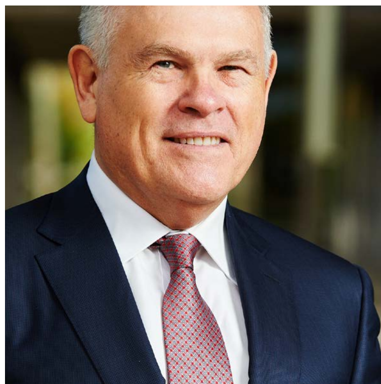
THE SPECTRE OF INFLATION HOW BEST TO PROTECT PORTFOLIOS?

Op Ed by Dr Rory Knight



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JOONGANG GLOBAL MONEY

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Investors worldwide are currently wringing their hands over the threat of inflation. Inflation is dominating portfolio review discussions, and every briefing from investment banks and asset managers is sounding the same alarm: it is coming. This message has of course been broadcast and amplified in the financial media. And indeed there have been some disquieting signs of late. US inflation hit 5.4% in June (up from 2.6% in March). Predictably, there have been warnings from academia of impending disaster. One prominent professor has compared the global economy to a slow-motion train wreck, heading for a major recession. Larry Summers, Harvard, echoed this, branding 'Bidenomics' as the most irresponsible economic policy in forty years.

The doomsayers argue that if central banks further loosen policy they risk double-digit inflation accompanied by stagflation. If they raise rates, they will trigger a debt crisis-driven recession. They are damned either way. Certainly many now believe a post-Covid pick-up in demand, together with lockdown-induced supply chain disruption amid unprecedented levels of fiscal stimulation, will usher in a new era of secular inflation. The argument goes that as economies begin to recover after the pandemic crisis increasing consumption from pent-up demand, fuelled by loose monetary policy, will inevitably lead to inflation. Indeed there are those who maintain that a period of inflation inevitably follows the end of a crisis. They cite the Korean War in the fifties and the Oil Crisis of the seventies, the former of which was an example of transitory inflation which subsided whereas the latter required the shock therapy implemented by the then Chairman of the Fed Paul Volcker to reverse inflation.However others, among them many central bankers, are much more sanguine. The current Chair of the US Federal Reserve for instance, has gone on record that the inflation threat is likely to be a merely transitory, short-term phenomenon. So is inflation a real threat? We argue 'no' - and the reason for that is that the world economy is nowhere near its full capacity.

History is no longer a guide

Should monetised debt continue to grow at anything like the current pace - and it promises to do so at least in the nearer term - history suggests inflation will ultimately re-surface. That would be a profound change, re-

TABLE 1: Assets held by central banks
SOURCE: Central bank reports. (To June 2021)

CENTRAL BANK	2007 $B	2016 $B	2020 $B	2021 $B	% Change 2007 to 2016	% Change 2007 to 2021	% GDP 2007	% GDP 2020
BANK OF KOREA	346	405	492	500	17%	45%	31%	28%
BANK OF JAPAN	989	3,473	6,760	6,971	251%	605%	21%	130%
PEOPLE'S BANK OF CHINA	2,317	4,830	5,928	5,902	108%	155%	62%	38%
FEDERAL RESERVE	922	4,467	7,363	8,101	384%	779%	6%	35%
BANK OF ENGLAND	156	652	1,182	1,318	318%	745%	5%	45%
ECB (SYSTEM)	2,218	3,854	8,533	9,427	74%	325%	16%	62%
SWISS NATIONAL BANK	112	732	884	896	554%	700%	22%	142%
TOTAL ASSETS	7,059	18,412	31,142	33,115	161%	369%	17%	51%

versing some forty years of deflationary demographic and technological trends. The application of Modern Monetary Theory (MMT) and the emergence of China have further changed the equilibrium - the answer no longer lies at the level of the national economy but at the global monetary position. The global economy has been the subject of two massive experiments in the last decade and a half and inflation has not appeared – why should it happen now? After the global financial crisis of 2008-2010 the major central banks embarked on an unprecedented programme of expansion accompanied by increasing debt. We were told two things about this. Firstly, there would be inflation followed by recession and secondly if there were another shock there would be a global economic slump. Well, inflation did not appear and there was another crisis in the form of a pandemic induced lock down. The experiment has been repeated on a larger scale – not only has inflation been absent but asset prices have soared. Why should we believe the doomsayers when they were wrong last time?

