Anticipating inflation: historical and multi-asset perspectives

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Introduction

Will inflation be among the new normals to emerge from the COVID-19 pandemic? The erosion of purchasing power has been subdued for much of this century, particularly since the global financial crisis, but could an ongoing raft of extraordinary fiscal and monetary measures herald its return?

There are two opposing schools of economic thought to consider here. The first has dominated for several decades and is much admired by governments and central banks. The second is nowadays consistently ignored by policymakers but should not be forgotten by investors.

The "New Keynesian" outlook implies that inflation will remain weak for the foreseeable future. Rightly or wrongly, this interpretation is likely to shape the decisions of the policymaking community in the months and years to come.

By stark contrast, the "monetarist" outlook suggests that the prospect of rising inflation is not only real but significant. This interpretation, we say, should help shape the decisions of the investment community in the months and years to come.

In this report, which summarizes our Global Investors' Forum on Inflation, we explore the arguments underpinning each view. We explain why we believe that the threat of inflation cannot be discounted – and, crucially, we discuss what investors might do in anticipation of what could lie ahead.

Invesco Global Investors' Forum on Inflation

- **John Greenwood,** Chief Economist
- **Duy Nguyen,** Chief Investment Officer, Investment Solutions
- **Joe Rodriguez,** CIO, Listed Real Assets
- **Scott Wolle,** Head of Systematic and Factor Investing
- **Kevin Holt,** CIO, US Value Equities
- **Rob Waldner,** Chief Strategist, Head of Global Macro Research

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> "Friedman declared inflation 'always and everywhere a monetary phenomenon'." It had never occurred, he said, in the absence of money growth outstripping the growth of real GDP."

A clash of theories

Understanding inflation

It is sometimes easy to forget that inflation was rampant in many OECD countries for much of the last quarter of the 20th century. Between 1973 and 1990, with annualized core inflation of almost 10%, prices effectively doubled around every seven years.

As figure 1 shows, the picture has been rather different since the turn of the millennium and especially since the global financial crisis. Between 2002 and 2020, for example, annualized core inflation was 1.9%. At this rate prices would double only roughly every 36 years.

A key question now is whether the unprecedented measures implemented by governments and central banks in response to the COVID-19 pandemic could at last signal inflation's return. As John Greenwood, our Chief Economist, explained in opening our Global Investors' Forum (GIF), this is an issue on which the economics profession is sharply divided.

The dispute can be traced back hundreds of years, with both sides taking turns to dominate. The initial blow was struck in the 16th century, when the quantity theory of money (QTM) first proposed that the general price level of goods and services is directly proportional to the amount of money in circulation.

This idea is usually attributed to Nicolaus Copernicus, the Renaissance-era mathematician and astronomer more widely known for determining that the Sun, not the Earth, is at the center of our universe. Subsequently endorsed by the likes of Adam Smith and David Hume, QTM essentially held sway until the 1930s.

From QTM to Keynes and back again

It was not until the aftermath of the Great Depression that QTM came under serious attack. Puzzled by the global economy's failure to bounce back from meltdown, John Maynard Keynes posited that no economy would return to full employment if left to itself and that activist fiscal and monetary policy should be used to manage demand and, by extension, spending[1].

Keynes reasoned that this approach could prevent recessions, and his notion seemed to work well for the next few decades. By the 1970s, however, inflation was becoming a severe problem, and the Keynesian revolution gave way to a monetarist counter-revolution spearheaded by Milton Friedman[2].

