FINANCIAL PARTNERS

Inflation, here it comes! Or not?

Weekly Digest

29 January 2018

– *Jernej Bukovec, CFA*

If you are an asset allocator today, by far the most important question you should attempt to answer is what will happen to inflation, or more explicitly, to inflation expectations in the coming years. Are we on the verge of entering into a higher-inflation environment? Or will we slip back into a Japanese-style, disinflationary low rate environment?

All major economies posted strong economic growth in 2017, oil prices have increased 60% since June, unemployment rates have continued to decline and we have started to see the first signs of wage increases. Even China, the biggest exporter of deflation in recent years, has reported increases in wage growth For years, Chinese workers have had little pricing power given inflows of labour supply from rural areas, but this trend may have started to turn. In addition to this, since 2009 we have seen a huge increase in money supply by central banks and if the velocity of money speeds up again, inflation might become difficult to control. If inflation surprises on the upside, central bankers will be busy raising rates and bond yields will increase a lot faster and further than markets are currently expecting.

An inflation shock would not only be negative for bonds but probably for equities as well. Although companies are usually good at passing through inflation into higher earnings, the negative impact on valuation multiples could be significant due to higher discount rates.

There are few asset classes that would perform well in this higher inflation scenario, at least in the short term. Traditionally cash and short duration assets fare better, but given the negative real yields, the returns might be limited. Commodities and commodity linked companies should do well, as should emerging market equities, given lower valuations and the fact that emerging market companies are more used to operating in higher inflationary environments.

On another side, the structural disinflationary forces are still present and well. Demographics, high debt levels and technological advances all have strong disinflationary impacts and should put a cap on inflation. On top of that, central banks are planning to remove over half a trillion dollars of liquidity over the next 12 months, which will have implications on global demand. All this points to a future that will look more like the recent years, with a low level of inflation and the continuation of low rates. Japan over the last 20 years might be a good example of what one might expect. In this scenario, bonds and equities might avoid any major declines, but future investment returns would be lower than in recent years.

Portfolio managers believe in genuine diversification and robust portfolio construction as the best chance of achieving our targeted outcomes. As such, they aim to avoid portfolios becoming hostage to any particular scenario by allocating to investments that can benefit from higher inflation as well as holding investments that can perform well in a disinflationary environment. At the margin, the risk of higher than expected inflation today has increased, and portfolio managers have been adding to inflation-linked bonds, short duration bonds, emerging market equities and liquid alternatives.

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The Marketplace

- Brent crude oil finished the week up 2.8% at 70.3
- Gold was up 1.5% standing at 1353.3
- World leaders convened in Davos
- Global Equity funds attract a record $33.2bn last week

Market Focus

US

- The Dow Jones rose 2% again this week closing at 26616, yet another all-time high close on the week
- A similar story on the Nasdaq which gained 2.8% closing the week at a record high of 7022.9
- The wide-ranging investigation by Robert Muller of potential ties to Russia and obstruction of justice by Donald Trump gathers pace
- Apple expected to announce its best quarterly performance ever of $19bn on the back of strong iPhone X sales
- USD was at its lowest level in three years last Wednesday after seven weeks of losses against the Euro,
- 10 year Treasury yields at the highest level since 2014 after an extended sell off

UK

- The European Withdrawal Bill is to be rewritten in the House of Lords this week. Given the majority of the house's misgivings over Brexit , some turbulence may be looming ahead
- Further potential woes for Bitcoin's valuation as Theresa May mulls clamping down on cryptocurrency trading amidst concerns of its use amongst criminals
- The FTSE fell 0.8%, closing at 7665.5
- UK economy expanded 0.5% in Q4 of 2017 which was marginally better than expectations (0.4%) though overall growth was the lowest in five years at 1.8% and lagging behind G7 peers

Europe

- The Eurostoxx finished the week flat at 3639.8
- Financial leaders in Davos suggest the strong possibility of consolidations across the European banking industry, citing shrinking margins, challenges from fintech start-ups and legal costs amongst the main drivers
- PMI rose to 58.6 from 58.1 pointing to a quarterly growth of nearly 1%

