CIO BLOG

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THE GREAT RATE DEBATE

The investing world has been aflutter as it digests the possibility of renewed inflation. Some consider this a paradigm shift in markets, which for years have experienced anaemic levels of price rises. Indeed, for most of the period since the Great Financial Crisis, the spectre of deflation has been the overarching concern for major central banks.

This potential sea change has several supports.

One, while neither quantitative easing (QE) nor deficit spending are novel, the sheer scale of the programs today certainly is. Most notably, the newly elected Biden administration in the US has pushed through a $1.9 trillion stimulus package on top of the $900 billion support bill passed in late December – together, a staggering 13.4% of GDP. The Federal Reserve is doing its part, continuing its purchases of $120 billion in bonds each month. The US is hardly alone. In the UK, the budget deficit is on par to be 16.9% of GDP in 2020-21 and 10.3% next year, levels akin to during World War II. The European Central Bank has clearly stated that it is monitoring bond yield increases closely and remains committed to “accommodative” financial conditions.

Two, money supply has shot up dramatically, particularly in the US. In previous editions of QE, nothing on this scale occurred because much of the liquidity stayed on bank balance sheets. Therefore, the money multiplier remained low amid muted demand for loans. Fiscal spending was much smaller too, relatively speaking. Today, a much larger proportion of spending is going straight to households via direct payments: In the immediate wake of the pandemic, $1,200 cheques were sent out as part of a massive relief package. A second stimulus payment of $600 was sent to most US adults late in 2020. Now, $1,400 cheques are being remitted to all but the richest Americans. This is unprecedented.

Three, with a rapid ramp-up in vaccinations in most developed countries, expectations are that a surge of spending will occur once restrictions on mobility are lifted later in the year, particularly in the services sector. Economists fear that unleashed consumer spending will overheat the global economic recovery and stoke the inflationary pressures fomented by huge government spending and monetary excess.

For these (and other) reasons, inflation expectations have surged from the historical lows witnessed in the throes of the pandemic last year. This has market implications. Investors have been tolerant of higher equity valuations given the extremely low or negative base rates set by central banks. Presumably, if inflation continues to rise, central banks will be forced to tame it by raising those base rates, thereby calling into question historically high prices for stocks when compared to earnings.

Perhaps more importantly, fears of inflation have driven yields on government bonds around the world sharply higher (i.e. investors should demand more yield when inflation expectations rise if they want to receive the same inflation-adjusted income). In the US, the yield on 10-year Treasuries has jumped from 91 basis points (bps) at end-2020 to over 170 bps now; UK gilts have gone from 20 bps to 85 bps; and German bunds from -57 bps to -27 bps. This has caused direct losses for holders of these securities. However, it also makes government bonds more attractive, assuming yields don't keep rising, and partly erodes the relative attractiveness of equities, which has been one of the important pillars supporting risk assets for many years.

However, markets may well have got ahead of themselves regarding inflation expectations. While we recognise the above factors, there are important mitigants. They include the following:

LABOUR MARKET

There are gaping output gaps in the labour market. US employers now report 10 million fewer jobs than before the pandemic and US unemployment is at 6.3% vs. 3.5% last year. Wide swathes of the public are dependent on cash injections from the government simply to stay afloat; this is where the stimulus is largely targeted.

According to the US Bureau of Labour Statistics, the US participation rate - which measures the percentage of the population of working age that are working - was recorded at 61.4% in February 2021, compared to a pre-pandemic level of 63.4%. In the same month, average hourly earnings were rising at an annual rate of 3% and the core rate of inflation was rising at 2.3% a year.

Recent expansions in the United States – and the UK – have demonstrated that the labour market only starts to generate wage inflation when it gets exceptionally tight. Employment looks destined to rise strongly in the medium term but with so much spare labour there seems little reason to fear rising wage inflation, which in turn is an essential factor for general inflation. It is also worth bearing in mind that there is much more slack in the system now than in the pre-pandemic period, where inflation remained muted even as unemployment was at record lows: We underestimated the scale of slack even at "full employment" levels.

Long-term structural trends such as aging and inequality remain entrenched too – older, richer people tend to save more and spend less. These factors should keep medium and long-term inflation under control, which will eventually stabilise the bond market.

REAL ESTATE

There is enormous underutilised capacity for office and retail real estate. My colleague John Birdwood – Fund Manager of our Target Return Strategy – has written extensively about the collapse in the value of the Trafford Centre as an example of the issues facing the owners of commercial real estate. In a nutshell, the Trafford Centre, a large shopping centre in Manchester, was purchased by Capital Shopping Centres (now Intu Properties) for £1.65bn in 2011. According to Intu's 2018 annual report, the Trafford centre is, at over 2 million square ft, the third largest retail centre in the UK. It attracted a peak valuation of £2.3bn in the 2017 annual report, featuring high-calibre tenants such as Selfridges, John Lewis, M&S, Boots, Primark, H&M and Next. Also boasting a 20-screen Odeon multiplex and Europe's largest food court, the complex attracted 30 million people a year.