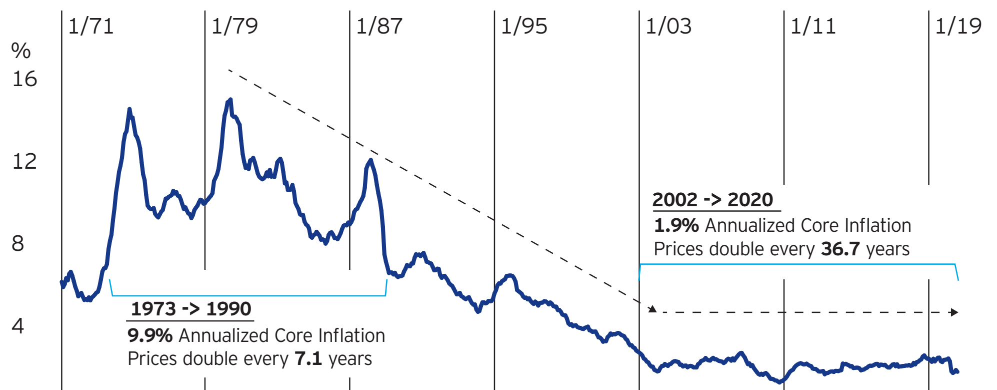
Believing that Keynes had misinterpreted the relationship between savings, investment and economic growth, Friedman famously declared inflation "always and everywhere a monetary phenomenon". His research showed that inflation had never occurred in the absence of money growth outstripping the growth of real GDP (i.e. the annual output of goods and services).

In advocating a shift back to QTM, Friedman also dismissed the supposed long-term trade-off between inflation and unemployment. "This indicates that the Phillips 'curve' is actually vertical in the long run and simply doesn't work," Greenwood told the GIF, "and that monetary policy should therefore focus on keeping inflation low rather than maintaining full employment."[3]

Importantly, Friedman further argued that monetary policy is far more powerful than its fiscal counterpart. This being the case, a government's efforts to manipulate its budget balance to achieve full employment could be regarded as largely futile.

Figure 1: From rampant to restrained – a half-century of inflation

OECD Consumer Price Index (excl. Food & Energy)



Source: OECD; Bloomberg; as at Sept. 30, 2020

"If fiscal and monetary policy remains 'easy' in the meantime then the next key question will be what investors can do to protect their portfolios against inflation."

Why monetarism still matters

In the grip of the New Keynesian view

The pendulum swing towards monetarism proved short-lived. Central bankers in particular were less than happy with Friedman's perspective, as they found operating on the basis of interest rates easier. A "New Keynesian" counter-counter-revolution was already under way by the mid-1980s, and QTM was increasingly sidelined in major policymaking circles during the final decade of the 20th century.

Many of the economists who led the fightback have since gone on to occupy positions of considerable influence. Foremost among them today are Richard Clarida, co-author of one of the most influential New Keynesian works of the 1990s and now Vice Chairman of the US Federal Reserve[4], and John Williams, President of the Federal Reserve Bank of New York.

In August 2020, in a speech entitled The Federal Reserve's New Monetary Policy Framework: A Robust Evolution, Clarida had this to say about inflation: "There is broad agreement among academics and policymakers that achieving price stability on a sustainable basis requires that inflation expectations be anchored at the rate of inflation consistent with the price-stability goal. This is especially true in the world that prevails today, with flat Phillips curves in which the primary determinant of actual inflation is expected inflation."[5]

Speaking a month later, Fed Chairman Jerome Powell appeared similarly confident that inflation should not be seen as imminent. Asked about the road ahead in light of the pandemic, he said: "There will be slack in the economy. The economy will be below maximum employment, below full demand. And that will tend... to put downward pressure on inflation."[6]

In other words, the New Keynesian outlook maintains that economies have been so badly damaged by lockdown and other impacts of COVID-19 that levels of activity, employment and inflation will inevitably be weak for the foreseeable future. This could mean that the Fed and other central banks will continue to provide stimulus (or rapid money growth) through 2021 and will not cease until inflation is a reality – which would be too late.

What if the Fed is mistaken?

The monetarist outlook is very different. It suggests that the growth of money – that is, money held by the public rather than by central banks – has been so rapid (30% p.a. for M2 in the US over the nine months March-December 2020) that it will inevitably lead to some inflation. Monetary economists envisage the possibility that once the pandemic is over, with risk aversion overcome, we could witness another Roaring Twenties – a period characterized by a major boom in consumerism – this time on the back of the biggest and fastest peacetime increase in money growth since the Fed was founded more than a hundred years ago.

