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Fixed Income Research

Inflation Strategy

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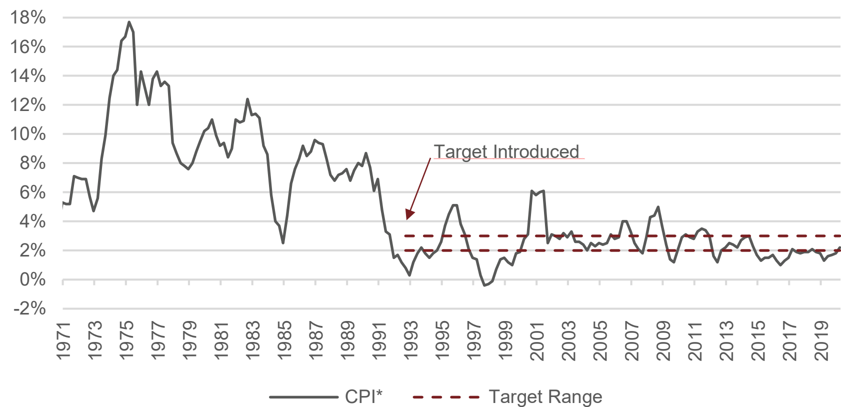
99 Problems but Inflation Ain't One…Yet

More (helicopter) money, more problems? Perhaps. Considering all the negative commentary surrounding the economics caused by COVID-19, equity and credit are doing fantastically. The ASX 200 and AusBond Credit Index are, at time of writing (6 May), up ~18% and ~10% respectively from lows. The response from markets has been to lap up support packages and money printing.

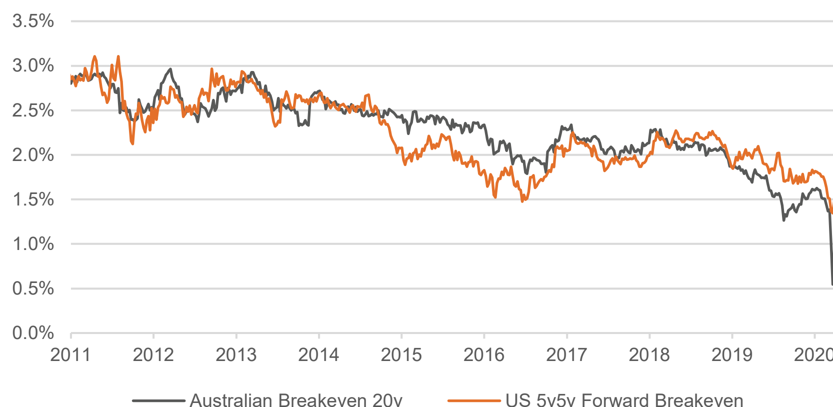
For all its flaws, with business spending halted, if there ever was a time for helicopter money, it would be now. Whilst political pressure to avoid this can be immense, the biggest theorical issue is inflation. Generally, Australia and the broader developed world have avoided serious issues of rising prices for ~30 years. Short memories are getting shorter here and the experience of the last decade will not help, where expanding asset purchases from central banks did a whole lot of nothing in spurring inflation.

Figure 1. No Breach in Sight for Eight Years – Australian CPI YoY



Source: BondAdviser, ABS, RBA

Figure 2. No Inflation in Sight

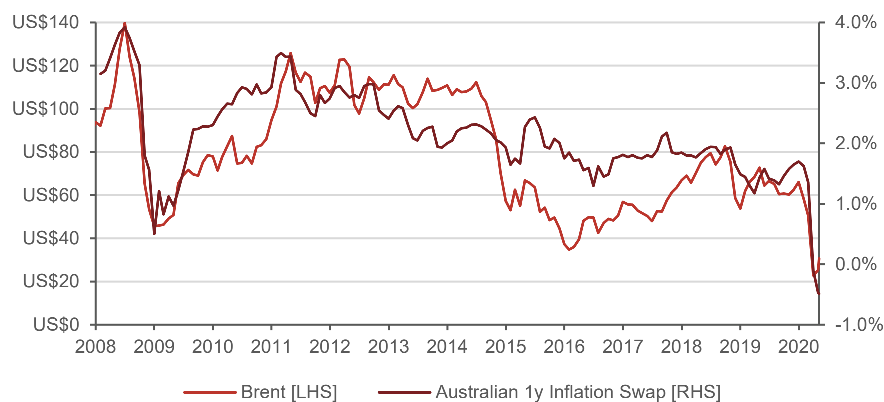


Source: BondAdviser, Bloomberg

Markets are not thinking much of an inflation vendetta, neither in Australia nor the US. Figure 2 illustrates this, with the Australia 20yr breakeven (the implicit average inflation rate over the next 20 years) and the US 5yr/5yr breakeven (implicit five year forecast for inflation in five years' time – this helps to cut away some front-end noise) both continuing their downward trend.

