JOHCM Funds

Global Value and Income Dispatch

Ten thoughts for the new inflationary regime

With a Democratic, stimulus-oriented congress in the US, accommodative central banks globally and an EU that is unified behind an investing boom to spur decarbonization, the "Low-flation" regime of the past 10 years may finally be behind us.

Add to that a world that – thanks to mass vaccination - is beginning to dig itself out of pandemic-induced isolation, and you could have an environment where inflationary forces are back in play.

10 thoughts to help prepare for new inflation and interest rate regimes:

1. **Listen to the Fed:** The Fed has told us that they are happy to have the economy run hotter to make up for prior undershoots to the inflation target. It could be folly not to heed their warnings and prepare.
2. **Rethink defensives:** If we truly have reached an inflection point after almost **four decades of falling rates**, then many backtested conclusions will have to be discarded. Among these, the asymmetric upside-downside capture of many high quality defensive assets may be a thing of the past. As a starting point, for **any new regime defensive pricing power is a MUST.**
3. **Rethink cyclicals:** Cyclicals, such as financials, and inflation hedges, such as commodities, could become a necessary portfolio element to protect and grow capital in a rising rate / rising inflation environment.
4. **Rethink fixed income:** 2021 seems to be the year when investment grade bonds finally start losing money. Tightening credit spreads were able to cushion rising rates in late 2020. With spreads now nearer to the all-time tights, this has stopped happening thus far in 2021.*
5. **Focus on what is real:** Investors often give too much credence to nominal interest rates and ignore inflation expectations. If real interest rates stay low, rising 10-year bond yields do not necessarily mean policy is restrictive. This could allow cyclical stocks to perform even if bonds and defensives fade.
6. **Antifragility evolves:** Many of the assets viewed as antifragile - long-term bonds and even alternative currencies like gold - have benefited from a backdrop of falling real rates. With real rates having bottomed below -1%, we are on the lookout for new sources of resilience. We have some thoughts, but no great answers yet.

* Bloomberg, as of Feb 18, 2021

7. **Do we have global warming backwards?** As this winter's return of the polar vortex indicates, an important consequence of climate change could be **colder** winter temperatures across the northern hemisphere due to the waning stability of the Arctic Polar Cell. Among other impacts, this could have implications for inflation in energy prices and US energy infrastructure.

8. **Is there such a thing as "Responsible Sustainability"?** In this scenario, we ask ourselves if it is a responsible investment policy to completely divest from fossil fuels. To us, a possible third way between being in or out is to engage and partner with producers who have committed to **align with the goals of the Paris Initiative** (see if you can name them and for a hint … see our portfolio). We feel this approach can encourage a responsible transition to a post hydro-carbon future that doesn't leave both people and portfolios out in the cold.

9. **Be mindful of your regime:** Coming from a tradition of bottom-up value investing, we have been long-time skeptics of any sort of macro predictions. We still are and acknowledge Benjamin Graham's warnings about the uncertainty of the future. There is something to be said for being mindful of the present and having a playbook for different regimes. Investment managers can justifiably be accused of being static (or potentially even backwards looking), and there is much that bottom-up investors (ourselves not least!) can learn by occasionally looking up from the financial statements.

10. **Rethinking priorities:** If the pandemic experience has taught us anything, it is the value of human relationships and the void that we can feel when they are curtailed. Many of us have been working virtually and have been living off of the culture and trust built up over years of in-person interactions. Having drawn down on these supplies, they will naturally need to be rebuilt.

Please drop us a line if you'd like to discuss any of the above.