The great global experiments

Central Banks and governments around the world have been drawn into an extended series of experiments on monetary policy. As soon as the global financial crisis appeared central banks embarked on the most expansive policy the world has ever seen, the scale of which is reported in Table 1 and Figure 1 below. Table 1 reports the size of the central bank balance sheets for seven significant countries, to illustrate the scale of the Quantitative Easing (QE) programmes since 2007. In the first experiment the US Federal Reserve expanded its balance sheet by nearly 5 times between 2007 and 2016, a growth of 384% over that interval, growing from under one trillion dollars in 2007 to what then seemed a staggering $4.5 trillion in 2016. This expansion was coupled with a massive government expenditure increase to bailout failing banks and support the financial markets. Government debt increased as did government spending deficits. The loosest of monetary policies combined with the most extravagant bailout in history. As shown in the data this policy was followed in all the major economies. Many of the same commentators that are predicting inflation now were doing so after the first wave of QE. The markets reacted negatively, the so-called “taper-tantrums”, when the Federal Reserve attempted to reduce or taper their balance sheet. The central banks held their nerve and maintained the policy. Many detractors warning that the parlous state of their balance sheets meant that another shock could not be dealt with as reserves were beyond fully extended. Furthermore, inflation was not evident throughout the period. The entanglement of fiscal and monetary policy on this scale synchronised globally was novel. We were also told the experiment was temporary and would be reversed. The experiment was highly successful and equity markets have enjoyed an uninterrupted rise ever since. Central banks and government treasurers deserve some credit for avoiding a global recession. However, history will judge them on the long-term impact yet to be realised. The covid-induced lockdown gave rise to another experiment, more ambitious still. The world economy was locked down in Q1 2020, governments began a massive expenditure campaign to keep people at home and central banks grew their balance sheets further, reflecting the even more voracious appetite for monetary expansion than during the first experiment. After a slight set back in the first quarter equity markets have largely rebounded and are performing well...too well by some accounts. The new regime of high equity prices and low yields persists. It will be seen from table 1 that between 2007 and June 2021 the aggregate expansion in the size of the reported central banks is nearly five-fold. The US Federal Reserve balance sheet is over $8 trillion almost doubling since 2016 and expanding almost nine-fold since 2007. So much for not having the capacity to deal with another crisis. Figure 1 illustrates graphically the expansion in these two phases. The European Central Bank System (ECB) is now approaching $10 trillion in total assets from around $2 trillion before the financial crisis. Mario Draghi, erstwhile president promised the ECB would do whatever it took placing no limit on the extent of monetary expansion – this promise has clearly been kept. The ECB now has the largest balance sheet among central banks. It is interesting to note that the People’s Bank of China (PBOC) has expanded less in the covid period than it did in the earlier crisis compared to the ECB and the Fed, perhaps reflecting China’s greater economic resilience. The Bank of Korea (BOK) has been managed more conservatively showing only a 45% expansion in dollar terms – currency has a

TABLE 2: Government statistics
SOURCE: IMF

COUNTRY	Govt. expenditure/gdp		Govt. Deficit/gdp		Govt. Debt/gdp		Foreign eserves/GDP
	2007	2020	2007	2020	2007	2020	2020
KOREA	28%	25%	4%	-3%	29%	43%	26%
JAPAN	35%	47%	-3%	-13%	175%	266%	27%
CHINA	25%	37%	3%	-11%	29%	67%	21%
USA	37%	46%	-4%	-18%	60%	108%	1%
UK	40%	52%	-3%	-12%	30%	97%	7%
EUROZONE	45%	54%	-1%	-7%	66%	98%	1%
SWITZERLAND	28%	36%	2%	-3%	24%	43%	163%

large effect however as the change in local Korean Won terms is 66%. Most of the expansion has taken place in the first half of 2021. The BOK incidentally was also among the more conservative in the first phase with an expansion of 17%. The two right hand columns in Table 1 report the central bank assets as a proportion of GDP in 2007 and 2020 for each bank. Notable are Bank of Japan (BOJ) at 130% up from 21%; ECB at 62% up from 16%; the Bank of England (BOE) at 45% up from a mere 5% before the first crisis. At the time of writing the BOE assets to GDP exceeds 50%. The BOK in contrast has reduced the size of the balance sheet relative to GDP over the period reported..

