

# Is Sustained Higher Inflation On the Cards?

January 2021

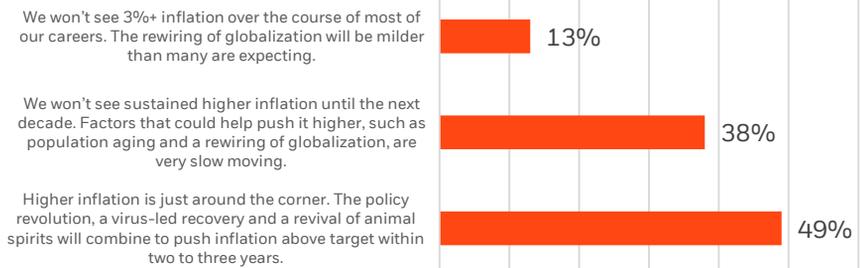
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BlackRock

The prospect of sustained higher inflation over the medium-term is at the heart of market debates in 2021.

Many see near-term deflationary forces associated with the ongoing coronavirus shock (e.g. business closures and reduced need for office space) giving way to an inflation spike as the end of lockdowns releases pent-up demand, but there is more debate around longer-term inflationary risks associated with demographic shifts, a slowdown in globalisation, and central banks' willingness to let inflation overshoot. In any case, there are meaningful portfolio implications.

**A market debate is simmering about inflation.** Many still see deflationary forces in the near-term – and inflation only in the longer-term. But timing is everything. What do you see as the most likely horizon for sustained inflation – core inflation above 3% – to hit markets? See below for the results of our public poll.



Source: BlackRock Investment Institute external poll available to global financial professionals, with data from SurveyMonkey. Note: Data does not include results from BlackRock social media polls. Click [here](#) for more on this poll.

In this piece, we discuss with BlackRock macro experts and portfolio managers:

## Divergent views in the inflation debate

- Most BlackRock portfolio managers don't see sustained higher inflation over the long-term, according to a recent internal poll. Yet others believe the policy revolution combined with surging animal spirits could finally spur inflation as the economy reopens following the COVID-19 shock.
- Responses to another investor poll suggest BlackRock portfolio managers are split 50-50 on whether core U.S. inflation will be above or below the 1.9% median forecast by year-end.

## What arguments are driving them?

- Inflation bulls see the potential for sustained higher inflation as a result of stronger growth, rising production costs, and lower real yields amid a vaccine-led restart.
- Inflation bears point to structural forces like tech-induced deflation and weak demographic trends that should continue to dominate and hold inflation at bay, among other factors.

## Portfolio implications of inflation

- We believe European inflation is cheap relative to other markets.
- We see the TIPS market as benefiting from generalised financial asset inflation.
- Dispersion in inflation expectations makes for an opportunistic trading environment.

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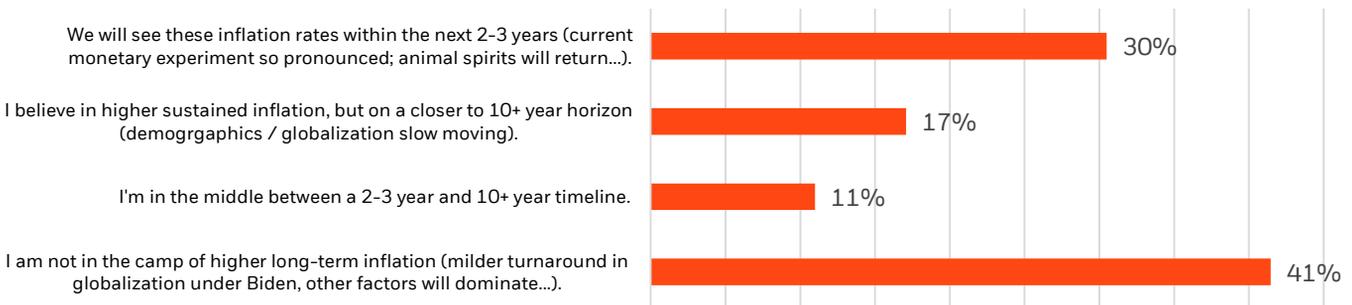
# Divergent views in the inflation debate

**Isabelle Mateos y Lago:** Michael, can you summarise for us the answers you got when you asked BlackRock investors about their outlook for inflation of the medium- and long-term?