It is fair to suggest that this is no surprise, given the plunge in oil prices. Figure 3 is unremarkable in displaying the close relationship between oil prices and inflation swaps. In the short-term, oil has a large effect on breakevens, given it can be a big component of inflation baskets.

Figure 3. No Oil Pressure in Sight



Source: BondAdviser, Bloomberg

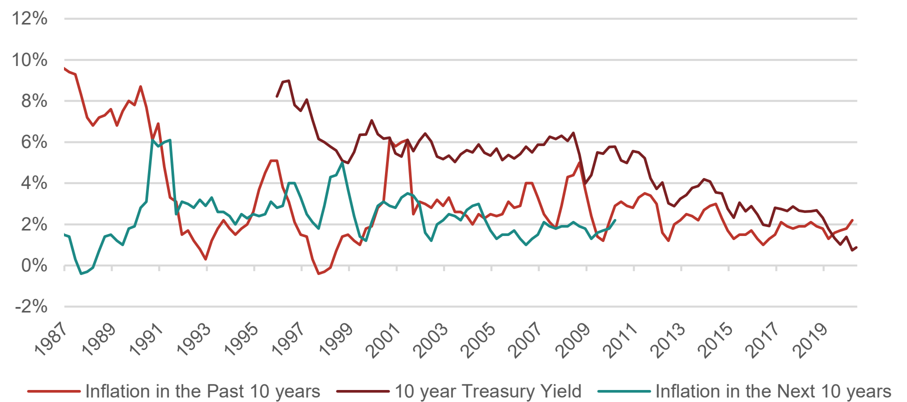
Nevertheless, **our current worry here is not demand-pull inflation** (this could become a distinct issue should governments not taper stimulus), **but rather cost-push inflation**. Fractured supply chains are making it costly to supply services, meaning these expenses get passed into prices. Broken supply chains mean less supply and higher prices. This is all gets doused in anti-globalisation gasoline. Countries that have been reliant on sourcing goods from far off nations, now must find local, more expensive alternatives.

Post GFC, whilst asset purchases continued to marginally increase (excluding the 2019 tightening in the US), most governments turned to austerity, somewhat via political pressures. Will governments do the same this time around? It would seem unlikely in a newly progressive, modern monetary theory environment.

So, if fiscal stimulus sticks around, which seems feasible, consumers will have had their spending habits constrained, putting them on a pile of cash, and a government-funded reason to spend it. Add quantitative easing into the tinder-pit and you have a case for an inflation bonfire that is far larger than the market is predicting.

Few like betting against bond-markets. It has been a losing trade for 25+ years. Figure 4 provides some consolation; over the long term, there appears to be far less of a direct relationship between bond yields and subsequent inflation, than textbooks would suggest. So how can this be rationalised if we think inflation may spike?

Figure 4. No Relationship in Sight

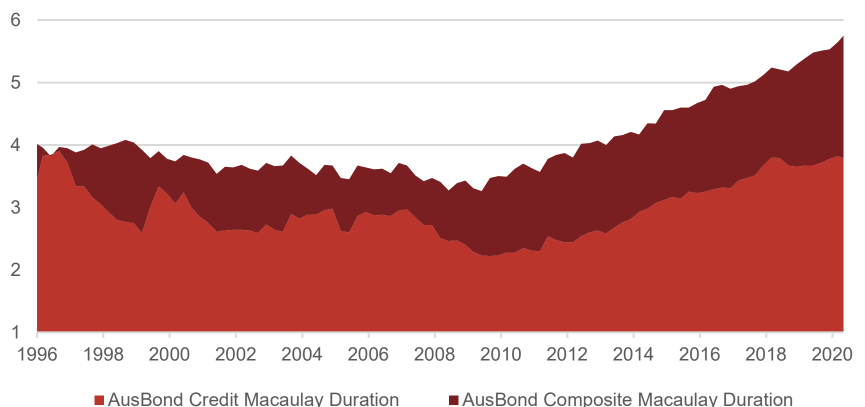


Source: BondAdviser, ABS

Well, **inflation can also be thought as a handbrake on fiscal stimulus**. The higher the expected rate of inflation, the more yield demanded on a sovereign bond. So if we go a step further and say; should governments not be in a position to stop spending, (think how unpopular austerity measures would be), financial markets, or rather bond vigilantes, may emerge from hibernation, forcing yields upwards. So, we rationalise that more money, might indeed, mean more problems.

Domestically, bond market duration has only increased in the past 10 years, as illustrated in Figure 5, any inflation surprise would not be an ideal outcome for fixed-rate bondholders. Considering this, inflation protection is cheap, and it would prudent to manage this risk through linkers or floating-rate notes.

Figure 5. No Duration Protection in Sight



Source: BondAdviser, ABS

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