

Investment Views

FEBRUARY 2023

Pandemics & War. Inflationary, deflationary or both?

US inflation should ease considerably during the first half of the year as the delayed impact of multiple Fed rate hikes constrains economic growth and cost pressures. Having peaked around 9%/y last June, headline CPI is currently 6.4%/y and will continue to trend lower absent a surprisingly strong economic recovery or geopolitical hostilities that reignite energy costs. Having peaked in June, US crude oil prices ended January unchanged over 12 months.

On the other side of the world, Chinese inflation looks set to accelerate from 1.8%/y as the economy reopens after three years of lockdowns. The abrupt and largely insouciant end of “zero-covid” policies will see stronger domestic growth than originally expected, creating demand-pull inflation across a wide variety of goods and services. That said, with the debt laden property sector still acting as a drag, we question the more aggressive forecasts for both growth and inflation in 2023.

The interplay of these two key inflation rates will have an outsized influence on asset markets as we move through the year. Even if Chinese CPI grinds higher, a further decline in US inflation should see Treasury yields and the US dollar continue their descent, boosting liquidity and sustaining the equity rally that began in October last year; non-US markets have been a particular beneficiary. Conversely, if American price pressures remain sticky as Asian economies recover, dollar rates will need to stay higher for longer, supporting the greenback and reviving the dynamic that undermined markets for most of 2022.

This unfolding narrative could also have far greater implications over the longer-term. Simply put, was last year’s inflation shock a painful one-off or the start of a new, multi-year regime of high and rising prices? Whilst US CPI averaged 2.2%p.a. during the thirty years to 2020, will this be repeated in the years ahead? The answer will be a key determinant of asset returns for the balance of the decade.

When considering the most likely outcome, we are conscious that last year’s inflation was the highest since the early 1980s. The intervening forty years were characterised by a consistent decline in global price pressures and relatively steady economic growth in what became known as the “Great Moderation”. The incumbent policymakers cite Central Bank independence and supply-side reforms as the primary drivers; in reality, favourable demographics and tech innovation fostered the bulk of the disinflation, with the headlong embrace of cheap debt underpinning both growth and asset prices.

The deflationary impact of China’s abundant cheap labour, after its accession to the WTO in 2001, served to reinforce these trends.

After the twin shocks of the coronavirus pandemic and Russia’s invasion of Ukraine, this multi-decade period of disinflationary growth has likely drawn to a close. It is not unusual for major exogenous shocks, like a pandemic or a war, to birth a new economic regime. Indeed, we can draw on at least three historic parallels when considering how the global economy could fare over the next few years; World War I/the Spanish flu, World War II and the 1970s.

Wartime tends to be inflationary. During WWI, UK and European government spending and monetary stimulus, in support of the military effort, created capacity constraints and rising costs. For similar reasons, price levels leapt in America when they joined the Allied cause; in 1917, US inflation hit 17% as GDP jumped by 14%.

Inflation remained elevated immediately after the war. Economies were ill-equipped to meet post-conflict demand for “normal” goods as millions of soldiers returned home. The working population was decimated by conflict casualties (the Allies lost 5.7m soldiers) and factories had to retool to meet peacetime demand. These strains were amplified by the 1918-1920 Spanish flu, which resulted in an estimated 50-100 million global fatalities. It heaped pressure on a global economy that was, by then, also having to deal with much tighter monetary policy.

US short-term rates had fallen below 4% during the war, but reached an 8% peak in 1920 as the newly-formed Federal Reserve sought to combat inflation that had surged to 24%. The combination of the flu pandemic and rising borrowing costs birthed the early 1920s Depression that saw US CPI fall 15% in 1921. It was a brutal, disinflationary downturn that ultimately laid the foundations for the prosperity of the “Roaring Twenties”.

Much like the 1914-18 conflict, US inflation rose sharply during and immediately after WWII, hitting around 20% in early 1947. However, it decelerated sharply thereafter as the economy quickly adjusted to a peacetime setting with the mismatch between pent-up demand and supply chain disruptions only lasting a couple of years. This late 1940s experience is often cited as the template for those that believe the most recent inflation will be relatively short-lived.

Indeed, US CPI fell into negative territory during 1949 as policymakers attempted to cull double-digit inflation. Whilst the US Fed maintained wartime yield-curve-control until the early 1950s (by capping long-term rates at around 2.5% p.a.), it redeemed the securities it had purchased to help fund the war effort. This was an early example of today's "Quantitative Tightening," where a Central Bank reduces market liquidity and tightens policy by shrinking the size of its balance sheet. The result was a brief, mild recession in 1949, which would likely have marked the end of the inflationary regime were it not for a resumption of military hostilities in the early 1950s; the Korean War sparked another, albeit brief, CPI surge in 1951 before falling back for the remainder of the decade.

Turning to the 1970s, with the notable exception of Weimar Germany's hyperinflation, the decade was one of the worst inflationary episodes of the twentieth century. Many Western nations experienced several waves with CPI rising above 10%. These peaks were interspersed with brief periods of slower, but still elevated, inflation.