## Investor views

**Michael Krautzberger:** This has been a hotly debated topic among BlackRock investors. Back in late December I asked my colleagues how long it would take to see sustained higher inflation (i.e. core inflation above 3% on a sustained basis). 30% of respondents saw sustained higher inflation in the next 2-3 years, while 41% are not expecting a higher inflation regime. Fewer investors opted for the 'middle of the road' answer choices (i.e. higher inflation in either a 5-10 year or 10+ year time horizon), illustrating the polarizing nature of this topic.

### BlackRock Question of the Week: What do you think about the timing of sustained higher inflation?



Source: BlackRock internal investor poll as at 11 December, 2020; 82 responses.

**Tom Parker:** Like Michael, I also polled internal BlackRock investor colleagues on inflation, but focusing on the year ahead. Asked in early January whether we'll come over or under various consensus inflation estimates by the end of 2021, most people voted under. But over the medium-term, more bulls emerged citing the fact we have fiscal policy for the first time in a while and that it's interacting with monetary policy being conducted on an unprecedented scale. It seems in the one-year horizon people are more bearish: the results of whether we'll be over or under the 1.9% U.S. Core PCE forecast at the end of the year was a close 52% to 48% of poll respondents, and for the 1.6% European CPI forecast it was 31% to 69%. When respondents were asked about the conviction behind their responses, however, only 7% and 5% of respective respondents stated this view represented their highest conviction trade.

I too have a lot more uncertainty about the future direction of inflation than I've had in a bit of time, and we're currently in one of the most uncertain environments for the inflation outlook we can remember. In my series of investor polls, responses suggested most are more optimistic about the outlook for economic growth and risk asset prices than already bullish consensus forecasts. Inflation is a notable exception where there is the most uncertainty; for this reason, it could ultimately be the most consequential for portfolio performance.

## What arguments are driving inflation views?

**IML:** Elga, the BlackRock Investment Institute (BII) has set out a clear view on inflation in its [2021 Outlook](#), namely that we should expect meaningfully higher inflation over the medium-term. Can you explain why?

**Elga Bartsch:** Three forces underscore why BII thinks inflation is set to rise:

1.

Rising global production costs due to the fallout from COVID-19; businesses' need to hike prices to survive; and the rewiring of globalisation and 'just-in-time' global supply chains. As companies review their supply chain and make them more resilient to a broad range of risks, this implies higher production costs.

# What arguments are driving inflation views?

2.

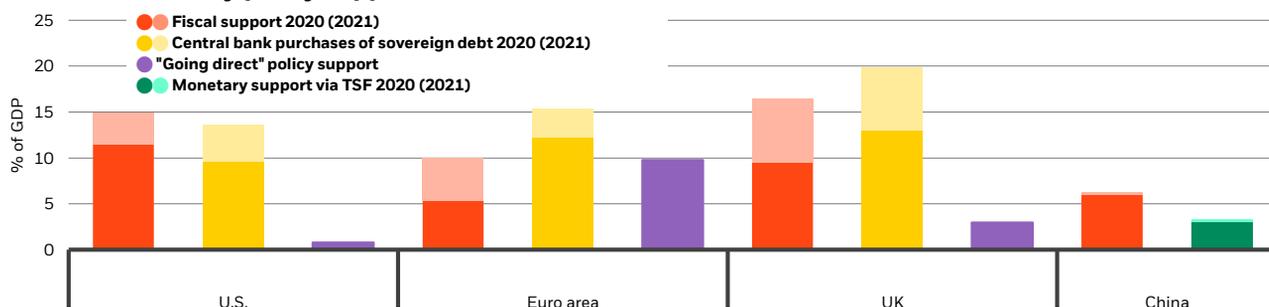
Fundamental changes in Central Bank policy frameworks, where Central Banks like the Federal Reserve have explicitly communicated a greater tolerance for inflation overshoots in order to make up for decades of missing inflation targets as well as no longer looking at a tight labour market as a potential harbinger of rising wages and eventually inflation.

3.

Closer coordination between monetary and fiscal policy, which was born from a need to respond adequately to the COVID-19 crisis and opened Central Banks to material political pressure to maintain low interest rates.