As figures 2 illustrates, the historical link between money growth and inflation is clear. This must have significant implications today, given that money growth rates in the US – as well as in the UK, the eurozone and Japan – have all increased abruptly since March as a result of the central banks' responses to COVID-19[7]. Yet recent official Fed documentation does not feature a single mention of the growth of money or any intent to control monetary growth[8].

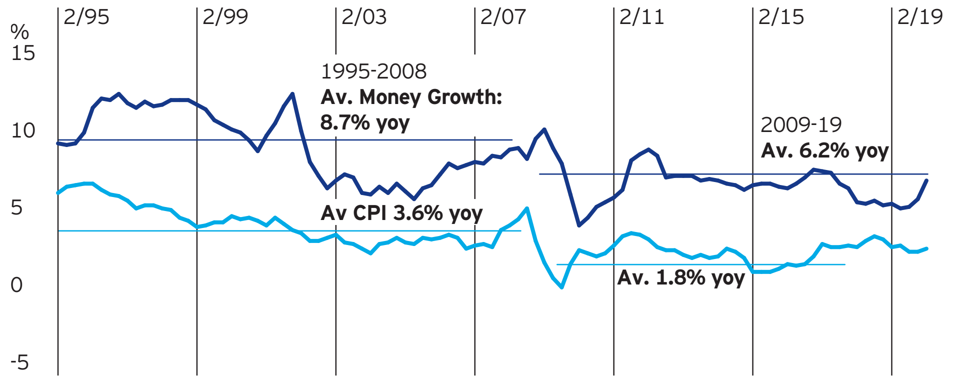
So when might we expect to see inflation if – unlike the Fed – we pay heed to the monetarist school of thought? Monetary analysis emphasizes that the lags in effect can be lengthy and variable and that it could be up to two years before inflation manifests itself.

"The business cycle is fundamentally a monetary phenomenon," Greenwood told the GIF. "The first impact of sustained faster money growth is on asset prices – which explains the surge in the stock market since March 2020. The next impact is on economic activity, which typically follows after six to 18 months. And then, finally, the impact on inflation comes last, normally between 12 and 24 months after the surge in money growth – though it could be delayed by further outbreaks of the pandemic. The short-term relationship between money and what happens in the economy may not be too reliable – but the long-term relationship between money and inflation is very reliable."

According to this cycle, we are currently in a sweet spot where the consequences of excess money growth are evident mainly in asset markets, with stronger spending likely to follow in 2021 and inflation due in 2022 or 2023[9]. We believe that this potential progression demands the close attention of the investment community, because if fiscal and monetary policy remains "easy" in the meantime – as the prevailing New Keynesian view signifies – then the next key question will be what investors can do to protect their portfolios against inflation.

Figure 2: The relationship between money growth and inflation

OECD* Money Growth & Inflation (YoY change %, 1995-2017)



Source: Refinitiv to Dec. 31, 2019.
*The OECD comprises 35 member countries across North and South America, Europe and Asia-Pacific.

A solutions-based approach to inflation protection

The importance of a holistic view

We know from our conversations with clients that many investors are increasingly conscious of the prospect of inflation. They are also aware of the risks that their portfolios could face if this prospect were to be realized.

We believe that the answer to this challenge lies in devising and implementing holistic strategies. These demand solutions-based thinking – an ability to understand how multiple assets can combine to meet the threats and opportunities to which an inflationary environment might give rise.

Some asset classes are routinely associated with inflation protection. Others are much less readily linked with the task. Even within each class there are assets that are more likely than others to help safeguard or even strengthen portfolios.

This means that a crucial objective for any farsighted investor is to identify an optimum mix. As discussed during our GIF, this could involve a broad range of assets – including real estate, infrastructure, commodities, equities and fixed income. Exposure might be determined through a sector lens or through a factor lens – with the latter helping demonstrate, for instance, which assets are most likely to provide portfolios with a defensive element[10].

Below we summarize some key insights from our panel members, each of whom oversees Invesco's expertise in a particular asset class. Appropriately, this session was moderated by Duy Nguyen, CIO and Portfolio Manager of Invesco's Investment Solutions Development and Implementation team.

