Analysis

Inflation and Financial Markets

- *Central bank easy-money policies have made markets resilient to external shocks.*
- *However, their ability to continue to do so will diminish in the wake of higher inflation.*
- *Volatility will increase, and expected returns will have to be scaled back.*
- *Even so, there are opportunities for long-term investors.*

No longer 'forever upward'

Markets' strong rise has been undeterred by bad news

Financial markets seem to have known only one direction since their Corona-crisis lows in the spring of 2020. The S&P 500 has increased around 90% since March of last year, while the EuroStoxx 50 has gained as much as 60%. Corporate bond markets, private debt and equity markets, and real estate have also risen significantly. Negative news, including repeated break-outs of the pandemic and increasing production bottlenecks, has not derailed the markets in their recovery.

For investors, the past year and a half have brought exceptional returns. However, there is now growing concern that prices have reached such a lofty level that significant corrections have to be expected. Whether this will happen depends above all on what can be expected from the major central banks. Their accommodative policies, by keeping interest rates and bond yields extremely low, have supported the high valuations of equities or risky corporate bonds.

To put it differently, stocks may look expensive by historical standards, as price-to-earnings ratios are clearly above long-term averages: but they do not look overpriced when comparing them with the minimal yields of government bonds. And what is true for equity also holds for more risky corporate assets or real estate.

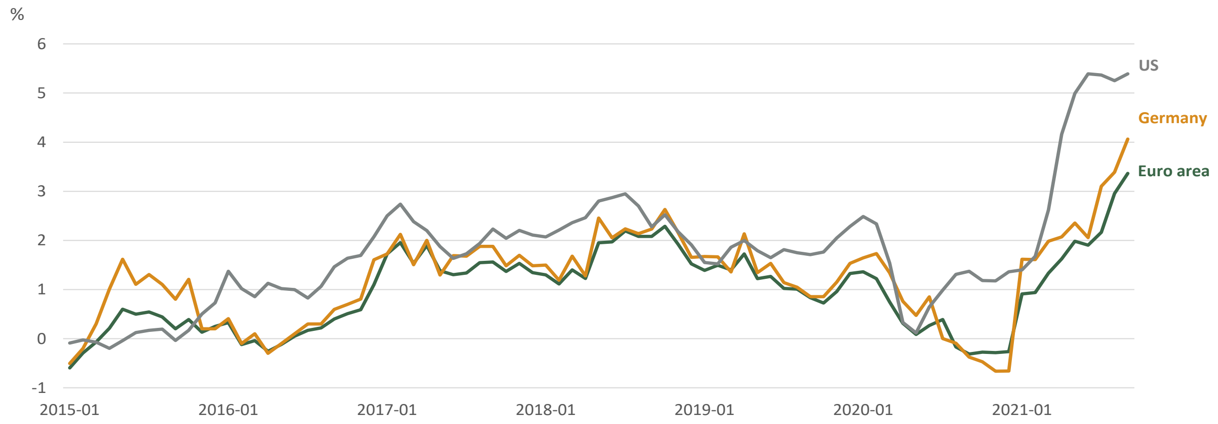
Inflation – the determining factor

However, inflation has the potential to change that …

The linchpin for the possible path of monetary policy is the likely development of inflation. Stronger and more persistent inflationary trends would oblige the monetary authorities to reduce their degree of accommodation, and would diminish the room for manoeuvre that might be needed if financial markets were to be shielded from any further negative developments.

Currently, central banks in most advanced economies are rather optimistic about the inflation outlook. Current inflationary tendencies are seen as temporary, given that base effects are coming to an end, and commodity price inflation and supply bottlenecks may

Figure 1: Consumer prices, y-o-y changes



Source: ECB, Deutsche Bundesbank, Federal Reserve Economic Data (FRED).

diminish or disappear at some point. If this view holds true, and inflation rates fall back significantly in 2022, then the stance of monetary policy will not be altered much, thereby remaining quite expansionary.

… and indeed inflation does seem set to pick up

However, the view that inflation will be very subdued after the spike in 2021 is likely to be put to the test if supply bottlenecks prove to be longer-lasting, and the already-visible upward pressure on wages becomes stronger. While the situation is not like the extreme scenarios of price-wage spirals in the 1970s, some wage acceleration is almost certain, as there is a shortage of labour in many sectors of the developed economies, and employees are demanding compensation for the loss of purchasing power that has already occurred. In view of high job vacancies, at least some of these demands are likely to be met.

Hence more volatility

The prospect is for higher volatility …

Given the prospect of a world with higher – it might be said 'normalised' – inflation rates, investors should brace for higher volatility as upcoming risks, such as developments in China, or new waves of the pandemic, will not be cushioned by monetary policies in the way to which investors have become used. Hence markets' vulnerability to negative developments is likely to increase.

… but not necessarily for a bear market

However, this does not imply a trend reversal on stock markets or for other risk assets. For a bear market to develop would almost certainly require a surge of inflation outside the energy and commodities sectors that would oblige the central banks to push the brakes hard by ending asset purchases and raising short term rates rather quickly. This is a risk scenario with quite a low probability.

Four conclusions

Expect investment to be channeled toward 'real' assets …

First, in view of the increased inflation expectations, substantial funds will continue to be channelled towards investments that offer a certain hedge regarding price level rises. Such assets include equities and other corporate shareholdings and real estate. Their long-term return prospects are much more favourable than those for fixed-income securities in a situation with higher inflation rates. The 'TINA' investment motive still holds: "*there is no alternative*."

… volatility to be greater than in the recent past …

Second, with less monetary support and a gradual normalisation of policies, valuations stand to fluctuate more strongly than they have so far in the post-Covid recovery. Monetary policy will no longer be able to insulate the financial markets from emerging risks as effectively as it did in past quarters when inflation was scarcely an issue.

… but probably no major reversal in monetary policy

Third, a market crash that abruptly ends the financial upswing and initiates a trend reversal seems unlikely at present. It would probably require a fairly massive turnaround in monetary policy, which is not on the horizon in the current situation and would require inflation to skyrocket.

Fourth*,* what seems rather certain however is that, with less monetary accommodation and the phasing out of large fiscal programmes, the speed of the recovery will slow down. Return expectations for coming quarters will have to be scaled back after the boom since early 2020. But even with significantly weaker upward momentum and stronger ups and downs on the stock markets, there are opportunities for long-term investors.

Watch-fors

With inflation likely to be the most important determinant of financial market returns, the most important leading indicators to monitor include commodity prices and corporate price expectations.

Ultimately however, the most important development to watch for will be rising unit labour costs, where the likely evolution of the two components – nominal wages and labour productivity – are both more than usually uncertain.■

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