Research
Macquarie Wealth Management

MACQUARIE

Investment Strategy Update #57

A ‘*chill-pill’* for inflation anxiety

- Inflation prints are coming in hot and are giving inflationistas’ plenty of ammunition for arguing we are on the cusp of an inflation regime change.

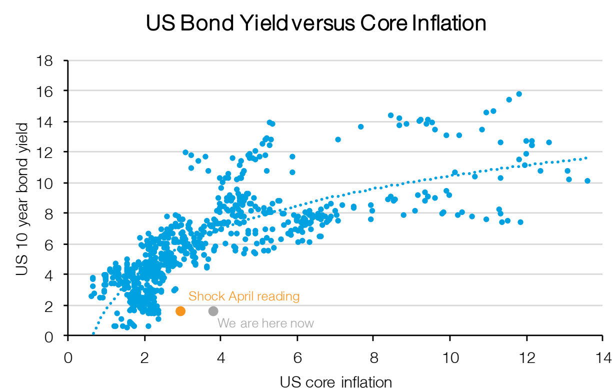
- Despite multi-decade high prints, financial markets have remained relatively undeterred in recent months. Last week, US bond yields declined (continuing the trend since peaking in March), the US dollar index weakened and equity markets (in particular rate sensitive growth stocks) rallied post the worse than expected US inflation release.

- Macquarie think inflation prints have peaked and will decline into year end. Even if this proves incorrect, the transition from a low to a high inflation regime takes time and is “evolutionary rather than revolutionary” according to analysis by Oxford Economics. In addition, a regime change generally requires a series of policy mistakes and is harder if inflationary expectations remain anchored.

- We think it is too early to position for a high inflation regime and we are even reluctant, at this time, to have a foot in either camp. We remain positioned for reflation and for bond yields to creep higher, but in an orderly way. Markets are telling us inflation risks are lower than what market commentators suggest, and we see no reason to doubt them for now.

Inflation is dominating almost every conversation we have with investors. Admittedly the data is causing some anxiety and has given plenty of credence to the inflationistas’. In the US, last week’s monthly print pushed core inflation up to 3.8% - its highest year on year level in nearly 30 years, but this rapid increase – although certainly faster than expected - is hardly surprising given it reflects a reversal of developments that occurred 12 months ago when COVID-19 restrictions saw demand plummet and supply take time to react.

But…is the Fed too sanguine on inflation?



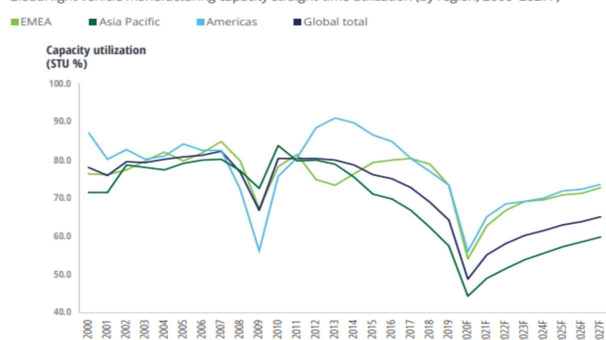
Source: Factset, MWM Research, June 2021

It is logical that as these base effects drop out and as supply bottlenecks are addressed, that the rate of increase will begin to slow as Macquarie is expecting. For example, car and truck rentals, used cars and trucks and new vehicles were three of the four largest contributors to the May inflation print. But, ironically, the world has plenty of capacity to build automobiles and satisfy end demand should there be enough semiconductor chips and other input materials on hand.

Unfortunately, the global shut-down has created bottlenecks that are inevitable as the world reopens in a slow and somewhat piecemeal fashion. This is not the same for all areas and the potential for hiccups and delays will contribute to further inflation anxiety. However, prior to the onset of COVID-19, many inflationistas’ were arguing about secular stagnation (where demand is insufficient to meet supply) and it is hard to determine whether this excess capacity - driven in large part by structural forces - has now abruptly disappeared.

There is plenty of spare capacity in vehicle production

Global light vehicle manufacturing capacity straight-time utilization (by region, 2000–2027F)



Note: Straight-time capacity utilization (STU) is calculated based on individual plant crew structure (i.e., number of shifts), excluding overtime.

Source: IHS Markit, June 2021

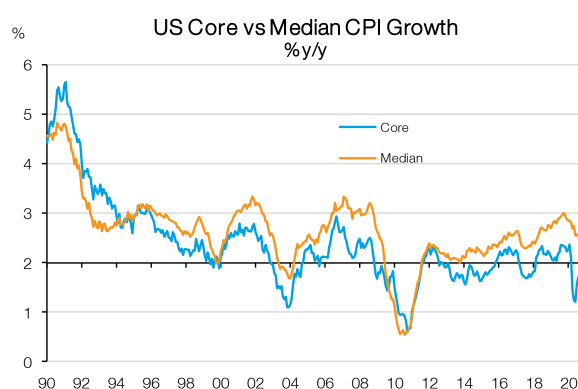
We don't intend to pen another lengthy article arguing whether inflation will be temporary or structural - Macquarie's house view is that it is temporary. Rather, we want to address three issues that have arisen from last week's developments. First, why the market took a disappointing inflation print so positively and what that means going forward; Second, what we need to see to permanently shift from a low to a high inflationary regime; and third, how we want to be positioned given the level of inflation anxiety and uncertainty around outcomes.