Asia

- The Nikkei fell 0.7% to 23631.8
- Concerns for NATO cohesion as fighting in Syria between Turkish and US backed Kurdish militia escalates
- The Hang Seng rose 2.8% up finishing the week at 33154

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 27 Jan. 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	2.2%	7.5%	7.5%	26.8%
United Kingdom	GBP	-0.8%	-0.2%	-0.2%	11.1%
Continental Europe	EUR	-0.1%	3.6%	3.6%	13.2%
Japan	JPY	-0.5%	3.4%	3.4%	24.2%
Asia Pacific (ex Japan)	USD	2.5%	7.8%	7.8%	39.0%
Australia	AUD	0.7%	-0.2%	-0.2%	11.4%
Global	USD	1.9%	7.0%	7.0%	27.0%
Emerging markets equities					
Emerging Europe	USD	2.8%	10.7%	10.7%	31.2%
Emerging Asia	USD	2.9%	9.4%	9.4%	46.6%
Emerging Latin America	USD	5.5%	14.7%	14.7%	31.0%
BRICs	USD	4.2%	13.1%	13.1%	49.9%
MENA countries	USD	0.2%	5.1%	5.1%	2.9%
South Africa	USD	5.0%	7.8%	7.8%	38.4%
India	USD	2.2%	5.8%	5.8%	39.8%
Global emerging markets	USD	3.3%	9.9%	9.9%	41.9%
Bonds					
US Treasuries	USD	-0.1%	-1.2%	-1.2%	1.4%
US Treasuries (inflation protected)	USD	0.0%	-0.7%	-0.7%	2.1%
US Corporate (investment grade)	USD	0.2%	-0.8%	-0.8%	5.5%
US High Yield	USD	0.3%	0.9%	0.9%	6.9%
UK Gilts	GBP	-0.7%	-1.8%	-1.8%	3.0%
UK Corporate (investment grade)	GBP	-0.3%	-0.6%	-0.6%	6.0%
Euro Government Bonds	EUR	-0.2%	-0.2%	-0.2%	2.1%
Euro Corporate (investment grade)	EUR	-0.2%	-0.1%	-0.1%	3.0%
Euro High Yield	EUR	0.1%	0.7%	0.7%	6.7%
Japanese Government	JPY	0.1%	-0.1%	-0.1%	0.8%
Australian Government	AUD	0.2%	-0.7%	-0.7%	2.5%
Global Government Bonds	USD	1.0%	1.5%	1.5%	8.6%
Global Bonds	USD	0.8%	1.2%	1.2%	8.8%
Global Convertible Bonds	USD	1.3%	4.5%	4.5%	12.3%
Emerging Market Bonds	USD	0.3%	-0.3%	-0.3%	6.8%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 27 Jan. 2018	Month to date	YTD 2018	12 months
Property					
US Property Securities	USD	1.2%	-3.9%	-3.9%	-1.1%
Australian Property Securities	AUD	0.1%	-3.3%	-3.3%	2.6%
Asia Property Securities	USD	3.2%	10.3%	10.3%	34.0%
Global Property Securities	USD	2.8%	2.2%	2.2%	17.3%
Currencies					
Euro	USD	1.7%	3.5%	3.5%	16.4%
UK Pound Sterling	USD	2.4%	4.9%	4.9%	12.7%
Japanese Yen	USD	2.0%	3.8%	3.8%	5.6%
Australian Dollar	USD	1.4%	3.8%	3.8%	7.6%
South African Rand	USD	2.9%	4.3%	4.3%	12.5%
Swiss Franc	USD	2.9%	4.1%	4.1%	6.9%
Chinese Yuan	USD	1.2%	3.0%	3.0%	8.7%
Commodities & Alternatives					
Commodities	USD	2.5%	4.4%	4.4%	7.9%
Agricultural Commodities	USD	1.0%	2.0%	2.0%	-5.8%
Oil	USD	2.8%	5.5%	5.5%	25.4%
Gold	USD	1.5%	3.6%	3.6%	13.9%
Hedge funds	USD	0.6%	2.8%	2.8%	7.7%

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