In June 2020 Intu Properties was placed into administration, triggering an auction for the Trafford Centre. A Sky News report at the time mentioned a valuation of £1.7bn and noted that the administrators expected to ultimately sell at a 20% discount (i.e. circa £1.36bn). A Bloomberg report dated 17th November reported the Centre remained unsold with no bids above £1bn.

If we assume these difficulties are representative of the retail industry in general, it is clear that the process of finding new owners as well as recognising losses for existing owners and lenders is going to be long and painful. If the downturn in the office market turns out to be as severe as in retail, the situation will become even more difficult.

The development is set to work itself through the sector slowly, and painfully (for the owners) for a considerable time to come. To compete with online platforms, lower prices must be part of any package offered by those businesses continuing to sell on the High Street or in shopping centres. Landlords should expect considerably lower rents to enable their tenants to compete.

It is still unclear to what extent office work will resume once lockdown restrictions are lifted. In recent days we have seen a range of approaches unveiled by different companies: Nationwide Building Society has given its staff the option to "work anywhere" in the UK, HSBC announced a reduction in office space by 40%, while the CEO of Goldman Sachs rejects working from home as the "new normal", describing it as an "aberration, [to be] corrected as quickly as possible".

As John Birdwood has noted, if the average experience is a 40% decline in office attendance, then tenants will see a significant reduction in operating costs and landlords will have to find an alternative use for their assets. As a result, it seems inconceivable that lower rents will not form part of any package they offer to prospective new occupiers. Indeed, lower capital values and rents are likely to make important contributions to keeping inflation subdued.

ENERGY

Once again, I rely on analysis conducted by my colleague John. In March 2021, OPEC estimated that the world's oil demand fell by roughly 10% in 2020 to 90.4m barrels a day. Given that productive capacity did not shrink, the self-restraint of major OPEC producers - cutting supply in order to maintain the price - was remarkable. But can it last? Several factors suggest it cannot:

1. All major producers have faced increased financial pressure in 2020. Saudi Arabia has taken a considerable share of the cut in oil output – from an average of 10m barrels a day in 2019 to just over 8m barrels a day now. As a result, its foreign reserves have fallen by a tenth to $450bn over the same period. (Source: Bloomberg, 25 March 2021) How much longer will they want (or be able) to sustain lower revenues?

2. Iran was more or less shut out of world markets under the Trump administration. According to a Reuters news report in January, Iranian oil exports dropped from 2.8m barrels a day in 2018 to only 300,000 a day in 2020 – a reduction of almost 90%. However, the Biden administration seems likely to acquiesce to higher Iranian oil exports.

3. Despite the disruption from a crippling cold spell in the US midlands in February, US production is likely to start growing rapidly again. Many shale producers have gone through bankruptcy, causing a reduction in production costs and likely resulting in a strong output rise as the new owners of these businesses seek to capitalise on better margins.

4. While the future of commuting remains unclear, a permanent change in behavior seems all but certain. Indeed, demand for fuel to get the workforce to and from their desks in Organization for Economic Co-operation and Devlopment (OECD) countries will likely follow a lower trajectory than before.

5. Lastly, there is the long-term impact of electric and hybrid vehicles. According to BP, 42% of oil production is consumed in form of gasoline while a further 21% is consumed as diesel or gasoil. In other words, nearly two thirds of all global oil production is ultimately used as fuel for vehicles and ships. It seems inevitable for that share to decline sharply over the next few years. Worldwide sales of hybrid and fully electric cars rose from 2.3m in 2019 to 3.2m in 2020; an increase in sales of almost 40% in a market which shrank overall. Many governments and most manufacturers are now committed to phasing out sales of new internal combustion engines over the next few years. That, in turn, must result in a sharply lower demand for oil.

In summary, a steady capacity to supply is set to meet strong incentives for producers to increase output. On the other hand, there are equally strong forces weighing on demand. It would be surprising therefore if lower demand was not accompanied, over time, by significant price reductions for consumers. This, again, will contribute to lower inflation figures.

CONCLUSION

A rise in actual inflation would presumably not be rapid, given the huge excess capacity in the labour market, diminishing demand for commercial real estate, and downward pressures on energy prices. Let's not forget that actual inflation remains very muted at present in most of the West; and in China – on track to become the world's single biggest economy – year-on-year core consumer prices rose by 0% in February.

We do accept that prices may start to rise in the short-term, as a result of pent-up demand once economies go through post-vaccination bonanzas and subsequent increases in money velocity. However, this should be transitory, not structural. Moreover, this constructive spending surge should lead to robust economic growth and earnings, as well as higher employment. This is beneficial to corporates as it increases sales and profits while allowing for maintained margins, which helps support the case for equities and risk assets.

Finally, we take central bankers at their word that they have little intention to raise rates until pre-pandemic levels of unemployment and economic activity are firmly in hand. It is much more likely they act to curb the increase in yields – buying long-dated bonds as part of ongoing QE programs for example – than raising rates and endangering a nascent recovery.

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