AGF INSIGHTS

Inflating Expectations

The U.S. Federal Reserve says it wants to let inflation run "hot." But will the central bank get the chance to prove it? Members of AGF's Investment Management Team recently sat down (virtually) to discuss the Fed's new policy mandate and why differentiating long-term deflationary trends from short-term inflation expectations is critical to investors and their portfolios going forward.

Questions and answers that follow have been edited for clarity and length.

By Steve Bonnyman, Regina Chi, Andy Kochar, Mark Stacey and David Stonehouse

Let's start with the U.S. Federal Reserve's recent decision to let inflation run higher than its 2% target in certain circumstances. What's the impact on monetary policy?

David Stonehouse (DS): The key change is its decision to employ a policy known as Average Inflation Targeting (AIT). If inflation is undershooting the Fed's 2% target, as it has in recent years, the central bank is now willing to let inflation run "hot" in hopes of overshooting the 2% target so that, on average and over a prolonged period of time, the inflation rate ends up at 2%. The same idea would also apply, albeit in reverse, if inflation was overshooting the target. The Fed has so far been short on specifics, however, and it's still unclear exactly what actions the central bank plans to take – or when it will take them – in pursuit of a longer-term inflation average of 2%.

And why did the Fed make the change?

Andy Kochar (AK): It seems like an acknowledgement that mistakes were made by the Fed in the past which were directly attributed to its approach of keeping inflation from rising above 2% based on a year-over-year measurement. This can be highly volatile and may overestimate the actual level of inflation in the economy, and, arguably, there have been several instances of the Fed tightening policy prematurely through higher interest rates. AIT should help prevent that from happening again. At the very least, it gives the Fed more flexibility to determine a course of action once inflation does start to pick up more substantially.

DS: The Fed has also been clear that it does not believe as much as it used to in the Phillips Curve, which is the trade-off between employment rates and inflation. In large part, that's because low unemployment levels have not resulted in a significant spike in inflation over the last couple of decades. As such, the Fed seems more intent on achieving full employment and focusing on better outcomes for society than it does about the potential ramifications for inflation – at least that is until higher prices truly start to manifest.

What is the probability that inflation does rise from here?

AK: It's hard to see significant inflation over the long term given some of the structural impediments that are currently keeping a lid on prices. But it's important to separate the long-term inflation trend from shorter-term inflation expectations. These are two different things entirely and it's likely that the latter measurement will climb higher if the economic recovery from the pandemic-induced recession isn't sidetracked and the Fed's new approach towards inflation is put into practice. Moreover, this rise in inflation expectations will have important implications for investors even if it doesn't properly reflect the longer-term economic reality facing them.

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DS: The Fed is clearly striving to generate more inflation than it's been able to since the Great Financial Crisis (GFC). In fact, there are only two, six-month periods in the last 12 years where it's been able to get the core inflation rate up over the 2% target. But while the market appreciates the Fed's desire to move the needle higher on inflation and be even more accommodative than in the past, it is also skeptical about the Fed achieving that goal because of the very fact that monetary policy has been so incredibly loose since the GFC. And that goes for other central banks around the world as well. In large part, inflation has been non-existent because of the structural headwinds alluded to earlier, which include slowing population growth rates and record debt levels that continue to act as a restraint on inflation and have resulted in disinflation and declining bond yields over the past couple of decades. So, while inflation expectations have rebounded of late and could easily move higher in the short term if the recovery continues to take hold, it's going to remain a Herculean effort for the Fed to generate higher inflation on a more sustained basis.

Regina Chi (RC): To that end, inflation expectations are being driven higher by the enormous amount of fiscal stimulus that's been enacted this year. It's rare that we've seen both highly accommodative monetary policy and this much government spending at the same time. Meanwhile, disruptions to the global supply chain are pushing the cost of goods sold higher, as are populist "Made In" initiatives in countries like India and China. But structural issues, as noted already, suggest inflation will remain subdued longer term. In addition to demographics and debt loads, the rise of the shared economy is another disinflationary factor to note because it allows businesses to scale up very quickly without incurring marginal costs.

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Mark Stacey (MS): Deflation does seem more likely than inflation over the long run, but it's precisely these deflationary issues that the Fed is trying to combat by not worrying as much about overshooting its 2% inflation target. Even if it doesn't lead to higher sustained consumer prices, the prospect of knowing that the Fed is going to hold off on raising rates a bit longer than they might have in the past could further inflate asset prices –if not create bubbles – for risk assets including stocks and hard assets including real estate, which have already benefited greatly from central bank accommodation over the past decade. So, this could accelerate that.

DS: That's an important point because what we've seen over the past decade is a wealth effect. There's been inflation in capital market assets due to the Fed's unconventional policies, but that hasn't resulted in greater consumption more broadly or higher inflation across the broader economy as was largely anticipated. Whether AIT can help change that, remains to be seen, but it's part of the reason for the Fed's changing approach.

Fiscal stimulus was mentioned earlier as being a catalyst for short-term inflation expectations. What potential impact does the rise of Modern Monetary Theory (MMT) – i.e. the idea that governments with their own currency have the capacity to spend more freely than in the past – have on inflation longer term?

AK: It could be profound and counteract some of the structural issues that we've discussed already as being deflationary. It's easy to anticipate higher inflation expectations if the economy rebounds over the next few months and growth accelerates. If you're looking back, that's usually what happens in the early part of a new economic cycle. But it's somewhat unprecedented to have this much fiscal and monetary stimulus backstopping the economy at the same time and should this dynamic persist, it could lead to a much more sustained level of higher inflation that many of us currently believe is likely.