Why did the market shrug off May's higher than expected US inflation print? Last week's May inflation print came in much hotter than expected with the headline number jumping to 5.0% year on year – the largest increase since August 2008 – while core CPI accelerated to a 29-year high of 3.8% year on year. However, bond yields fell, continuing the trend seen since March, the US dollar index weakened, and equity markets rallied, particularly rate sensitive growth stocks which have been under constant pressure from the threat of rising bond yields for the most part of 2021.

At first cut, the reaction from financial markets might appear perverse, but we think it supports a broadly held view that near term inflation prints looked to have peaked and are expected to decline into the back half of the year. Similarly, it is consistent with recent consumer surveys suggesting inflation expectations have also peaked as base effects begin to diminish and as further reopening of economies reduce idiosyncratic price anomalies. We doubt all inflation data will move lower in coming months, but we think financial markets have priced in a rising/higher inflation backdrop (as evidenced by the decline in bond yields over the past three months) and that it will require a sustained set of prints to reverse and/or alter expectations.

Last, the Fed and other central banks including the RBA have continued to lean against a structurally higher inflation backdrop and emphasized that it will be full employment (over moderate price pressures) that drive policy tightening and, potentially faster than expected tightening, if price pressures are still evident at that time. It is true that the Fed has been hoovering US Treasuries (buying around 50% of net issuance over the past 12 months) and that this is set to slow as it looks to taper into early 2022.

Inflation is surging but underlying measures are not



Source: Factset, MWM Research, June 2021

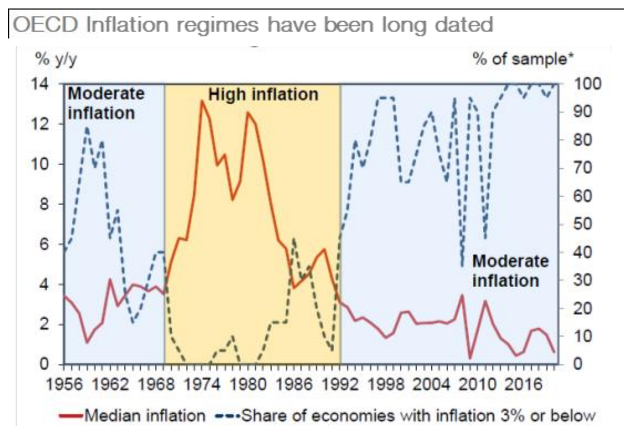
However, growth is recovering much faster than expected and financial markets are orderly so, in part, support to prevent disorderly markets is no longer necessary and we suspect that the Fed is still some way from shrinking its balance sheet – even if it tinkers at the edges. This suggests we do not need to fear a repeat of the 2013 taper tantrum or a rapid (disorderly) increase in bond yields that drives a substantial tightening in financial conditions and weaker equity markets.

What would we need to see for a permanent shift from a low to a high inflationary regime? Our base case has been that the inflationary spike is transitory and that if it proved to be more structural, that it would not be an issue for investors for some time. We have not altered this view, but for those who are more worried about a rise in inflation, we set out a number of considerations for the transition from a low to higher inflation regime as discussed by Oxford Economics in a recent piece titled "Assessing the risk of an inflation regime change".

In this piece they looked at historical evidence of shifting inflation regimes and made the following points. 1) Historical experience shows transitions from low to high inflation regimes do occur, although they are relatively infrequent; 2) Since the 1950s an economy has a 10% chance of switching from low to high inflation from year-to-year; 3) Inflation regime transitions can appear rapid, but the factors underlying them have often been building up for several years; and 4) A combination of elements including expansionary monetary and fiscal policies, upward price shocks, and policy errors, is usually needed.

They also note that regime shifts are more likely if inflation expectations are only weakly anchored beforehand. As such, the risk of a sudden shift now is lower than in past decades as the period since the 1990s has seen generally well anchored long-term inflation expectations, thanks in part to inflation targeting.

OECD Inflation regimes have been long dated



Source: Oxford Economies, Haver, OECD, June 2021

Based on this evidence, they believe the chances of moving to a high inflationary environment remains low, but that this risk has been rising. Nevertheless, if this transition is underway, it remains in the early stages and any shift is "evolutionary rather than revolutionary" given the low inflation starting point and that it would probably require a series of policy errors (either from governments or central banks) and there is no certainty around this yet. As such, their general conclusions support our stance that even if inflation is set to rise more sustainably, it is not something we are rushing to position for at this stage.