Real assets

Real estate and infrastructure are strongly associated with inflation protection. The simple reason for this is that rising prices are likely to increase construction costs and income levels needed to justify replacement of these assets over time. Yet a broad-brush approach to this asset class does not guarantee all-round success.

"It's important to think in terms of individual assets," Joe Rodriguez, CIO of Listed Real Assets, told the GIF. "It's not automatically the case that a particular property or infrastructure project will provide an inflation hedge, because some assets might be subject to locational, physical or some other form of obsolescence over time. So it's vital to know what you're doing – and what you're underwriting."

Those individual assets that are up to the task might help capture inflation over the short term or the long term. Some infrastructure projects – for example, airports and toll roads – can even have overt linkages to various inflation indices or at the very least considered during the feasibility of rate negotiations with government entities.

Long-term thinking remains key in this asset class, with environmental, social and governance (ESG) considerations playing an ever-greater role in investment decisions. "It's not just about what to hold today," Rodriguez told the GIF. "It's about the trends going forward. Long-term supply-and-demand conditions might not justify investing in a particular asset. Future cash flows from incorrectly underwritten assets might no longer be capable of producing satisfactory returns. We also have to consider our understanding regarding the impact of climate change on markets and locations around the world. At the end of the day, when investors contemplate potentially holding an investment for ten or twenty years, there are lots of factors that need to be taken into account."

With sector rotations and shorter time horizons also entering the reckoning for some investors, active management also has a part to play here. "Having an active manager navigate through the pluses and minuses of investment decisions in this space can be very helpful in navigating underlying risks," Rodriguez told the GIF. "We have a very positive story to share with investors in this regard."

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Commodities

Many investors turn to tangible assets in the face of inflation. Although their representation in the "basket" of goods has decreased somewhat in recent decades, some commodities are directly linked to the CPI.

"The overall correlation between commodities and the CPI has actually risen over the past 20 or 30 years," Scott Wolle, Head of Systematic and Factor Investing, told the GIF. "This implies there's a common factor – whether it's the impact of the dollar or monetary policy – that's driving both. In our view, commodities remain a very attractive way of capturing positive inflation surprises."

Commodities are notoriously cyclical, but their cycles tend to be extremely lengthy. Identifying a turning point – the beginning or end of a cycle – is therefore key. While it is possible to try to take a very long-term view, we believe that it is more sensible to make a series of shorter-term judgments and thereby allow the shorter term to gradually turn into the long term. With this aim in mind, a strategy that we think prudent is to analyze whether each asset is likely to rise or fall relative to cash on a monthly basis and then adjust allocations accordingly.

"Commodity indices aren't designed in a way that really emphasizes what drives returns," Wolle told the GIF, "so the way we approach the market is very benchmark-agnostic." It follows that active management is critical. "It's crucial with commodity futures," Wolle told the GIF. "One thing that makes this such an interesting niche is that how we think about success can be very different to how other market participants think about success. There's much more scope to derive performance from active management in an arena where everyone isn't pursuing exactly the same goal."

Equities

Many stocks have a decent chance of keeping pace with inflation – but not all. In light of the sheer size of the equities universe, this disparity is inevitable. Inflation will hurt some and help others. The crucial challenge, of course, is to distinguish between the two.

"Ultimately, it comes down to cashflows," Kevin Holt, CIO of US Value Equities, told the GIF. "That's the science here. We have to carry out the fundamental analysis, understand the balance sheets and think in terms of supply and demand."

One obvious rule of thumb for choosing inflation-defying equities is to identify those companies that are most easily and quickly able to pass rising costs on to their customers. Historically, materials and energy stocks have sometimes allowed investors to capture equity-like returns while retaining a commodity-like hedge. The technology sector, on the other hand, has tended to perform poorly amid rising inflation due to the higher discount rates used for discounted cash flow models, posing a particular headwind for higher growth companies.

