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INVESTMENT MANAGERS

Investment viewpoint

Back to the future: inflation scenarios for equities

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Key points

- As economies rebound, driven by fiscal stimulus and societal reopening, we believe equity markets offer cyclical reflation and value opportunities and exposure to long-term, structural themes: from the transition to net-zero to the affirmation of Northern Asia as global power, the ageing population, growth of fintech and increasing digitalisation
- In our view, equity markets will benefit from a supportive environment resembling the surging growth of the 1950s to mid-1960s, when economic expansion outpaced inflation as central banks remained dovish
- The current US equity risk premium, when forward earnings are taken into account, currently stands above its historical range at 6% – this should ease concerns about valuations and emphasise the extent of the opportunity available at this stage of the cycle
- Still, there are fears of a stimulus-driven outbreak of inflation that will suffocate returns – we are keeping watch on longer-term inflationary forces that echo the conditions leading to the 1971 Nixon shock and subsequent period of stagflation

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At last, the recovery is underway. Policymakers are focused on employment and investment, central banks remain dovish and businesses suppressed by lockdown can see a way forward. Growth expectations are strong and markets have been upbeat – until recent weeks, when long-term bond yields increased, rattling markets as fears that stimulus-induced expansion could drive an outbreak of inflation.

Are they justified? We believe that inflationary forces are cyclical and this environment provides attractive opportunities for disciplined investors. In the long term, however, we do see potential drivers for a structural rise in inflation and our outlook is informed by two historical episodes: the surging growth of 1950-65 and stagflation of 1966-81.

Recession, rebound, repeat?

In many aspects, the COVID-19 pandemic was an unprecedented shock. But like the global financial crisis and dotcom crash, this downturn is charting a familiar pattern of economic recession and rebound (see figure 1). As the pandemic spread and the outlook for growth darkened, inflation expectations naturally declined. Now, with vaccination and public-spending programmes underway in major economies – notably the US's USD 1.9 trillion American Rescue Plan, the UK's extensions of furlough through to September and the European Union (EU) Green Deal – economic prospects are improving. With such spending likely to boost growth and employment amid accommodative central-bank policies, market participants are bracing for inflation, driving long-term bond yields higher.

Inflation: the cycle lives on

The good news is that cyclical inflation is normal during economic recoveries. So, after the exogenous shock and upheaval of 2020, this pressure is comfortingly familiar. But some market participants believe the potential strength of this recovery – driven by immense public spending, pent-up consumer demand and central banks' desire to keep interest rates at ultra-low levels – will lead to structurally higher inflation.

In our view, these fears are overestimated in the short term but do justify constant vigilance as longer term risks. In the next two years, however, we believe the dynamic between growth prospects, inflation and interest rates in the context of healthy corporate-earnings forecasts will create opportunities for equity investors, and are positioning our portfolios accordingly.

Investing in the recovery

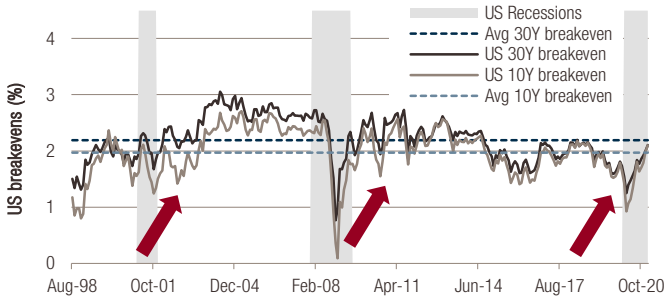
As the COVID-19 recession was caused by policy restrictions on business activity rather than financial or economic malaise, the cautious reopening of societies is helping to drive the recovery. What stopped is starting again: the transportation, retail, utilities, fast-moving consumer goods and consumer-services sectors are rallying, outperforming their historical averages during exits from previous recessions.