Akin to the wartime examples (and, indeed, the current situation), military spending was a notable feature, with the US government running a budget deficit in the late '60s/early '70s to finance the Vietnam War. The decade was also marked by the energy crises when the Yom Kippur war (1973) and the Iranian Revolution (1979) disrupted Middle East oil exports. Having averaged \$3 per barrel in 1970, US oil prices topped \$39 in 1981 (source: US EIA). These economic shocks were then amplified by dominant trade unions that secured inflation-busting pay rises, feeding a self-reinforcing "wage-price" spiral where higher prices triggered higher wages and so on.

Whilst geopolitical events triggered the cycle, persistent policy missteps magnified and sustained the decade-long period of rolling inflation. Unlike the monetary tightening introduced after both World Wars (and during the past 12 months), policymakers maintained a largely dovish bias throughout. President Nixon took America off the gold standard in 1971, untethering US money supply, whilst the Fed Chairman (Arthur Burns) succumbed to political pressure, cutting rates as growth softened despite rampant inflation. This meant US broad money supply rose by 5-10% pa throughout the 1970s, feeding rather than choking off price pressures. Interestingly, US M2 growth has recently turned negative for the first time in modern history, suggesting past mistakes are not being repeated.

So what lessons can be learned for the present day? Most obviously, policy stimulus and supply-side disruption are inflationary. Covid and the Russia/Ukraine conflict so evidence and, as they rumble on, it is safe to say that a swift return to a "Goldilocks" environment of stable growth and low inflation seems unlikely.

Aggravating matters, global supply chains are challenged by rising protectionism and de-globalisation. This is eroding the efficiency gains of the last 20 years and disrupting the free movement of labour. This suggests that industries and economies will struggle to recapture pre-pandemic productivity, posing an upside risk to inflation. On the positive side, Western economies are more flexible and labour is less unionised than the 1970s, making a sustained wage-price spiral less likely. Furthermore, the persistent rate hikes of the past year are more akin to the post-World War examples, that helped quell inflation, than the vacillation that stained the economic records of Messrs Nixon and Burns.

As importantly, the major disinflationary forces of excess debts, ageing demographics and technological revolution have not disappeared, which should limit the scale and duration of any inflationary cycle.

Taken together, we would not be surprised if the 2020s sees US inflation average more than the 2% p.a. rate of the past 30 years, but with a wide dispersion on both the up and downside. In short, neither inflation nor disinflation are likely to completely dominate. Nearer term, if Western cost pressures continue to abate, the recent market rebound could go further. However, as the Chinese recovery gathers pace and Central Banks moderate their hiking cycles, inflation fears could resurface, triggering a more challenging investing environment. For now, it seems prudent to assume that the "stop-start" economic and market trends of the past three years will remain. This argues for a focus on quality assets, secure yield and patience. The latter will be important as we expect elevated asset market volatility to endure.

POLICY MATRIX SUMMARY

The matrix below is a summary of our current 12-24 month outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high-level guide on where we stand at this time.

12-24 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives	Gold Miners China A Shares UK Small Companies Japan ESG & Impact funds	Inflation linked US Treasuries	Gold, Volatility Strategies
-		European US	European Japanese	

MARKET PERFORMANCE

All performance numbers show % changes except for bond yields which show yield changes.

	31st Jan 23	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.2320	2.0%	7.4%	-8.4%
CHF	1.0914	0.9%	9.3%	1.2%
AUD	0.7055	3.6%	10.3%	-0.2%
JPY	130.0900	0.8%	14.3%	-11.5%
EUR	1.0863	1.5%	9.9%	-3.3%
BOND YIELDS (10 yr)				
UK	3.33	-0.34	-0.18	2.03
US	3.51	-0.37	-0.54	1.73
Germany	2.28	-0.28	0.14	2.27
Australia	3.55	-0.50	-0.20	1.66
Japan	0.49	0.08	0.25	0.31
EQUITIES				
US. S&P 500 (USD)	4,076.60	6.2%	5.3%	-9.7%
UK. FTSE 100 (GBP)	7,771.70	4.3%	9.5%	4.1%
MSCI Eur ex UK (Local)	1,597.26	7.8%	11.5%	-3.8%
Japan. Topix (JPY)	1,975.27	4.4%	2.4%	4.2%
China. Shangai Comp (RMB)	3,255.67	5.4%	12.5%	-3.1%
HK. Hang Seng (HKD)	21,842.33	10.4%	48.7%	-8.2%
Australia. All Ords (AUD)	7,686.15	6.4%	8.9%	5.7%
MSCI Pac ex Jap (USD)	1,422.22	8.6%	24.4%	3.7%
MSCI World (USD)	2,785.00	7.0%	9.3%	-9.0%
MSCI World (GBP)	2,259.45	5.0%	1.7%	-0.8%
COMMODITIES				
Oil (WTI)	78.87	-2.0%	-4.8%	3.5%
Gold	1928.36	5.7%	18.0%	7.3%

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