Investment Strategy Update

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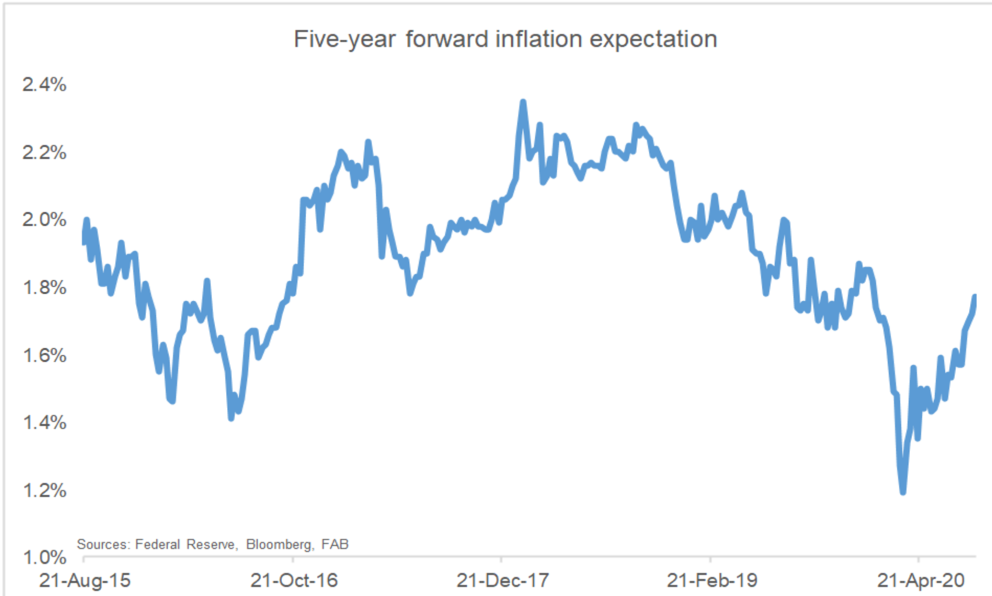
Is inflation coming back? Some investors seem to think so

- ♦ **US dollar five-year inflation expectations have risen 50 basis points in five months.**
- ♦ **Inflation surprises across the world have been mostly positive.**
- ♦ **Monetary and fiscal stimulus have not been used together to the extent they are now in decades.**
- ♦ **However, with record unemployment in many countries, it will probably take time for demand inflation to come back.**
- ♦ **The FAB AAC remains underweight equities while favouring gold and investment-grade debt.**



In the past decade, inflation has become the stuff of textbooks, the economic boogeyman of bedtime stories that never ventures out of the wardrobe. Despite record monetary stimulus between 2009 and 2019, year-on-year consumer price inflation in the US averaged 1.6% in the period, 40 basis points below the Federal Reserve's target of 2%. It did briefly flirt with higher levels in 2011, when it hit 3.9% in September of that year, but that was mostly driven by energy, as Brent crude prices hit US$125/barrel that year.

Otherwise, inflation has been so tame that central bankers are at a loss about how to increase it. In fact, one of the most economic models that central bankers pay a lot of attention to was questioned last year because of that. The Philips curve theory, which tends to associate general increases in wages and employment to rising inflation (though it is not that simple) was challenged last year as US unemployment fell to a 50-year low and consumer prices mostly stayed put.

That theory actually associates economic activity with rising inflation and it still holds, regardless of recent doubts. This is why economists generally do not expect to see real inflation for a while going forward, given the high level of unemployment across the world and the increased savings rate (which means people are keeping their money in the bank instead of making it help the economy grow).

Still, some indicators suggest investors are getting less sanguine about how prices will behave in the future. Five-year forward US dollar inflation expectations have risen 50 basis points in the past five months. They remain below 1.8% and below the 2% Federal Reserve target, so they indicate investors are not considering any interest rate hikes for at least five years.

Yet, the increase is noteworthy and has some basis. Commodity prices, affect all other products, for one, have been so low that any small increase could spur a significant change in inflation.

Five-year forward inflation expectations have increased 50 basis points in five months

Besides that, monetary stimulus and fiscal stimulus have not been used in tandem so widely and strongly across the world in decades. Since the 1970s, a growing number of central banks have first become independent from the government and then adopted inflation targets, which has often meant they increased rates when governments spent more. That has worked to keep inflation in check. Now, the whole world is back to printing money and giving it to governments to spend.

It may be early to see inflation ahead, but if it does materialize that will hit portfolios. Cyclical stocks, gold and commodities would outperform while bonds would lose. Higher prices may still be a fairytale, but perhaps investors should start thinking about how to face the boogeyman.

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