Beyond these comebacks, structural trends continue to be in play. One of these major themes is digitalisation, which has been accelerated by the pandemic and benefits semiconductor foundries and other firms aligned with the growth of 5G networks, cloud computing and the internet of things. Sectors not aligned with the recovery or structural trends, like consumer staples and pharmaceutical majors, are lagging.

In our range of portfolios, we continue to focus on quality stocks while seeking growth and value opportunities benefitting from the cyclical recovery. Quality is a hallmark of our investment approach, and economic recoveries have shown us that the performance of this style persists during cyclical upturns (see figure 2).

FIG. 1 RISING INFLATION EXPECTATIONS ARE A FEATURE OF ECONOMIC REBOUNDS

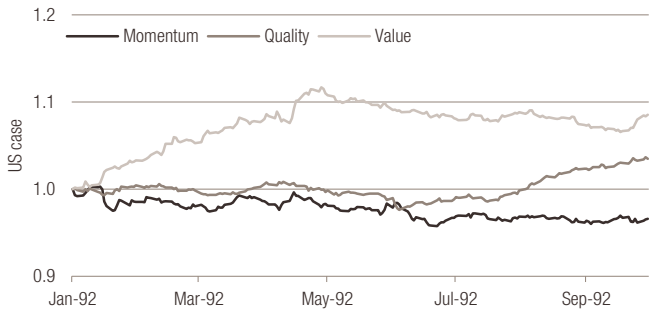
US BREAKEVENS IN PERCENTAGES



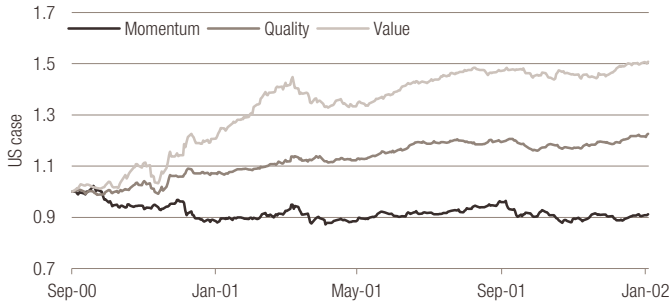
Source: LOIM analysis, Bloomberg, FRED Economic Data as at March 2021.

FIG. 2 CONSISTENCY AMID CYCLICALITY: THE PERFORMANCE OF QUALITY VS VALUE AND MOMENTUM DURING PAST EPISODES OF CURVE STEEPENING

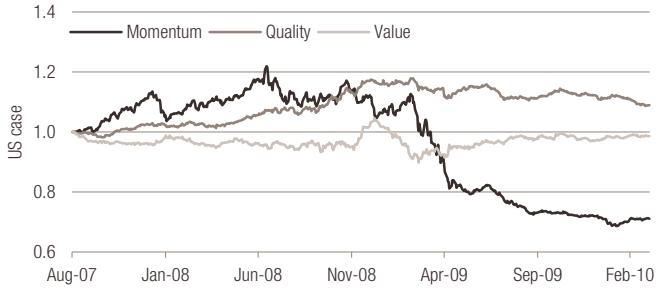
JANUARY TO SEPTEMBER 1992



SEPTEMBER 2000 TO JANUARY 2002



AUGUST 2007 TO FEBRUARY 2010



Source: LOIM analysis, MSCI Indices as at March 2021.

Our current positioning reflects what we have learned throughout previous cycles:

- Focus on quality, as it typically generates strong returns more consistently than value and momentum
- For exposure to value, seek attractively priced, quality cyclical companies as they are usually superior to other dull value stocks, which can perform well but in unpredictable bursts
- Be wary of momentum stocks – especially those with rich valuations and of limited quality, because they tend to be very costly on a relative basis as they tend to underperform

These views guide our approach in the short term, with robust growth and low interest rates accommodating a cyclical rise in inflation. But what lies further ahead? Here, revisiting the interplay of economic, fiscal and monetary dynamics that drove growth, inflation and markets in recent decades provides potential insights into what might come.