How do we want to be positioned given the level of inflation anxiety and uncertainty around outcomes?

Macquarie believes that inflation, while clearly rising, will prove to be transitory with a dip in goods consumption - as spending rebalances back to services - taking the heat out of recent hard commodity prices.

At some stage, zero rates and increased fiscal spending plans will cause a tightening in policy both here in Australia and in many other economies, but we think there is a reasonably long runway before investors need to be concerned about this eventuality or need to aggressively position for an inflation regime change.

Consequently, we remain positioned for higher inflation but not a regime change. We expect bond yields to rise in a pro-cyclical manner, but not enough to end the bull market in risk assets over coming quarters. We don't think inflation risks are evenly balanced and while a *"foot in each camp"* may provide protection against an inflation surprise, we think the uncertainty around whether there is a transition towards a higher inflation regime means it remains too early to be positioning in this way and so are more aligned with reflation over inflation.

Tactical asset allocation tilts by inflation regime

Underweight ← → Overweight

Asset class	Style/Sub-asset class	Low Inflation	Moderate Inflation	High Inflation
Equities	Dev. Large			
	Dev. Small			
	Dev. Growth			
	Dev. Value			
	EM Equities			
Cash				
Fixed Income	Sovereign			
	IG Credit			
	HY Credit			
	EM Debt			
Real Assets	Commodities			
	Property			
	Infrastructure			
Alternatives	Hedge Funds			
	Private Equity			

Source: MWM Research, June 2021

At an asset allocation level, this means being underweight sovereign bonds but remaining overweight credit. We remain overweight equities and real assets (particularly commodities and real estate) but with a relatively even style (value vs. growth) and size (large vs. small cap) preference.

We like long / short strategies within equities which provides a hedge against downside and rising (bond driven) volatility. We are overweight alternative assets both cyclically and structurally where returns are

heterogenous and valuations offer more upside versus public markets. We recommend investors remain vigilant for rising inflation risks, but caution against getting overly bearish when economic fundamentals are improving and central banks continue to have the markets back.

Macquarie WM Investment Strategy

The report was finalised on 15 June 2021.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

The analyst(s) responsible for the preparation of this research receives compensation based on overall revenues of Macquarie Group Limited (ABN 94 122 169 279 AFSL 318062) ("MGL") and its related entities (the "Macquarie Group", "MGL", "We" or "Us"). No part of the compensation of the analyst(s) was, is or will be directly or indirectly related to the inclusion of specific recommendations or views in this research.

This research has been issued and is distributed in Australia by Macquarie Equities Limited (ABN 41 002 574 923 AFSL 237504) ("MEL" or "We"), a Participant of the ASX. MEL is not an authorised deposit-taking institution for the purposes of the Banking Act 1959 (Cth), and MEL's obligations do not represent deposits or other liabilities of Macquarie Bank Limited (ABN 46 008 583 542). Macquarie Bank Limited does not guarantee or otherwise provide assurance in respect of the obligations of MEL.

This research contains general advice and does not take account of your objectives, financial situation or needs. Before acting on this general advice, you should consider if it is appropriate for you. We recommend you obtain financial, legal and taxation advice before making any financial investment decision. Past performance is not a reliable indicator of future performance. You should consider all factors and risks before making a decision. Please refer to MEL's Financial Services Guide (FSG) for more information at https://www.macquarie.com.au/advisers/financial-services-guide.html.

This research has been prepared for the use of the clients of the Macquarie Group and must not be copied, either in whole or in part, or distributed to any other person. If you are not the intended recipient, you must not use or disclose this research in any way. If you received it in error, please tell us immediately by return e -mail and delete the document. We do not guarantee the integrity of any links, e-mails or attached files and are not responsible for any changes made to them by any other person. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any transaction. This research is based on information obtained from sources believed to be reliable, but We do not make any representation or warranty that it is accurate, complete or up to date. We accept no obligation to correct or update the information or opinions in it. Opinions expressed are subject to change without notice. We accept no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research. The Macquarie Group produces a variety of research products, recommendations contained in one type of research product may differ from recommendations contained in other types of research.

The Macquarie Group has established and implemented a conflicts policy at group level, which may be revised and updated from time to time, pursuant to regulatory requirements, which sets out how we must seek to identify and manage all material conflicts of interest. The Macquarie Group, its officers and employees may have conflicting roles in the financial products referred to in this research and, as such, may affect transactions which are not consistent with the recommendations (if any) in this research. The Macquarie Group may receive fees, brokerage or commissions for acting in those capacities and the reader should assume that this is the case. The Macquarie Group's employees or officers may provide oral or written opinions to its clients which are contrary to the opinions expressed in this research.

Important disclosure information regarding the subject companies covered in this report is available at macquarie.com/disclosures.