Investment Strategy Group
Investment Update

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Investment Strategy Group:

Strategy: Phil Borkin
+64 9 365 0897
philip.borkin@jbwere.co.nz

Asset Allocation: Hayden Griffiths
+64 9 365 0895
hayden.griffiths@jbwere.co.nz

NZ Equities: Rickey Ward
+64 9 365 8902
rickey.ward@jbwere.co.nz

Analyst: Andrew Thompson
+64 9 365 0884
andrew.thompson@jbwere.co.nz

Analyst: Harrison Knapp
+64 9 365 8903
harrison.knapp@jbwere.co.nz

Analyst: Katie Thompson
+64 9 365 0887
katie.thompson@jbwere.co.nz

The prospects of an extended period of ultra-supportive policy conditions and historically low interest rates, together with the likelihood of a strong economic (and corporate earnings) recovery this year, has been a powerful driver of global equity markets over the past 12 months. It is a narrative that has helped push some major equity markets to all-time highs, and it is JBWere's view that further upside to equities is likely, although we suspect the pace of market gains going forward will be more moderate than what has been experienced over the past 12 months. Nevertheless, **it is our constructive view towards equity market returns overall (especially relative to other asset clases) that is the key reason why we made the active decision last year to increase the exposure to growth assets within the MAS Funds to modestly above their strategic targets**.

Over recent months, however, the narrative of ongoing ultra-supportive policy conditions has admittedly been tested by the market. Led by some prominent economists, including former US Treasury Secretary Larry Summers and former IMF Chief Economist Olivier Blanchard – a debate has intensified about the potential for the US economy to overheat, fuelling a substantial pickup in inflation. And these overheating fears have driven a noticeable shift in global bond markets so far this year. Over the second half of 2020 and into early 2021, longer-term government bond yields rose in a relatively measured fashion driven by a steady lift in market-based measures of inflation expectations as optimism towards the economic outlook improved, helped of course by the development of some effective COVID-19 vaccines. Real (inflation-adjusted) yields stayed low and stable over this period. However, as this overheating debate has intensified, not only has the lift in yields accelerated, but it shifted to being driven more by a sharp jump in real yields as markets began to reassess the outlook for monetary policy. At one point, the US 10-year real yield was up over 40bps in the space of two weeks – one of the sharpest moves since the infamous 'taper tantrum' of 2013. Given the supportive relationship that low interest rates, and low real bond yields especially, have had on equity market valuations, the fear is that these higher yields (and further possible increases) could prove to be a significant headwind for share prices going forward.

Are these inflation fears justified and are higher bond yields set to stymy the equity rally? A strong recovery in global economic activity this year as vaccine rollouts build momentum is now a consensus view. **The question surrounding overheating fears really centres on the magnitude and persistence of this economic recovery**. In the US especially, some worry that with a significant amount of policy stimulus already provided (and potentially more on the way) the economy is set to quickly absorb spare capacity (i.e. closing what economists call the output gap) and fuel a period of inflation that forces the US Federal Reserve to remove monetary policy stimulus earlier and more rapidly than would otherwise be the case. Under that scenario, it is quite possible that equity markets face some headwinds as central banks 'apply the brakes' on the economy.

And at face value, the stimulus numbers are considerable. Specifically, the Democrat-controlled Congress passed a fiscal package (the American Rescue Plan) in March of close to US$1.9 trillion, or 9% of GDP. It came hot on the heels of a roughly US$900bn package passed in December. Moreover, US households now sit on a large amount of pent-up saving because they have not been able to spend as freely during lockdowns as they normally would. One of our global research partners estimates total cumulative pent-up saving could peak at ~US$2.4 trillion (or 11% of GDP). If households choose to spend even a portion of this pent-up saving, it is likely to unleash a significant consumption boom.

We don't disagree that these are all clear factors set to support a strong economic backdrop in the US (and likely elsewhere) this year. We also don't disagree that rates of CPI inflation are set to rise in most economies over the coming months too driven by base effects (weak COVID-impacted inflation figures last year), higher commodity prices and well-publicised supply-chain issues that have plagued many economies. **However, we are not overly concerned by this, and see the jump in near-term inflation as largely transitory. We expect central banks to take a similar view,** therefore maintaining stimulatory policy conditions for some time yet.

We say this for the following reasons:

- **US fiscal stimulus is largely one-off in nature.** Unlike a permanent tax cut or sustained lift in transfer payments, much of the Democrats' stimulus package is one-off (i.e. stimulus cheques). Furthermore, things like higher unemployment insurance payments will naturally subside as the labour market continues to recover, while support to the states, and the health and education sectors is likely to be spread over several years, dampening its growth impact. Ultimately, it is likely that the fiscal multiplier (the amount that this package boosts total spending in the economy) is well below one.
- **Most of the pent-up saving is likely held by high-income households**. Some estimates suggest 40% of the pent-up saving is held by the top income quintile. Not only do these households have lower marginal propensities to consume, but it is also likely that this excess saving has already been used for debt reduction or investing in illiquid assets (like real estate for example).
- **Economies potentially have more spare capacity than appreciated**. Assessing what an economy's speed limit is (i.e. the rate it can grow without generating excessive inflation) is a challenge at the best of times and central banks typically have teams of economists attempting to estimate this very thing. However, one interpretation of the experience of the past decade, where inflation has consistently undershot central bank targets, is that economists have consistently underestimated economies' supply-side potential.
- **The 'Phillips curve' is flat.** Even if we are wrong on the above bullet and economic activity expands well above trend this year, a large break out in inflation seems unlikely by the fact that the Phillips curve (the relationship between inflation and spare capacity in an economy) is now extremely flat. Anchored inflation expectations mean that even very low unemployment rates fail to generate much in the way of inflation pressures.

To be fair, we have sympathy for the view that the average rate of annual inflation will be higher over the next decade than what was experienced over the past decade. Bigger roles played by governments (with its implications for productivity growth), government redistributive policies in response to inequality pressures, deglobalisation moves, and more tolerance for higher inflation from central banks, could all add to future inflation pressures to varying degrees. **However, this is something, if it does develop, that is likely to emerge gradually over time rather than abruptly, and so is not something we believe warrants a shift in investment approach now.**

Stepping back, history has taught us that for equity investors especially, there is nothing necessarily to fear from modestly rising inflation and higher bond yields. As long as inflation ultimately remains contained (i.e. below 3%) and bond yield increases are reasonably orderly and driven by improving growth expectations, equity market gains are still likely. **It is not until central banks explicitly start to turn hawkish and are actively attempting to slow economies by aggressively tightening monetary policy that equity markets typically start to struggle, and we are still some way away from that point in our view**.

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