PACIFIC MULTI-ASSET SOLUTIONS

INVESTMENT OUTLOOK

2021: 3rd Quarter Insights

OUTLOOK SNAPSHOT: (Estimated reading time 60 seconds)

1. Inflation: "as violent as a mugger, as frightening as an armed robber and as deadly as a hit man."

Inflation:

After a decade of rising asset prices boosted by deflationary forces inflation becomes a growing concern for investors.

Google searches for the word "inflation" in the US are standing at the highest they have been since they were first measured in 2004.

In the short term, inflationary pressures are likely to ease; over the long term, risks of higher inflation are increasing.

Key Focus on Central Bank Policy:

All eyes fall on the US Fed with increased rhetoric around the timing of the removal of huge quantitative easing programs.

2. Looking Ahead

Tactical Positioning:

Multi-Asset portfolios continue to remain highly diversified in nature, adapting to changing market conditions, seeking the best blend of assets for this market environment.

OUTLOOK: (Estimated reading time 6 minutes)

INFLATION

> "as violent as a mugger, as frightening as an armed robber and as deadly as a hit man."
>
> **Ronald Reagan**
> Former President of the United States

Inflation no longer fills the world with dread as it did in the late 1970s when Ronald Reagan, the then future president of the United States, described it "as violent as a mugger, as frightening as an armed robber and as deadly as a hit man."

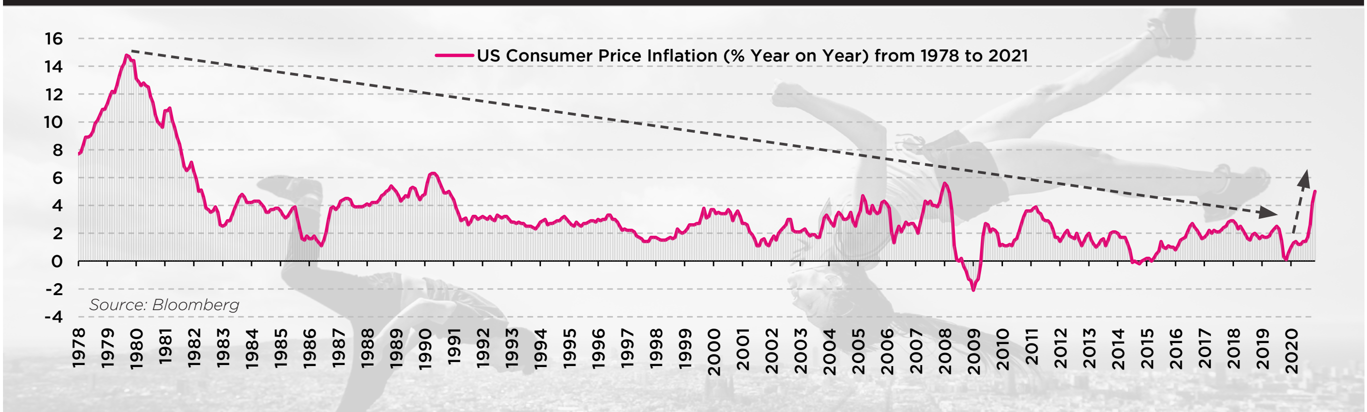
But today, with US consumer price inflation running at 5% investors are scanning the investment horizon nervously.

Recent inflationary numbers have been contrary to the strong disinflationary forces over the last forty years, to such an extent that there had been fewer and fewer people that think of inflation as a threat. The combination of globalisation, a surge in the size of the global workforce, technology and falling union membership have crushed inflationary pressures.

Recent headlines have at least started to reignite interest in inflation, with Google searches for the word "inflation" in the US standing at the highest they have been since they were first measured in 2004.

Before we dive into the reasons for the latest rise in inflation, it's worth considering two trends that have coexisted with falling inflation: rising asset prices and increasing inequality. During the bout of inflationary pressure that took place in the 1980s, then Federal Reserve chair Paul Volker raised interest rates to 20% to bring these inflationary pressures under control. Since then, however, the last twenty years have seen central banks reduce interest rates to ever lower levels to fight the risk of deflation. Steadily falling interest rates have done wonders for asset prices, pushing up the value of houses, art, commercial property, stocks and bonds around the world. Clearly then higher inflation, particularly if accompanied by higher interest rates, would be a threat to the price of some assets. This is important: a portfolio designed to thrive in an inflationary environment looks very different to one that's set up for a low inflation regime.

US Consumer prices spike



Inflation has been muted both for the price of goods and for wages as the expanded global workforce has encouraged companies to move production to countries with cheaper labour. Most affected have been those workers with lower salaries, who also tend to own fewer assets than those with higher salaries. Stagnant wages whilst asset prices soar is a sure way to fuel inequality and populism. US voters first turned to Donald Trump to level the playing field with his promise to bring manufacturing back to the US and Make America Great Again, and populist leaders have sprung up in other nations throughout the world as similar trends gripped other economies. Last November, American voters backed a more traditional champion of the workers: A Democrat candidate who promised to redress the balance, in the form of Joe Biden.

