

THOUGHTS ON INFLATION



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- Many commentators are increasingly asking whether we should expect a return to an inflationary environment after decades of declining inflationary pressures.
- If inflation does pick up, it will completely change the financial environment to which investors have become accustomed, with important implications for equities and bonds if hyperinflation worries take centre stage, as well as posing problems for companies with overextended balance sheets.
- While we are not loudly proclaiming that inflation is set to soar, it is currently part of our thinking. Hence our priority remains the minority of businesses with genuine pricing power, whether through a clear competitive advantage or explicit inflation-linking e.g. within contracts or regulatory structures, such as utilities and contract caterers.

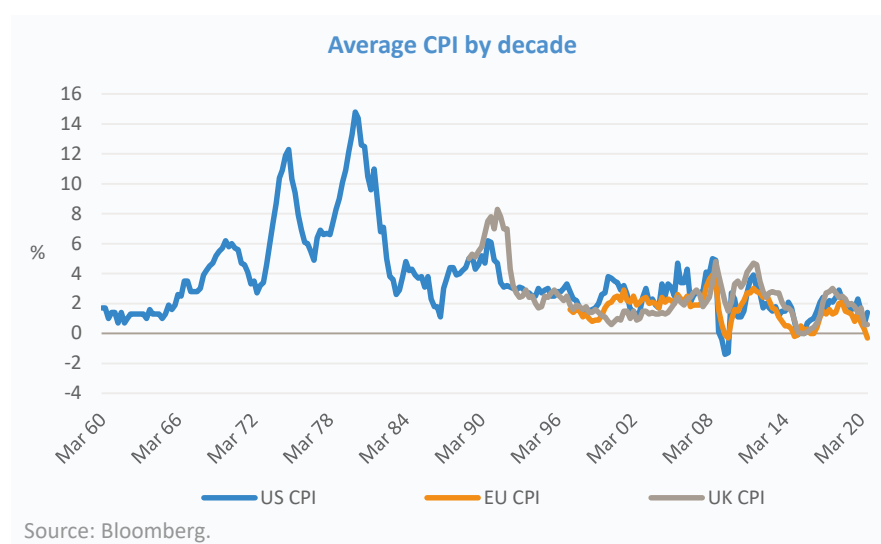
JOHCM Global Opportunities Fund

This week's cover of 'The Economist' poses a question: will inflation return? It's a question that appears to be on many minds, including our clients, with an increasing number of well-respected commentators arguing that this decade will be more inflationary than the last.

The short-term inflationary outlook is impossible to predict given the complex interplay of disrupted supply and locked-down demand, both on the way down earlier this year and on the way back up. The immediate impact of lockdowns was deflationary, so one would expect 'back to work' to be accompanied by a spike in inflation as pent-up spending power is unleashed.

More important for investors' strategic positioning is the longer-term outlook. There are a variety of suggested reasons, including expansionary fiscal policy and modern monetary theory (MMT) in response to Covid-19 and inequality, demographics (US baby-boomers, a falling Chinese working age population), de-globalisation and a lack of investment in new productive capacity, especially in the resources sector since 2015. We are very aware of these arguments and take them seriously.

Whatever the reason, if inflation picks up it will have very important consequences for investors. It will completely change the financial environment we have all become accustomed to, both since the 2008-9 global financial crisis and, in a much longer sense, since the early 1980s. Few people can remember the last proper inflationary period 1968-82, at least in a professional capacity. An anecdote from American author David Foster Wallace resonates here. Two young fish pass an older fish swimming the other way. The older fish asks them "Morning boys, how's the water?" The two young fish swim on a little, then one turns to the other and says "What the hell is water?"



Among the most important consequences of a return of inflation would be that equities and bonds would become positively correlated at times of crisis (because everyone worries about hyperinflation not outright deflation). Multi-asset portfolios lose their natural hedge and bond proxies won't work as ballast in an equity portfolio.

At the same time, many companies would suffer margin pressure as they would lack the pricing power to offset cost inflation (this may be part of a broader narrative that corporate profits would fall as a percentage of GDP as wage, tax and interest rate tailwinds turn to headwinds). And a rise in interest rates would also present problems for companies needing to refinance overextended balance sheets – although there is also an argument from some of the same commentators that financial repression would keep real rates very negative by preventing too big a rise in rates. Therefore, stock selection would become more important, active investors would have the advantage over passive investors and the pendulum would swing back away from the extreme pro-US and pro-growth position it has reached this year – not least because the “low rates justifies high multiples for scarce growth stocks” argument would be undermined.

Hence our priority remains the minority of businesses with genuine pricing power, whether because of competitive advantages or explicit inflation-linking, for example in contracts or regulatory structures (such as utilities and contract caterers). And we are on the lookout for commodity producers with the right combination of low-cost production, strong balance sheet, ESG compliance and reasonable valuation.

Banks are an interesting debate. Many commentators are arguing the case that higher inflation equals higher rates and a steeper yield curve, resulting in higher bank profits and ultimately a re-rating of bank stocks from currently very low price-to-book value ratios. Obviously, financials have been one of the worst performing sectors over the last decade, and they are a large component of the ‘value’ index. But the problem is that low returns ultimately reflect a lack of pricing power – except in a few markets, asset spreads couldn't expand to offset the collapse in liability spreads. Rising rates may therefore benefit savers (through rising deposit rates) more than shareholders. As usual, selectivity will be essential.

JOHCM Global Opportunities Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

	30.11.20	30.11.19	30.11.18	30.11.17	30.11.16
A USD Class	4.21	11.04	1.75	16.82	4.73

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra. NAV of share class A in GBP, net income reinvested, net of fees, as at 30 November 2020. All fund performance has been shown against the MSCI ACWI NR Index (12pm adjusted). Performance of other share classes may vary and is available on request.

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