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RC: The question is whether MMT is going to persist beyond this recession and how widespread it becomes. No doubt, fiscal stimulus has been critical to combating the economic fallout from the pandemic, in part, because monetary policy has been so accommodative over the past decade, leaving central bankers short on tools for stimulating the economy further on their own. But coming out of this recession, will the idea that governments can spend so freely remain a key tool? In Emerging Markets, at least, MMT has not been so evident to date. In fact, countries like Brazil are being forced by the market to remain fiscally disciplined or suffer the consequences of a plummeting currency.

DS: It also likely depends on how MMT continues to manifest if, in fact, it does persist. Traditionally, the mechanism for stimulating the economy is to put money into the hands of the banks who will lend it to consumers who go out and spend their expanded credit on the goods and services they desire. In turn, that should lead to better growth and higher inflation, but that's no longer the obvious outcome because higher and higher debt levels make it difficult for people to service more of it. However, if money is put to work more directly, as some proponents of MMT suggest, through programs like a Universal Basic Income, for example, or debt relief that would unburden people of their student loans, a more resolute brand of inflation may take hold and lead to a much different economic reality than is widely forecast now.

Let's turn back to the here and now. If inflation expectations do start to rise more significantly in the coming weeks, how will that impact your decisions as money managers?

Steve Bonnyman (SB): Given my focus, I'll be looking closely at my exposure to the materials sector and looking to add some of the beaten-up parts of the market such as chemical companies that have a tie to consumer demand in autos and similar industries. Energy would probably get a bit of a boost out of a cyclical rebound as well, but also top of mind will be the decision to potentially reduce lower duration asset holdings such as utilities.

RC: In Emerging Markets, inflation varies quite dramatically by region and by country. While it may be evident in Eastern Europe, India or South Africa, for instance, it can be relatively benign in emerging Asia. As such, a nuanced approach is what tends to work best. But if the economy reflates and materials do well and commodity prices rise, then countries like South Africa and Brazil may benefit the most.

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>
> **– Mark Stacey**

MS: Generally speaking, every aspect of what we do as investors would be affected, from asset allocation to sector and/or factor positioning within each asset class. However, more specifically, it's usually a good idea to find companies with enough pricing power to offset a rise in inflation and continue to generate attractive profits. And if the Fed does let inflation run hotter and continues to keep a lid on raising interest rates, dividend-yielding stocks may also prove attractive.

AK: The materials sector would also be a major focus of opportunity from a credit perspective, as would consumer discretionary. Both of these sectors are sensitive to changes in the economy and should benefit from a cyclical upturn and rising inflationary expectations.

DS: As for government bonds, yields would rise in a more inflationary environment, but an emphasis on shorter-duration maturities can help limit the damage of that. Inflation-linked bonds would also look attractive, relatively speaking, in this environment and have already rebounded to some extent in anticipation. Lastly, it wouldn't be surprising to see convertible bonds outperform the rest of the fixed-income universe as well.

Given these potential opportunities, what concerns you most about the prospect of higher inflation?

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>
> **– Steve Bonnyman**

SB: It's not so much about the inflation level, as much as it is the starting point and which direction it's moving. A lower inflation rate, as is the case today, that begins to rise has different implications for real assets, for instance, than does a higher inflation rate that is also rising or a higher inflation rate that is starting to fall. At the same time, the source of the inflation is equally important. Is it supply-based inflation whereby there are supply constraints? Or is it demand driven? Because, if the inflation is being driven by higher wages, then it's going to have a very different impact across sectors and economies. A highly service-driven economy, for instance, is going to be far more damaged by massive wage inflation than is one that is not as service oriented.

RC: It's interesting that there hasn't been more of an increase in Emerging Market inflation given the currency depreciation and interest rate cuts that we have seen in various developing countries like Brazil. But one of the worries I have is the stickiness of inflation if and when it takes hold and how policy makers respond to that. Yes, the Fed has said it will let inflation run higher than in the past and has committed to keeping rates low for the next few years, but it remains to be seen whether that holds true. And even a slight change in the central bank's language suggesting it will become less accommodative could be enough to undermine EM stocks, not to mention other risk assets.

AK: The Fed's ability to follow through on its new stance is one of the biggest questions facing investors. Presumably, the threshold for Fed tightening has just gone up with the introduction of AIT, but beyond saying interest rates will be anchored near zero through at least 2023, it's somewhat unclear what other actions the central bank might take, including on yield controls and its buying and selling of bonds in the future. So, this does leave room for surprises even though the Fed is being more transparent with its intentions than in the past.

DS: The Fed is leaving itself wiggle room, but there's not a lot of interest in having a stillborn rise in inflation and economic rebound because of a premature policy move. That's why the Fed is going to so much trouble trying to convince the market that it has no intention of doing anything for years.

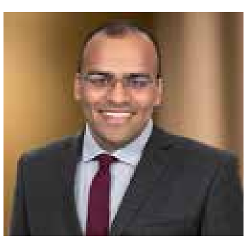
Contributors

Steve Bonnyman, MBA, CFA®

Co-Head of North American Research and Portfolio Manager

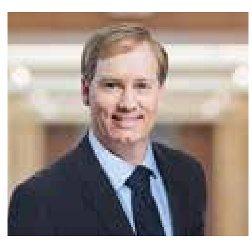
Regina Chi, CFA®

Vice-President and Portfolio Manager



Andy Kochar, CFA

Portfolio Manager and Head of Credit



Mark Stacey, MBA, CFA®

Senior Vice-President, Co-CIO AGFiQ Quantitative Investing, Head of Portfolio Management

David Stonehouse, MBA, CFA®

Senior Vice-President and Head of North American and Specialty Investments

For more information, visit AGF.com

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