Surging growth: 1950-65

The post-WWII boom, driven by nation-building investment, deregulation and diminishing trade barriers, drove a groundswell of growth. Bretton Woods, the original international monetary order, saw the dollar pegged to gold at USD 35 per ounce along with capital controls. It provided stable exchange rates and helped drive down protectionism and hot money flows. Inflation surged in the early years but central banks, particularly the Federal Reserve, were accommodative and real interest rates remained negative to marginally positive until 1960. This, combined with the economic expansion, helped governments reduce wartime debts by about 50%.[1] Meantime, consumers enjoyed a purchasing-power increase of more than 30% in the post-WWII years.[2] By the mid-60s, the bull market had run for 15 years and the equity risk premium (ERP) was close to 3%.[3]

Stagflation: 1965-81

In the 1970s, the good economic vibes began to fade. The US deficit increased as the nation took on debt to fund domestic social programmes and its war efforts in Vietnam. Meantime, its share of global gold reserves – essential for maintaining the value of the USD under Bretton Woods – had declined from about 60% to 20%[4] and many foreign buyers of the dollar began to lose faith in the country's ability to cut its trade and budget deficits.

Notably, France and the UK sought to convert their USD holdings into gold. This pressure, compounded by the growing strength of the dollar, diminishing US gold reserves and rising inflation as the Fed prioritised full employment, eventually forced the US administration's hand. In 1971, the US banned the convertability of its currency into gold as part of a presidential order dubbed the Nixon shock. The dollar collapsed in value, Bretton Woods effectively ended and interest rates rose with inflation, suffocating growth.

Great Moderation: mid-1980s to 2007

After the ensuing period of the stagnant growth and inflation, conditions improved. Higher productivity enabled by technology, financial deregulation and globalisation helped smooth macroeconomic volatility. Coined the Great Moderation, this period was also characterised by the stronger presence of central banks as their responses to inflation and output dynamics became more systematic and they improved their communication frameworks. However, market shocks still occurred:

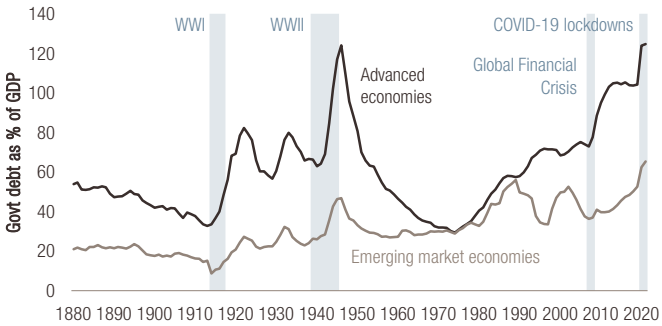
- 1982: Latin American debt crisis
- 1984: Collapse of Continental Illinois National Bank and Trust Co.
- 1987: Black Monday stock-market crash 1987
- 1997: Asian financial crisis
- 1998: Collapse of Long Term Capital Management
- 2000: Dotcom bubble
- 2008: Global Financial Crisis

The role played by central banks in the recovery from each of these crises increased throughout the period, with liquidity injections and interest-rate cuts becoming instrumental in restoring stability and growth. Despite this, inflation remained subdued. The aforementioned forces of technology, deregulation and globalisation – combined with a rise in precautionary savings as more people deferred consumption by investing for retirement or through wealth accumulation – helped keep inflation down.

Is history repeating?

Fast forward to 2021, and the global economy still enjoys structurally low inflation. However, largely due to the measures taken to fight downturns during the Great Moderation, public debt levels and deficits in major Western economies have worsened during each recession in the last 40 years. Following the stimulus pumped into markets and economies to counter the COVID-19 pandemic, government indebtedness in developed markets is now similar to WWII levels (see figure 3).