The fiscal fallout

In combination with monetary expansion most governments have massively expanded their fiscal interventions, bailing out banks in the first crisis and households in the second. Their combined impact is clearly reflected in national accounts. Four key statistics in those accounts for 2007 and 2020 for the world's seven major economies are provided in table 2. The first of these relates to government expenditure as a proportion of GDP, where the general trend is of a significant and worrying rise. In the UK and the Eurozone government expenditure is now more than 50% of GDP, up respectively from 40% and 45% in 2007, while in the US government expenditure is approaching 50% of GDP. The recent expenditure package announced by the Biden administration will certainly take it above 50% for the first time. Only Korea has kept the growth of government expenditure in check. China, at 37%, is also some way below the 50% mark. Another key metric is the ratio of government deficit to GDP, and here again there has been worrying increase. As a result of increasing government expenditure fuelled by an expansive monetary policy all countries have overspent their revenues. The US reports an 18% deficit in relation to GDP, and this deficit is likely to increase further in the latter half of 2021. Inevitably such deficits lead to an increase in government debt. A further key metric, therefore, is the ratio of government debt to GDP which almost everywhere is nearing or exceeding 100% of GDP. In Japan it is 266%, in the USA 108%, in the UK 97% and in the Eurozone 98%.

China is key

So, while there are some early signs of inflation in today's financial markets, a far greater danger lies in fears of inflation rather than in inflation itself. This state of the global economy is a formula for secular inflation based on the historic record. So why will history not repeat now? Simply put the world economy is not at capacity. The expansion is being accommodated by growth in China and in the increasing foreign reserves held by China and other Asian countries. China, Japan and Korea all hold reserves of over 20% of GDP compared to a mere 1% held by the US. (Table 2.) As long as China grows and is prepared to fund US and European monetary expansion and debt, inflation will be manageable in the US and Europe as a transitory phenomenon. Eventually China's economy will mature, its growth will slow and then, and only then, the world will have no option but to grapple with inflation. When this will happen is probably the single-most important question facing investors. Investors should therefore ask when they need to act to protect themselves and how?

Five portfolio adjustments

The impact of inflation is of course not uniform across equities, and some are even relatively better off under inflation, but in general inflation is bad news for almost everyone Inflation is disruptive, resulting in slower growth in real cash flows for businesses. The uncertainty created by unexpected inflation increases volatility and consequently risk premiums – all leading to poor average performance overall. On top of this is the increased volatility in currency markets that attends inflation. Some turn to gold. Its dynamics are favourable when you consider that the physical stock of gold is only increasing by about 2% annually, while the stock of fiat currencies these days is growing at ten times that figure with nearly no cash yield to favour them. However, the history of investing in commodities priced at twice the cost of production - as is the case with gold - is not good. Others turn to inflation-protected bonds. But here too the picture is problematic. The real interest rate on such investments is now well below zero and, as such, brings in its wake the certainty of longer-term wealth destruction. International investors in equities might therefore consider making the following five long-term adjustments to their portfolios:

1. **Diversify**. More than ever there is a need to diversify across the markets, sectors and currencies that are differentially impacted by inflation. Investors should consider increasing their allocations to growth areas in China such as e-commerce, local consumption stocks, financials and Chinese dividend-paying stocks. Korean technology companies are also attractive.

2. **Take another look at real estate.** This traditional asset class is no longer homogenous in terms of its exposure to inflation. A careful selection of types of real estate avoiding retail and high-street is recommended. Liquidity is a major drawback but the protection against inflation probably justifies a little over-weighting in this asset class.

3. **Re-weight gold**. Over the long-term gold has always provided a hedge against inflation, and real returns in the last few years justify an allocation of up to 5% for the long-term investor.

4. **Digital assets**. Although the nascent cryptocurrencies are volatile, they are here to stay. They are the new gold and careful consideration should be given to a judicious allocation to these assets.

5. **Switch from growth to value investing**. Although value strategies have lagged behind growth strategies in recent years, resilient brands with predictable cash flows should do well here.

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