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Investing in the age of financial repression

A new scenario of inflationary risk is upon us but investors seem to think that it is going to be all right, as long as central banks will continue to save the day. But is this really going to be the case? We believe that the ending is not yet written on the wall and the potential outcomes will be path-dependent. In contrast to the last 12 years, delivering investment returns in the new scenario will be extremely difficult, and investors will need to keep flexibility and rely less on market "betas" than they did in past.

Is the world becoming inflationary?

The reasons for expecting an inflationary environment are complex. After 12 years of extraordinary measures by central banks, a new type of life support was unavoidable to address the economic consequences of the Covid crisis. Radical policy changes were required. The biggest shift has been the move from monetary policy driving economic growth and financial markets to a convergence of fiscal and monetary policy at a scale which has never been seen in (at least modern) history. It is a game-changer in a number of ways.

The combination of money creation on an extraordinary scale, plus unprecedented peacetime public deficits is the textbook recipe for an increase of inflationary forces. But there are also strong counter-arguments.

The main case against inflation is that the world is still plagued by enormous output gaps and high unemployment. In 2020, the savings rate in most countries spiked due to COVID19. Can we expect this to become permanent? In that case an inflationary outcome would be a distant threat.
Furthermore, the proponents of "low inflation for longer" argue that 'QE infinite' has not led to inflation in the last decade, because structural deflationary forces were in place: 1) demographics, particularly what we have experienced in the last 40 years with the largest cohort of people of working age 2) technology driven productivity improvements, and 3) China entering the global trade system with obvious deflationary effects.

The opposite argument is that these structural forces, though significant in the past, are waning. Globalization of supply chains is going into reverse and the deflationary effects of new disruptive technologies are diminishing. Some economists (e.g Goodhart and Pradhan[1]) even argue that the disinflationary impact of demographics is going into reverse, due to the exit of the baby boom generation from the active workforce.

However, the key argument in favor of a major inflationary spike is political: free expansion of public deficits financed by central banks is becoming an acceptable theory in policy making (it is what the proponents of Modern Monetary Theory are effectively advocating) . In fact, the argument goes, the service of the current size of public debt will only be manageable at zero or negative real interest rates. We expect governments to be strong supporters of inflation as a debt-reduction tool, simply because the alternative (default or restructuring) would be much worse. And the "good" alternative, i.e. an increase in real economic growth, is pretty difficult to achieve in a world plagued by low productivity growth.

This is obviously bearish for government bonds. In fact, the believers in the saving role of central banks argue that what we will finally see is "financial repression". Which implies that once the first signs of inflation appear, central banks will step in and implement yield curve control, very much like Japan did in the recent past. Therefore, bond holders will gradually lose money in real terms, by sitting passively on nominal yields kept artificially below the inflation rate. A policy of financial repression which had already been implemented in the 50's and 60's, although at higher levels of nominal rates.
In this scenario, though, more "risky" assets, such as equities, would be fine: they would continue to benefit from a "search for yield" driven by negative real interest rates.

We are not convinced. The real question is how investors (and monetary authorities) will be able to distinguish between a moderate increase in inflation that leads to the goldilocks scenario of an "acceptable" rate of inflation and something much more serious, or dangerous. Something like a 1970's style inflation. It is quite possible that when the data points of inflation rise above a certain (currently unknown) threshold (3%, 4%, 5%?), investors will become increasingly nervous and try to front run the acceleration of inflation, starting an exodus from bonds. Alternatively, the adjustment could happen through the devaluation of the currencies of those countries engaging in yield curve controls. It will all become matter of confidence.

As we said, there is no predetermined final outcome, a lot will depend on the interdependence between the actions and reactions of central banks and market practitioners.

The call to action and opportunity for asset managers

This is not just a short term issue. Due to the unconventional policies of the last 12 years, all asset classes' prospective returns have been lowered dramatically, at a time when most retirement systems are largely underfunded and the investment risk of retirement portfolios has been pushed from governments and corporates to individuals for over 40 years.

If the world we are about to enter does not resemble anything we have seen in the last decade of easy monetary policies and money printing, then we must prepare for a completely different environment. Asset managers have a historical opportunity to create products that address these issues.

The obvious answer to a new inflationary era is to build investment products that offer protection in "real terms". What assets qualify as 'real assets' in this context? Certainly the so-called "real assets" in the strict sense of the term: real estate, infrastructure, utilities etc. But leaving aside property which is a very large asset class, mostly owned in illiquid form, this begs the question: how many infrastructure projects or other type of real assets are truly available to address the needs to invest for retirement at a very large scale?

What about equities? They are the most liquid and largest asset class which can offer exposure to "real" economy growth and at least "some" protection from inflation. However, we are mindful of our previous comment about the low expected return of equities as an asset class, due to the effects of (past) monetary expansion and unconventional policies.

Summing up: savers will be in the unfamiliar position that they must hold more real assets while recognizing that broad asset class returns will be more muted. "Real" assets include property and infrastructure but also equities. Equities, however, look extremely expensive at this stage and promise low prospective returns. What to do? Commodities and precious metals will definitely find space in portfolios that aim to be "robust" to an inflationary environment. But that will not be enough. We do not believe that a simple call to overweight a particular asset class will suffice. Rather, this is an excellent example of how allocating at asset level arguably carries more risk than the potential return can warrant.

The idea of idiosyncratic investment has long been discussed by investment managers but is mostly not reflected in portfolios. This idea is the key to navigating the uncertain conditions we are facing. Equities, as an asset class, may not deliver returns, but individual companies can. And investors can decide on the best way to invest in them, across their capital structure. This supports the return of security selection, not in the traditional sense (selection versus a benchmark) but in the sense of 'what purpose does this particular holding serve in our portfolio?' A portfolio of different idiosyncratic investment ideas selected from a wide range of "real" asset classes (equities and credit, publicly listed and private companies) represents the best strategy to navigate the coming era.

Conversely, the old method of first allocating to 'asset classes' and then filling the asset "buckets" with individual securities chosen within a benchmark can no longer deliver the required returns. The new role of active asset managers will be to build resilient portfolios based on individual investment cases explicitly chosen to deliver the final outcome, rather than relying on traditional methods.

A final point relates to risk. The new scenario will undoubtedly be more uncertain than the one we have been living through in the last decade. The so called 'central bank put' will not work anymore and we will likely experience periods of more pronounced volatility and shortened market cycles. Therefore, investors must redefine their concept of risk. Risk is no longer the simple volatility of mark to market prices. Real risk describes the probability of achieving desired outcomes (for example: retirement goals).

Why is the definition of risk important? Because an appetite for "risk" will be necessary for producing "real" returns, i.e. returns after inflation, thanks to an exposure to a selected number of investment ideas generated cross-assets. If we continue to define risk purely in terms of mark to market volatility we will not have enough sources of return. And we will lose sight of the final destination of the journey: producing decent portfolio returns above the inflation rate.

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[1]*"The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival" by Charles Goodhart (Author), Manoj Pradhan (Author)*