FIG. 3 LOADING UP: GOVERNMENT DEBT AS A PERCENTAGE OF GDP



Source: International Monetary Fund as at March 2021.

Sources: [1] International Monetary Fund as at 2021. / [2] LOIM analysis, Factset, FRED Economic Data as at March 2021. / [3] LOIM analysis, Bloomberg as at March 2021. Equity risk premium formula: 1/T12m PER – (10y risk free rate – 3y trailing inflation). / [4] LOIM analysis, Bloomberg, FRED economic data, World Gold Council as at March 2021./ [5] LOIM analysis, Central Banks, OECD data as at March 2021.

Deficits are deep underwater, too, led by the US at -15%,[5] and spending won't stop anytime soon: spurring growth and employment are policymakers' foremost economic objectives, and the current regime of ultra-low interest rates needs to continue in order for immense debts to keep being serviced cheaply.

Janet Yellen, US Treasury Secretary and a former Chairman of the Federal Reserve, captures this sentiment well:

> **"The most important thing we can do today to set us on a path to fiscal sustainability is defeat the pandemic, provide relief to the American people, and make long-term investments that will grow the economy and benefit future generations."[6]**

Spending is currently *de rigeur* in the policy sphere, and, as in the post-war years, stimulus will be geared towards physical assets and in employment. Following WWII, rebuilding efforts focused on restoring cities and infrastructure. Today, investment is required to counter the existential threat of our current way of life. Capital is needed to drive the transition to an economy with net-zero carbon emissions, far greater circularity and an emphasis on preserving nature and biodiversity to safeguard the welfare of current and future generations, while unlocking new sources of growth. In the main, governments and people worldwide support this, as it appeals to long-term environmental, employment and growth aspirations. But this doesn't mean there won't be adverse side effects.

The capital committed to US and EU stimulus programmes will overcompensate for the negative output gaps in these economies (see figure 4). If they meet the objectives of generating strong employment and growth, these plans could not only deliver the relief and expansion desired by policymakers but – as feared by some market participants – also become a force for a structural rise in inflation.

Note that governments aren't the only entities keen to put money to work. Consumers who have accrued savings during lockdowns will have more opportunities to spend as lockdowns ease, and it remains to be seen whether companies that acquired cheap debt opportunistically or as a precautionary measure will invest or simply pay it back as the recovery progresses.

Inflation faultlines

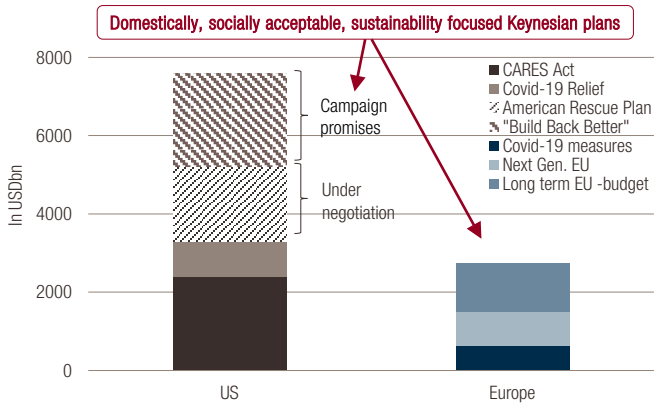
As in the late 1970s, questions about the fiscal discipline of major economies and the potential for dramatic currency revaluation presents a looming inflationary risk. China, the world's second-largest economy and a manufacturing powerhouse, has a strong trade surplus but suppresses the value of its dollar-pegged currency through a range of measures. These include: purchasing assets denominated in USD or EUR, financing overseas development projects through the Belt and Road initiative, and encouraging domestic investors to buy assets outside China.

But as heavily indebted Western economies pump out further stimulus, will China continue to have confidence in the debt of these arguably ill-disciplined sovereigns? Should it judge the risk to be too high, or it exhausts ways of funneling reserves overseas, the renminbi would rapidly appreciate, becoming the epicentre of a price shock that exports a structural inflation surge throughout the global economy.

