What if inflation weren't transitory after all?

Published November 25, 2021 | Length 4 minute(s) read

Though unlikely to materialise at this point, there is an alternative scenario: stickier inflation accompanied by a broad upward trend in interest rates. This could have major implications for investors, warns Frédéric Leroux, a Strategic Investment Committee Member at Carmignac.

Inflation is one of the key issues on the minds of investors, savers and consumers today. What's your take on this?

Frédéric Leroux: Investors expect the inflation we're now seeing to be transitory in nature. But there's analternative scenario being supported by the rising consumer prices on both sides of the Atlantic now that the global economy has perked up, and by a likely increase in wages for some job categories in the United States. Inflation may in fact turn out to have real staying-power, and may be accompanied by a broad upward trend in interest rates. Such a threat is unlikely to materialise at this point. But if it does, it will have major implications for investors.

How so?

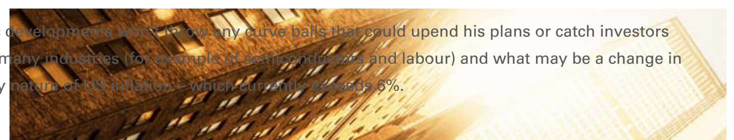
F.L.: An end to persistent disinflation would force us investors to throw off the conditioned reflexes we've developed over the last few decades and learn to adapt to a changed environment. To put it plainly, such an outcome would impact prices for certain stocks, gold and real-estate assets. But as I said, this is just an alternative scenario for now. In fact, to keep it from occurring, a number of central banks – whose role is to moderate fluctuations in economic activity – have begun to take action.

What have they been doing to tame investors' inflation forecasts?

F.L.: Several of them – in commodity-exporting nations and a few other emerging economies – have already taken steps to push up interest rates in the past few weeks. The US Federal Reserve (Fed) has likewise announced it will be winding down the financial-asset purchases it initiated several years ago to bolster the economy, and will eventually be lifting its own policy rates some time next year. As Fed Chair Jerome Powell has made very clear, his primary aim is to avoid unsettling financial markets. That involves letting them know well in advance what the Bank plans to do, how large the changes will be and at what pace they will unfold.

This is the same Fed Chair who's often repeated that the recent bout of inflation will soon be over.

F.L.: That's right. If you take him at his word, you'd be tempted to assume that economic developments won't throw any curve balls that could upend his plans or catch investors off guard. It would be great to share Powell's assurance. But the trouble is, shortages in many industries (for example of semiconductors and labour) and what may be a change in American attitudes towards work are starting to cast doubts on the supposedly transitory nature of US inflation – which currently exceeds 6%.



What attitudes are you referring to?

F. L.: The excess savings people have built up over the past eighteen months, steadily rising stock and real-estate prices and growing concern about quality of life are apparently leading a good many workers to contemplate retiring early, having one member of the household drop out of the labour market or shifting into jobs with less constraining schedules. Besides, with the number of openings for decent-paying jobs approaching record highs, US workers are now in one of the strongest wage-bargaining positions they've seen in decades. That's likely to add to existing upward pressure on prices. And there are other potential drivers of inflation worth considering.

Such as?

F.L.: The first such driver has to do with measures introduced by various governments to supplement household incomes, like the cheques sent out by the Trump administration to tide people over the pandemic-induced slump – including those with a high propensity to consume.
The second potential driver of higher inflation is today's concerted push towards the energy transition, which may generate lastingly higher natural gas and oil prices, due to weaker investment in fossil fuels. Replacing them with other energy sources will take years.

Yet investors have responded positively to the Fed's latest announcements.

F.L.: True, but that's something that perhaps should worry us. Despite the ominous economic outlook, investors feel the economy has yet to depart from its path of the past several decades – i.e., lastingly weak inflation that has no chance of bouncing back – with the result that interest rates will stay low. Investors expect those low rates will make it easier to borrow money and will deliver slower economic growth.

Why should that worry us?

F.L.: Because given how high debt levels currently are, if central banks hike policy rates too fast or by too much, that could trigger a sharp slowdown in the world economy. The opposite danger – central banks reacting too little or too sluggishly – doesn't appear to be a major concern for investors. But if it comes about, inflation could stay higher for longer. And if global growth weakens, the adverse effects of lastingly high inflation on financial markets would be much greater than any positive fallout from a gradual deceleration in rising prices.

How do you reckon the current situation will affect equities?

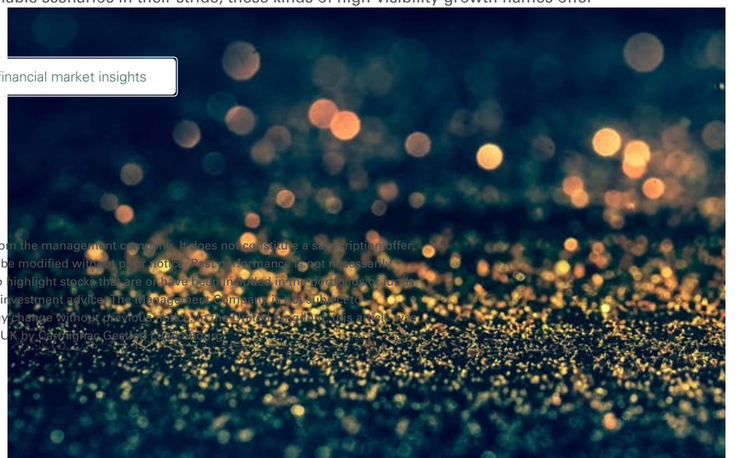
F.L.: If inflation gradually subsides after the current shortages are over and if economic growth doesn't tank, stock markets will likely maintain their upward momentum, with high-visibility growth companies[1] still leading the pack. Now, suppose that central banks fail to get the situation under control and this results in a heftier economic slowdown than anticipated. Even then, those same high-visibility growth names will still be turning in superior relative performance. It would take an out-and-out slump for more defensive stocks – issued by companies whose business would be less affected by a weakening economy – to carry the day.

What will happen if inflation stays high?

F.L.: The closest thing to what that scenario might entail would be the era of the Nifty Fifty, extending from the mid-1960s to the early 1970s, when the first oil shock in 1973 brought the US bull market to a halt. Round 1965, inflation began rising, driving interest rates up, but investors for the most part kept on buying the period's premium growth names like Digital Equipment (technology), Disney (entertainment) Eli Lilly (pharmaceuticals), Kodak (consumer products) and General Electric (industrial conglomerates). The fifty-or-so high-flying names that could easily shrug off inflation were called the Nifty Fifty.

Once again, a case of good earnings visibility.

F.L.: Exactly. Please bear in mind that persistent inflation is just an alternative scenario for now, and it will stay that way as long as we have no real evidence of strong, long-term wage inflation. That said, due to their apparent ability to take any and all currently imaginable scenarios in their stride, these kinds of high-visibility growth names offer considerable relative value.



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Source : Carmignac, Bloomberg, 12/11/2021

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