Overall, contrary to the bifurcation Michael laid out we find ourselves more in the middle; we see some modest overshoots over the medium-term both in Europe and the U.S., but from an investment view don't think these will be translating into materially higher bond yields or much tighter monetary policy.

## Fiscal and monetary policy support set to continue into 2021



Source: BlackRock Investment Institute, with data from Haver Analytics, December 2020.

**IML:** What are the core rationales for the bullish and bearish views on sustained inflation over the medium-term?

**MK:** In my internal discussions with BlackRock portfolio managers, inflation bulls articulate a few different arguments

1.

Central Banks' adoption of 'make-up' strategies that aim to let inflation overshoot to make up for periods of too-low inflation.

2.

The fact that we'll have had almost a decade of zero or negative interest rates that will lead to a melt-up in risk asset and commodity prices, which will be inflationary in the long-term.

3.

The private sector has been well protected by government policies and there will be a lot of 'animal spirits' and pent-up demand unleashed once the economy reopens after the COVID-19 crisis.

4.

The COVID-19 crisis has also shown us it's problematic to rely too much on globalisation and globalised supply chains, and that some domestic onshoring to come should cut against the fact that globalisation has been a generally disinflationary force.

5.

Past balance sheet restrictions on governments were much stricter and prevented the use of too much fiscal policy due to debt sustainability issues. Now, we're talking about monetary policy cooperation and governments being much more prepared to use fiscal than in the past, and this supports inflation on balance.

In terms of the bearish view on inflation, many people say the world hasn't changed much, and we'll still be in a low-inflation environment for the immediate term. Technology is part of this argument (and may be exacerbated further by the COVID-19 crisis), as is the fact that Central Banks have been fighting for decades to get inflation up via tactics like Quantitative Easing, albeit unsuccessfully. Additionally, the Biden administration may lead to less of a globalisation retreat than we may have seen under a second Trump administration, so globalisation will continue to be a disinflationary force at the margin. In terms of household behaviour, people aren't necessarily consuming or investing more because of the demand for excess savings – and at low rates, people may be inclined to save more on a precautionary basis.

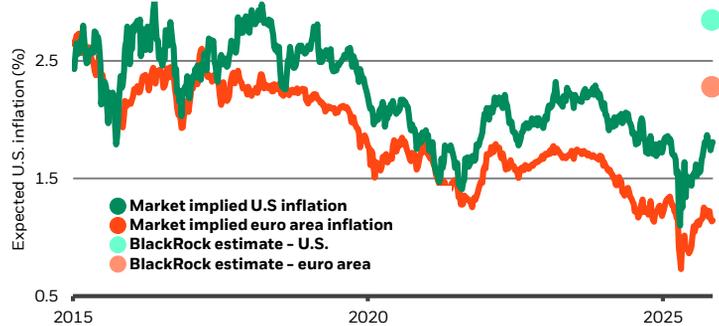
# What arguments are driving inflation views?

**IML:** We've discussed the views of other BlackRock investors. What about your own?

**MK:** I believe sustained higher inflation (e.g. core inflation above 2%) is at least a five-year story for Europe and the ECB will have to leave interest rates negative or zero until at least the middle of the decade. We think the recovery will be mild and contain a bit of volatility across sectors like travel and hospitality.

**TP:** I am in the camp that we will not see higher long-term inflation and that we will stay below Central Bank targets. Prior to COVID-19, we were in an environment of secular stagnation and low expected inflation for longer. If you blast a hole in the economy with COVID-19, there's a lot of fiscal and monetary policy to refill that hole but eventually you're back in the same pre-COVID-19 environment with weak demographics, technology deflation, secular stagnation, large private sector savings, and a global imbalance of supply and demand.

## BlackRock forward inflation estimates vs market pricing, 2015-2025



Forward-looking estimates may not come to pass. Sources: BlackRock Investment Institute and the Federal Reserve with data from Refinitiv Datastream, November 2020. Notes: The chart shows market pricing of expected average inflation over the coming five-year period. We show it using the five-year/five-year inflation swap which is a measure of market expectation of inflation over five years, starting in five years' time. In the chart, the lines are shifted forward five years. The orange and green dots show our current estimate of average U.S. CPI and euro area inflation for the same five-year period of 2025-2030. Euro area refers to all 19 member states.

