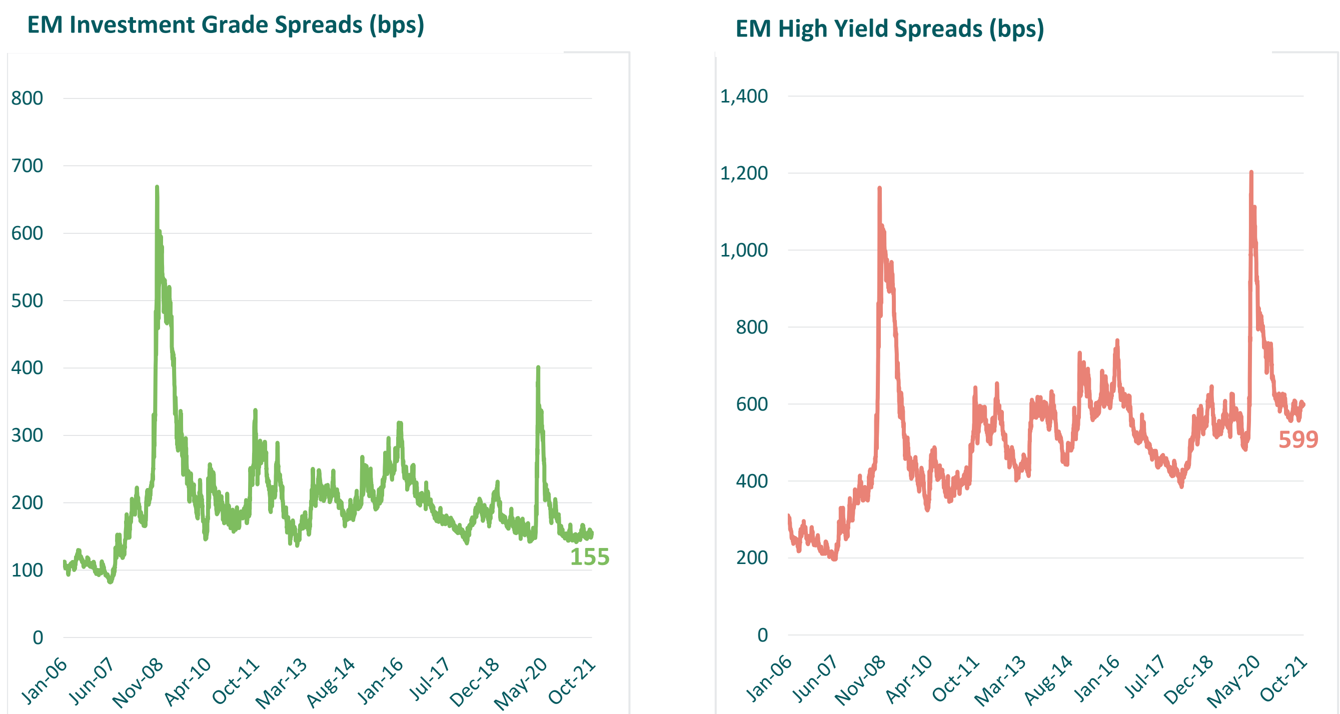
Environmental, social and governance (ESG) considerations

Mario Eisenegger, Investment Director: ESG and financial returns are inter-linked. We assess ESG risks and opportunities as part of our value assessment. I think it makes sense from an investment point of view if, for example, when you assess a sovereign asset, that you factor in political risk. Also a lot of emerging market countries are exposed to climate change risks in various ways, whether in terms of agricultural output or electricity supply, for example those dependent on hydroelectricity.

On the corporate side, it's exactly the same. If you think of food or beverage companies, for example in emerging markets, that perhaps don't have access to clean water and have to operate reduced hours because of that, that could have an impact on their ability to service their debt.

Another issue is the regulatory angle. There is a question over the real-world impact of excluding sovereigns: do you actually make things worse for the people who live in that country by cutting them off from essential infrastructure projects and the public debt market? Those are the kind of things we need to consider. We need to

Figure 5. EM hard-currency Sovereigns credit spreads: Investment Grade vs High Yield



Past performance is not a guide to future performance.

Source: JP Morgan Indices, 31 October 2021.

Information is subject to change and is not a guarantee of future results.

apply a forward-looking approach and know the companies we invest in.

I think companies do take ESG factors seriously. There is too much to lose if you are cut out of this growth market. Investors are still paying a small premium on green and social bonds. Investors are keeping a close eye on things, they want to get something for their money. But we need to perform quality checks, not just on reporting but also on the corporate strategic alignment to try to minimise the greenwashing risk.

The market for green bonds is pretty mature. Next year, it will be crucial to watch sustainability-linked bonds (SLBs), which is a fairly new market that gives issuers more flexibility in terms of how they use the proceeds. Issuers do commit to sustainability during the lifetime of those bonds. We really need to do our work as investors to assess the quality of those deals.

Stefan Isaacs: The climate crisis is a huge issue for humanity and for capital markets as well. Bruegel, a think tank in Europe, estimates that spending will need to increase by 2.0% every single year out to 2050, as well as implementing all of the technological impact that we have today, in order to tackle this crisis.

That will be impossible with the fiscal rules that we currently have in Europe. We have a massive challenge here, and I think that will inform how we invest, how we consume and the financial returns that we get from the different industries that will be impacted.

The “death of democracy” we see in some parts is another reason for concern. We’ve seen this play not just in places like China and Russia but we’ve also seen this partly in the US and at home in the UK. This is worrying for investors as it leads to poor allocation of capital and is consistent with poor economic and financial returns.

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