Thus far, Biden has proposed a wide-ranging set of policies designed to support growth and combat this rise in inequality. His Build Back Better fiscal plan is designed to combat inequality in several ways: by providing free education to the very young and those entering community college, by making childcare more affordable and by helping pay for family and medical leave. Biden aims to fund this spending by raising taxes on both corporates and those earning more than $1m annually, which would help to arrest and reverse rising inequality in America. Ongoing stimulus will fuel faster economic growth and has the potential to reverse the low growth, low inflation environment.

IMPACT ON MARKETS

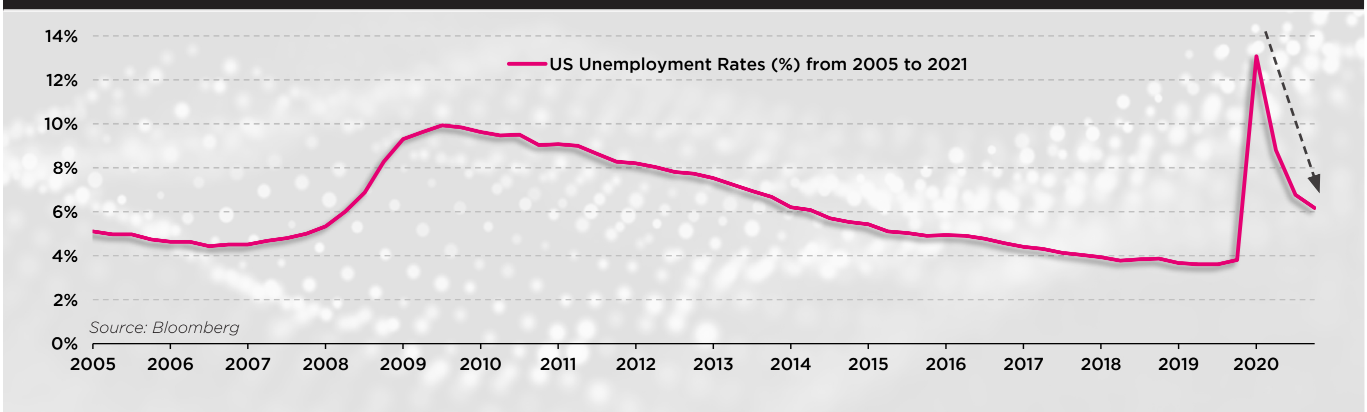
Turning to the impact on markets, the response of central banks to rising inflation will be critical to asset prices.

> **The Federal Reserve has been consistent in its messaging: it views the current inflationary pressures as temporary or "transitory" in their words. For the Fed there are two critical questions – how long is this transitory period and what is the outlook for the longer term?**

In the short term, inflation has spiked due to soaring commodity prices and comparisons with weak data a year ago. Bottlenecks in both the production and shipping of commodities ranging from copper and lumber to semiconductors have caused prices to spike higher. This has also impacted the price of used cars, which were also fuelled by the demand created by fear of using public transport in a pandemic. This has had an outsized impact on headline consumer price measures.

Wage inflation is more complex. The global economy is recovering rapidly, and job openings are running at record levels. However, unemployment remains high and many of the global furlough and unemployment benefits are in the process of being rolled back by Governments. How unemployed people returning to work respond to this dynamic and whether they can push for higher wages remains to be seen.

Unemployment is falling in the US but remains above pre-COVID levels



Over the longer term there are signs that some of the structural headwinds to inflation are starting to fade, and with time will become tailwinds to rising prices. The first is demographics, where there is a reduction in the growth of the labour force and an outright decline in the number of workers in many economically important countries such as Germany, Japan and China. Secondly, globalisation is slowing and there is an increased focus on re-shoring as the differential of wages between countries narrows and the fragilities of long, complex supply chains are re-assessed. Thirdly, shifting demographics to an ageing population leads to increasing numbers of people that consume but do not produce, as argued by Charles Goodhart and Manoj Pradhan in their book The Great Demographic Reversal. Finally, the old tend to spend rather than save, so the downward pressure on yields may ease as the "savings glut" diminishes.

CONCLUSION

As we have laid out, the crosswinds of inflationary and deflationary forces are complex and shifting and it is our assessment that the risks of inflation are rising. As a result, it's important to have portfolios that are balanced and include assets that can thrive in an inflationary environment. These include exposure to classic inflationary assets such as gold as well as value stocks that would benefit from faster nominal (ie including inflation) GDP growth and that trade on wide discounts to the broader market. Most importantly, we believe this means limiting exposure to assets whose returns have been flattered by ever falling inflation and bond yields, notably growth stocks, some of whose sky-high valuations are vulnerable to any pickup in inflation.

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