How to make sense of the current inflationary environment

To anyone paying even moderate attention to economic affairs, it has been impossible to miss that the path and severity of inflation has become an intense source of global contention. As the debate rages on, market players have largely divided themselves into "persistent" versus "transitory" inflationary camps – with each new data point around consumer prices, labour markets, supply shortages, or money supply providing vindication and vigour to each side's ideology. If global headlines and three-year interest rate forward prices are to be believed, one should be gravely concerned that inflation will rise. If global central bankers and equity valuations are to be believed, one should be quietly convinced that inflation will fall.

Are the rise of money supply and labour market shortages not entrenched structural factors that will fundamentally and persistently alter inflation dynamics? Similarly, are supply-chain bottlenecks not the symptom of a sudden economic re-opening, which should be worked through given a bit of time?

South African policymakers can't ignore the dynamics at play, leading them to raise interest rates at the recent November meeting. If US inflation persists at closer to recent levels of 6% year-on-year and dollar and euro interest rates eventually buck the trend and move higher, the rand is even more vulnerable if we leave our local overnight interest rate at historic lows and encourage capital flight.

Rob Perrone, from our offshore partner, Orbis, explains how Orbis is thinking about the current context, while Thalia Petousis, a portfolio manager at Allan Gray shares some local insights, including some thoughts around the recent rate hike.

Orbis: Inflation – the bottom-up case for caution

To us, markets seem a bit too relaxed about the risk of higher or more persistent inflation.

To be clear, we have no edge in forecasting inflation, and big macro questions are not the starting point for our decisions. Macro forces are influenced by a dizzying number of noisy variables, and big questions attract droves of smart people trying to find the answers, making it fiendishly difficult to be different and right. As bottom-up investors, we strongly prefer to make decisions based on narrower questions about individual companies.

That does not mean that we ignore the big stuff, as thinking through these issues can be useful to help manage portfolio-level risks. Today, we see plenty of risks to worry about when it comes to inflation.

The impact of money printing

Classically, printing money leads to inflation, but it didn't after the global financial crisis because it got stuck in the financial system. Central banks pushed plenty of cash onto commercial banks' balance sheets, but businesses and households were busy paying down loans rather than taking out new ones, and governments were more concerned with austerity than generosity. As a result, relatively little of that freshly printed money actually made it to the real economy. It boosted asset prices for stocks and bonds but had a limited effect on consumer prices. COVID-19 has been very different. For a start, the Federal Reserve (the Fed) printed more money in three months in 2020 than it did in three years after the financial crisis. More importantly, the government spent freely on stimulus cheques, enhanced unemployment benefits, and forgivable loans, ensuring that much more of that newly printed money made it to the real economy. Today there are 35% more dollars sloshing around the US than there were pre-COVID-19 – an increase of US$5.5tn. This gave consumers the spending power to pay more for goods, which they bought with gusto as most services were shut.

As the economy re-emerges from COVID-19, businesses are struggling to meet that demand. A shortage of semiconductors has crimped the production of new cars, and the lack of new cars has propelled prices for used ones. COVID-19-related factory and port closures have revealed the weak links in "just in time" supply chains. Spiking prices for commodities and trucking have fed through to higher prices for consumers. Many workers are negotiating for better pay, conditions, and flexibility to return to the workplace. Still others have left the workforce entirely, leading to an unconventionally tight labour market.

To borrow the Fed's term, some of these forces may indeed be transitory. Unless the car was used to win Le Mans, used car prices do not generally race up year after year. Everybody involved would prefer to unload the hundred ships currently waiting to dock at the Port of Los Angeles. Sky-high prices for some commodities have fallen back to earth. More people may rejoin the workforce as COVID-19 fears ease and government support wanes.

Some forces may prove more enduring. Governments may permanently favour generosity over austerity. Capital investment increasingly aims to clean the economy rather than grow it. The many companies now paying US$15 an hour are unlikely to reverse those raises, just as big consumer brands are unlikely to reverse their many price hikes. Energy prices have risen substantially, and energy producers are still not ramping up production. House prices have been rocketing for over a year and are just starting to flow through to official inflation numbers. On those official numbers, inflation is now above 5% in the US, yet interest rates are at zero and the Fed continues to print tens of billions of dollars every month.