# Portfolio implications of inflation views

**IML:** What do various inflation scenarios mean for portfolios and investing?

## A new playbook needed for higher inflation

**EB:** Our BII view calls for stronger growth and lower real yields ahead as the vaccine-led restart accelerates and central banks limit the rise of nominal yields – even as inflation expectations climb. Inflation will have different implications to the past. This is what we call the “new nominal.”

### Strategic Implication

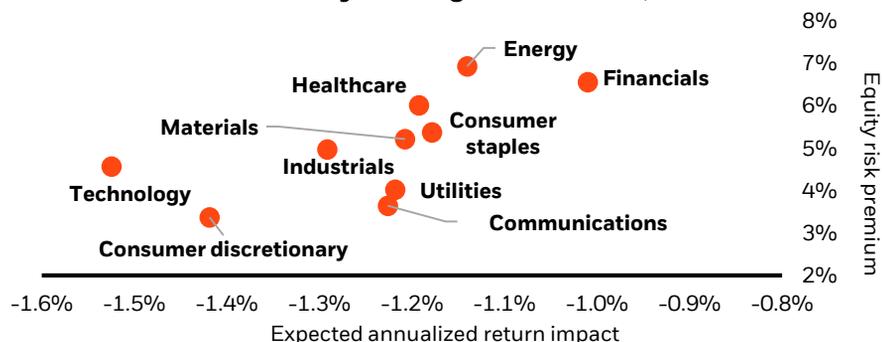
We are underweight government bonds and see equities supported by falling real rates.

Our inflation outlook has significant implications for strategic asset allocations. Key components include a rethink of the role of nominal developed market (DM) government bonds, given the implications of the policy revolution: a drop in real yields. That implies unusually in a more inflationary environment a favorable backdrop for equities as discount rates are contained by policy. It also means a preference for inflation-protected bonds. We acknowledge these are big calls with much uncertainty and we will be tracking them closely in the years ahead.

### Tactical Implication

Our low rate outlook keeps us pro-risk. We like U.S. equities and prefer high yield for income.

### U.S. sector return sensitivity to rising nominal rates, December 2020



This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance. Source: BlackRock Investment Institute, with data from Refinitiv Datastream, December 2020. Notes: The chart shows the implied equity risk premium and the sensitivity of 5-year expected returns to a 50 basis point rise in nominal rates for MSCI USA sectors. Past performance is no guarantee of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index.

# Portfolio implications of inflation views

## Wide dispersion of opinions creating trading opportunities

**MK:** In a portfolio context we think European inflation is cheap relative to our very moderate scenario and relative to other markets. In the U.S. inflation is pretty much priced at the Fed target, and in the UK, you could argue it's priced at above the Bank of England target. We are therefore running short positions in UK inflation with a view that it's priced too high in the UK. One risk factor for this trade was the disordered Brexit risk that would have led to a very weak pound and perhaps a short-term inflation spike, but we like that rate a lot now that the risk has passed and have been long European and U.S. inflation against it. But with the recent run in U.S. inflation we're starting to take some profit in the U.S. because inflation is in line with the Fed target for the next 10 years or even over shorter periods. Essentially, the market is pricing complete success on the Fed side and complete failure on the ECB side, and the spread of 10-year inflation expectations is near the wide.

**TP:** In the near-term we're long inflation across most of the markets where we trade it, off the idea that TIPS / breakevens are a financial asset and there's a lot of financial asset inflation going on. The TIPS market is very illiquid, so it always has a liquidity premium to it, and that liquidity premium has been high historically though narrowing in some ways due to excessive demand. Overall given all the uncertainty we've been discussing in terms of inflation views and estimates, it's a fantastic trading environment with lots of dispersion.

## Conclusion

**IML:** Ultimately, what seems clear from this debate is that inflation outcomes are not written in advance, and much will depend on the evolution of policy and political debates around the two keys issues:

- For how much longer can and should fiscal support be provided?
- Will central banks cater more to the needs of highly indebted governments or to inflationary pressures?

It is too soon to tell how these debates will be resolved, and chances are different economies will make different choices too. Something to keep watching closely to predict where inflation ends up.

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