Yet the axiom that past performance is not a guide to future performance could be markedly appropriate in these unprecedented times. "In a situation like the one we're in now, a once-in-a-hundred-years phenomenon, we have to be conservative," Holt told the GIF. "We don't want to bet the farm. We need to see who's going to get to the other side of this."

Here, too, long-term thinking enters the picture. Equities might generate slightly lower inflation-related beta over the short term than, say, commodities, but their status as cash-generating assets means that they could be more likely to deliver higher returns over an extended timeframe. "There are stocks that look excessively cheap to us right now," Holt told the GIF. "Inflation will probably be a catalyst for change, and if we do get it then we should see good upside in several areas."

Fixed income

Inflation is usually seen as a blow to investments in fixed income, as it often causes interest rates to go up – which in turn causes bond values to go down. Yet this difficulty may be overcome through investments in inflation-indexed instruments, of which Treasury Inflation-Protected Securities (TIPS) are perhaps the most popular in the US.

"The broad market in fixed income is obviously very susceptible to inflation," Rob Waldner, Chief Strategist and Head of Global Macro Research, told the GIF. "You're receiving a fixed coupon over an extended period of time, and that coupon will be devalued going forward if inflation picks up. But TIPS allow you to lock in a return relative to inflation for the duration of a security when you buy it, which can make them a very effective investment tool."

As with any asset, TIPS are better suited to some investment goals than others – especially in light of the current low-interest-rate environment and what this means for real yields. They might not meet every investor's objectives. But their ability to help protect against inflation cannot be disputed – and they can be particularly beneficial if inflation rises unexpectedly and sharply.

The fixed-income space is also home to some assets that can perform better in an inflationary environment than in a stable one. One example is bank loans, which are private debt obligations issued by companies – often in the course of leveraged buyouts, mergers or acquisitions. Bank loans aim to combine high income with short duration and use a floating rate to help protect against interest-rate increases. "These are specialized areas that can be very useful from an asset-allocation perspective," Waldner told the GIF.

While seldom an issue with assets such as TIPS, active management is essential for bank loans and other "alternative" vehicles in the fixed-income arena. Some are non-investment-grade assets, so risk mitigation is a priority in terms of underwriting and management. "You need to understand the firm you're dealing with, the structure and the underlying assets that support it," Waldner told the GIF. "All of that is highly conducive to active management."

Contact us

To learn more about how a solutions-based approach could help protect your portfolio from inflation, please contact your Invesco representative.

1 This argument was most famously framed in Keynes' General Theory of Employment, Interest and Money, first published in 1936.

2 Friedman's most influential texts in this arena included A Monetary History of the United States (1963), The Counter-Revolution in Monetary Theory (1970) and Studies in the Quantity Theory of Money (1973). Further publications emanating from the University of Chicago and the Federal Reserve Bank of St Louis also helped drive the shift back to QTM.

3 Named after its inventor, New Zealand economist William Phillips, the Phillips curve describes an inverse relationship between rates of unemployment and corresponding rates of wage rises within an economy.

4 With Jordi Gali and Mark Gertler, Clarida co-authored The Science of Monetary Policy: A New Keynesian Perspective, published in the Journal of Economic Literature in 1999.

5 Clarida delivered this speech via a webcast at the Peterson Institute for International Economics, Washington, on 31 August 2020.

6 Powell offered these remarks in response to a question from CNBC's Steve Liesman at a press conference in September 2020. See Federal Reserve: Full Transcript of Chair Powell's Press Conference, September 16 2020.

7 Money growth has risen by 11.8% in the UK, 9.3% in the eurozone and 7.9% in Japan during the same period, with the response to the pandemic accounting for the lion's share of the increase in each instance. (Calculations based on data from Macrobond, US Federal Reserve, Bank of England, European Central Bank, Bank of Japan and Invesco.)

8 Greenwood searched around a year's worth of Fed documents, to no avail.

9 Based on Invesco calculations; for illustrative purposes only.

10 An example of this kind of thinking is a collective trust that Invesco recently devised for a leading US manufacturer and employer. Broadly focused on inflation, the trust combines component strategies investing in real assets, commodities, equities and fixed income.

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