All of that leaves us concerned about higher inflation. But as bottom-up investors with no edge on big macro questions, we are not betting hard on higher inflation. What worries us is that so many investors seem to be betting so hard against it.

Impact on portfolio positioning

The effect on positioning is most obvious in our multi-asset funds, where for years we have held no long-term nominal government bonds. With negative real yields and no protection against inflation, nominal bonds strike us as return-free risk.

But inflation creates risks for equities as well. In 1982, inflation was slain but nobody believed it. Real interest rates were high, corporate profits were low, and valuations were cheap. Today, inflation may be resurgent, but nothing is priced like it. Real interest rates are negative, corporate profits are high, and valuations are rich. Markets expect US inflation of 2.5% over the next decade – higher than the recent past, but hardly an expression of deep anxiety.

Putting high price multiples on high profits is a recipe for overpaying. Should higher inflation persist and bond yields rise, the most richly valued companies – those where most of the perceived value is in the very distant future – would see their valuations hit hardest. We have found such shares unattractive for some time and have avoided the most frothy parts of the market, particularly in the US.

To assess the risk to the portfolios from inflation, it's helpful to measure it first. The tools developed by our quantitative analysis team allow our portfolio managers to do that in real time. If we look at our multi-region funds today, our analysis suggests that every one of them would fare better than their benchmarks in a higher inflation environment. That is chiefly a side effect of our bottom-up security selection, not the starting point for our decisions. But with markets betting so hard against higher inflation, we think the funds' positioning is prudent.

Allan Gray: The divided MPC draws a line in the sand, but gradually

At the November meeting of the Monetary Policy Committee (MPC), South Africa's repo rate was raised by 25 basis points (bps) to 3.75%. The recent dissenting rhetoric coming from MPC members made it clear that this would be a difficult call, but the narrow 3-2 vote has tipped the scales at last.

With the October US Consumer Price Index printing at 6.2% year-on-year, the highest in around 30 years, global inflation is becoming much harder to ignore; as are rising oil prices, local electricity tariffs, and a weaker rand. Escalating SA public sector wage demands are still a key unresolved risk, which may grow well beyond economic productivity gains, having a second-round inflationary impact on national prices. South African Reserve Bank (SARB) governor, Lesetja Kganyago, highlights that if such effects take hold, it will be too late to act.

The MPC also notes with unease the calendar-year decline in rhodium, iron ore, and platinum prices against the rise in oil. This has the effect of damaging South Africa's key export revenue while deteriorating the terms of trade and current account. Vulnerability in SA may have further crept in via a failure to use improved commodity prices to drastically reduce economic imbalances, like imprudent public debt levels.

How aggressive will the hiking cycle be?

Although the MPC's quarterly projection model suggests a rate hike at every meeting next year, Kganyago attempted to temper this suggestion by asserting that further increases in the repo rate will be *"gradual"* – presumably with a weak consumer in mind. It is likely that the MPC will not want to strictly follow the guidance of the model because it does not consider SA's feeble credit demand. Our recent inflation print of 5% year-on-year has fallen well behind that of emerging and even developed markets, highlighting the weakness in our consumer demand and the absence of a money printing regime. The only way to meet both MPC objectives – anchoring inflation and being supportive of SA's recovery – is to move gradually.

This narrative may not have been well received by foreign exchange traders who are keen to see a more hard line being taken, given the risks of emerging markets falling behind the curve should global central banks finally begin to raise dollar and euro interest rates. The rand's depreciation during the MPC meeting was also a classic case of our currency being thrown out with the Turkish bathwater given the lira's violent sell-off as their inflation flies to 19.9% year-on-year, while their central bank continues to inappropriately cut rates.

The quarterly projection model suggests that the SA repo rate should rise to 6.75% in 2024, which is still some time away. Will the actual path of interest rate normalisation be gradual or rapid? The MPC prefers the former, but they are, as ever, dependent on the data. This is the conundrum of monetary policy – to be forward-looking and data-dependent simultaneously. One cannot wait to see the whites of the eyes of inflation before making a move.

Commentary contributed by Thalia Petousis, portfolio manager, Allan Gray and Rob Perrone, Investment Counsellor Group, Orbis