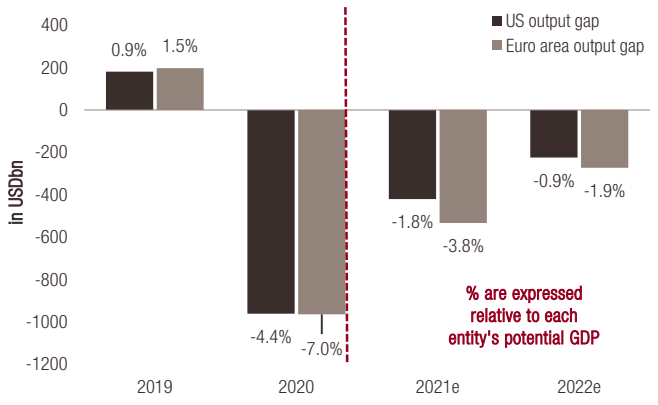
There are other inflationary pressures. Declining globalisation could result in further trade tensions, and labour costs could increase in the absence of new, cheap pools like the China or Eastern Europe of recent decades. Precautionary savings accrued during the Great Moderation could be released into the economy as ageing populations in the northern hemisphere retire and the increasing popularity of redistributive social policies in the West, such as universal basic income and wealth taxes, potentially converts income or savings held by the wealthy into spending money for others. All of these dynamics have the potential to push the prices of goods and services higher.

FIG. 4 OVERSTIMULATED? US AND EU SPENDING PLANS

FISCAL STIMULUS PLANS (IN USD BILLIONS)



US AND EU OUTPUT GAPS (IN USD BILLIONS)



Source: LOIM analysis, US Congressional Budget Office as at March 2021; ECB Macroeconomic projections as at December 2020.

[6] Hearing on the nomination of Dr. Janet Yellen. Responses by Dr. Yellen January 21, 2021. United States Senate Committee on Finance.

Our verdict: history is rhyming

How are these perspectives informing our investment decisions? In our view, the imminent spending spree should drive a cyclical upswing amid continuing low interest rates. History doesn't repeat, but this environment rhymes with the 1950 to mid-1960s: successive years of expansion in which central banks accommodated inflation as growth outpaced interest rates, generating a strong tailwind for equities and allowing for a period of economic deleveraging among sovereigns. And, looking beyond the macro to market metrics, we find further cause for optimism.

What does the ERP tell us about the potential returns on offer? Relative to all periods since 1960, the ERP of the S&P 500 is close to 4%, within its historical range of 2-5%. But consider the outlook: despite concerns about valuations, earnings are rebounding, real interest rates are low and structural inflation is below 4%. And if forward earnings amid the expected cyclical recovery are taken into account, the ERP rises towards 6%. These conditions are more supportive of equity investment than many environments in recent decades (see figure 5).

Investors are alert to the opportunity, having channeled USD 414 billion into global equity funds in the past four months – a 300% increase on the previous four-month high in January 2018.

These macro and market conditions also support long-term investment themes which we are deeply exposed to. For instance, the EU Green Deal and government commitments to the Paris Agreement, which seeks to limit the rise in global temperature to 1.5-2°C above pre-industrial levels, will direct fiscal spending towards the low-carbon transition. North Asian economies are recovering faster and more strongly from the pandemic than those in the West, maintaining the momentum of Asia's transformation. Ageing baby boomers continue to draw on savings to purchase products and services constituting a 'silver economy', and the global fintech industry continues to grow rapidly, driving the shift to a cashless society with greater financial inclusion. As societies reopen, the pandemic-driven consumer trends of health and hygiene, ecommerce will persist as stalled sectors like hospitality and travel are revived. We also focus on the emerging sustainability theme of natural capital, which provides a framework for identifying companies that are growing through products and services that either preserve nature or harness its regenerative power. In the current cyclical upswing and beyond, we anticipate opportunities aligned with all of these structural themes.

