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Private Asset Management Ltd

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THE 2023 CS GLOBAL INVESTMENT RETURNS YEARBOOK - PART 2: THE INVESTMENT IMPLICATIONS OF STAGFLATION

Back in January when the GIRY was being written and prior to the banking crisis the course of monetary policy and its implications for investing appeared to have gone full circle - from worries about secular stagnation with interest rates staying "lower for longer" to coping with a stagflationary environment and higher nominal and real rates. In that scenario of persistent inflation and low growth the long duration assets which had dominated the performance tables in the last decade would now be the worst impacted by higher interest rates. Since then we have had the collapse of various banking institutions around the world and bond markets have become more convinced that central bank tightening is coming to an end. Reflecting that optimistic view, in the fourth quarter to the end of March, long dated US treasury yields have fallen dramatically – from 3.88% to 3.48% and in the equity markets growth has outperformed value by an extraordinary 14.3%.

But as we all know markets are volatile and what worked last quarter may not outperform in the next three months. A key issue which investors need to focus on today is the outlook for inflation and interest rates and the 2023 edition of the GIRY has a lot to say on this issue particularly as regards the persistence of inflation and its impact on bond and equity returns. The professors note that, whilst both shares and bonds have beaten inflation over the long term, during years of high inflation both of these asset classes perform poorly, particularly when inflation rises above 4%. They make the important point that whilst it is widely believed that stocks are a good hedge against inflation the reason for their outperformance is simply that their returns have been high and add "it is important to distinguish between beating inflation and hedging against inflation". Even fund manager Vanguard which is more sensible than most gets this wrong: in a recent research note, reprinted in the Australian Financial Review, Vanguard described equities as providing "a hedge against inflation through capital appreciation".

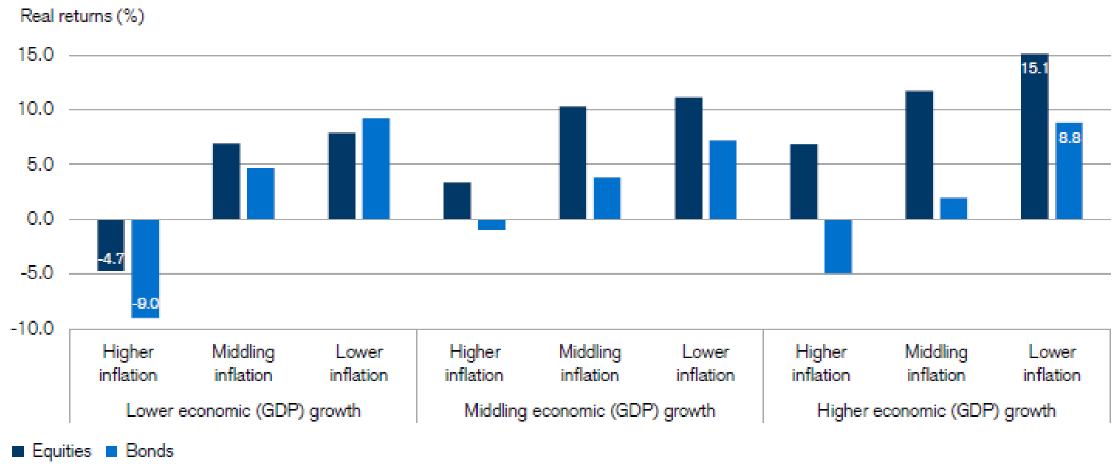
The reappearance of serious inflation, after a notable absence, has reminded investors that it can be a serious threat to investment portfolios. For conventional bonds high inflation is unequivocally bad news because interest payments are fixed. However an increase in inflation causes interest rates to rise but, as the interest payments are fixed, the price of the bond must fall so as to increase the yield on the bond to the prevailing market rate. Accordingly, the GIRY research confirms that real returns from bonds vary inversely with inflation and the authors emphasise that one generally owns them to protect against deflation i.e. periods when inflation goes negative.

Since 1900 NZ's inflation rate has averaged 3.6% pa which is much higher than that of the US, at 2.9% pa but lower than that of Australia (3.7%). NZ's highest inflation rate was in 1980 when it got to 14.7% and deflation peaked at -12% in 1932. Germany has the dubious record for the highest ever rate of inflation in a single year at 209 billion percent in 1923. As far as deflation records go Belgium is the clear winner at -37.9% in 1919 although the UK at -26% in 1921 is down there as well.

US inflation was just 1.4% in calendar 2020 but rose dramatically to 7% in 2021 and 6.5% in 2022. The US Federal Reserve sees inflation as being transitory and it's March 2023 forecast is for prices to increase by 3.6% in 2023, 2.6% in 2024 and 2.1% in 2025. However the GIRY warns that "the growing consensus that conditions will return to normal with low inflation re-established" may be optimistic and that history reveals that this outcome is unlikely. They cite research by Arnott and Shakernia which cautions that there is a worst-case scenario of high inflation persisting for a decade and write "Arnott and Shakernia argue that these forecasts are optimistic in the light of history. They studied inflation persistence in 14 developed economies from 1970 to 2022. They found that, "Reverting to 3% inflation … is easy from 4%, hard from 6% and very hard from 8% or more. Above 8%, reverting to 3% usually takes six to 20 years, with a median of over ten years."

If inflation is higher for longer than the market expects this has obvious implications for investment strategy particularly if it is accompanied by lower economic growth. The GIRY notes that the worst of all worlds, for a balanced portfolio, is when high inflation coincides with low growth, an economic condition known as stagflation. The GIRY examined the impact of stagflationary conditions on stock and bond markets by comparing their real returns at varying levels of inflation and economic growth. They did this for the 21 countries for which they have had a complete 123-year history and excluding the hyperinflationary period of 1922 – 23 for Germany and 1921 – 22 for Austria. The chart below shows the effect of inflation and GDP growth on bond and equity returns. Predictably their performance is best when higher economic growth is combined with low inflation. In this scenario equities have returned an average of 15.1% pa and bonds 8.8% pa. Of particular interest is the first bar chart illustrating the dire consequences of stagflationary conditions. A combination of high inflation and low economic growth has been associated with an average -4.7% for equities and -9.0% for bonds. The professors conclude: "These results reinforce the fact that inflation is bad for both stocks and bonds. They also show why investors are right to fear stagflation."

Figure 70: Real equity and bond returns versus inflation rates and real economic (GDP) growth, 1900–2022



Source: Elroy Dimson, Paul Marsh, and Mike Staunton, DMS Database 2023, Morningstar. GDP data is from Barro (2010), Maddison (1995), Mitchell (2007) and IMF (2022). Not to be reproduced without express written permission from the authors.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.