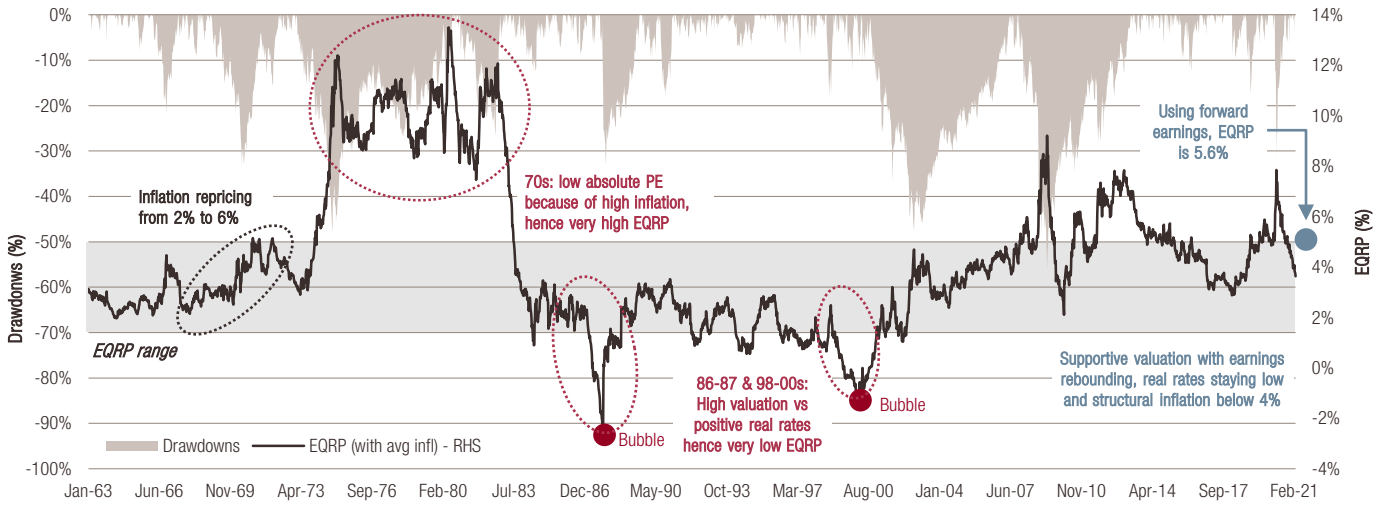
Investing in the present, for the future

Economies are recovering amid supportive fiscal and monetary policies, and consumers are responding to the reopening of societies. Growth will resume, and inflation will likely follow in a cyclical upswing. Despite central-bank commitments to support growth by accommodating inflation, the yield curve will steepen as markets anticipate higher interest rates in the long term.

Nevertheless, equity markets will remain attractive. Why? Taking forward earnings into account, the current ERP of almost 6% in the US indicates the there is strong return potential at current valuations. Drawing on our experience of investing throughout cycles, we continue to apply our tested approach of favouring quality stocks given their ability to generate consistent, positive returns, while investing cautiously in promising quality value and growth companies. Meantime, we continue to focus on long-term investment themes that we believe will create value in this cycle and those that follow: the climate transition, natural capital, fintech, global consumer trends, the transformation of Asia and the silver economy driven by ageing populations.

In our view, the forthcoming cyclical rise in inflation, with growth likely to outpace interest rates, should not spook stock markets. Rather, it should encourage investment. What should concern investors are the faultlines that could send an inflationary shock around the world. We see RMB appreciation as being among them, and watch vigilantly for signs that pressure is building.

FIG. 5 LOOKING GOOD: THE CURRENT US EQUITY RISK PREMIUM RELATIVE TO HISTORY



Source: LOIM analysis, Bloomberg as at March 2021. ERP formula: 1/T12m PER – (10y risk free rate – 3y trailing inflation).

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