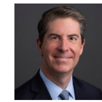
Inflationary Forces Set to Overpower Disinflationary Trends

The post-GFC environment of low rates appears to be over.

October 2022



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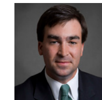

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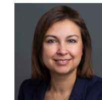

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KEY INSIGHTS

- We think the economy has reached a turning point where higher interest rates may be here to stay, which has implications for how we manage duration.
- The impact of inflationary and disinflationary crosscurrents will vary, but the underlying forces have shifted from almost entirely disinflationary to mixed.
- We think inflationary pressures, such as the reversal of globalization and the end of consumer deleveraging, could eventually outweigh disinflationary forces.

Interest rate volatility has been elevated in 2022 as multiple factors driving inflation have shifted from headwinds to crosscurrents. This has pushed the yield on the two-year Treasury note higher, increasing to 4.34% in late September from only 0.73% at the beginning of the year. Do the marked increases in Treasury yields indicate that markets have entered a new regime of structurally higher rates? Or will we return to the ultralow interest rate environment that dominated the post-global financial crisis (GFC) period?

We believe the economy has reached a turning point where higher interest rates may be here to stay, as longer-term underlying trends switch from post-GFC disinflation to post-pandemic inflation.

This likely transition to a new interest rate regime has implications for how we manage duration in portfolios, including the U.S. Ultra Short-Term Bond Strategy; primarily, that we are becoming more prudent about extending duration—even if rates begin to look attractive at higher levels.

Labor Globalization Reverses

The decades before GFC saw an acceleration of globalization and rising global trade flows, which facilitated the importation of cheaper goods from emerging market manufacturers to the developed markets. This led to a sustained period of very subdued goods inflation. However, this period of hyperglobalization seems largely behind us with global trade flows being on a declining trend post-GFC. In addition, declining wage differentials between the U.S. and emerging markets and rising trade tariffs were already adding additional momentum to global inflationary forces, even before the pandemic.

Pandemic-related supply chain disruptions greatly accelerated the reversal of globalization. This nascent repositioning of manufacturing to regions with higher labor costs to reduce

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supply chain risks further highlights that the U.S. likely will not be able to import goods deflation at the same rate that it did for the past 30 years. This trend is also reducing the savings glut in Asian countries that are manufacturing centers. These nations often invested much of this savings from export revenues in U.S. Treasuries, which helped to keep their currencies competitive and suppressed Treasury yields. As their savings recedes, demand for Treasuries could fall, allowing yields to increase.

U.S. Consumer Deleveraging Over

The decade following the GFC saw a global deleveraging trend where the marginal dollar went to debt reduction over consumption. This tendency held inflation down but has largely dissipated, removing a headwind to inflation. The financial scarring from the GFC also negatively impacted general willingness to take risks, which, at least theoretically, limited consumption and inflation.

As households deferred consumption in preference for reducing debt, the discount rate fell, reflecting an indifference between consumption today versus tomorrow. However, this shift down in the discount rate also helped to depress interest rates. While the private sector is still deleveraging in some regions outside the U.S., the trend has ended in the U.S., removing some downward pressure on inflation.

ESG Factors and Fiscal Policy Expectations Could Add to Inflation

Societal and investment forces that favor environmental, social, and governance (ESG) factors could also add to inflation. For example, the transition toward renewable energy and away from fossil fuels involves investment in technologies such as electric vehicles and batteries that are higher cost—at least in the short term. ESG priorities can also discourage investment in fossil fuel sources, helping to keep supply low and energy prices high during this transition period.

Also during this transition period, the economy will need to live with two sources of energy production, as greener sources take time to ramp up. However, the economy has not had an opportunity to restructure around these new methods, leading to lower efficiency and higher inflationary pressures in the short run.

Finally, fiscal support in the form of pandemic relief programs contributed to inflation. Following the GFC, relatively tight fiscal policy helped offset monetary expansion, keeping inflation contained. However, post-2020, the public mindset could shift to expect expansionary fiscal policy in the event of an economic downturn, lifting spending and inflation in the longer term.

Deteriorating Labor Force Demographics

The effects of changing U.S. labor force demographics will also add to inflationary pressures in the longer term. The disappointing rebound in the labor force coming out of the pandemic's economic shock has contributed to tightness in the labor market and driven wages—and inflation—higher.

Furthermore, this decline in the labor supply is not just a developed market phenomenon. Developing Asian and European economies, which had added significantly to the global labor supply in the 1990s and 2000s, are now aging at a rapid clip—in some places, more quickly than in developed economies. Globally, labor markets are likely to tighten going forward, adding upward pressure on global wages.

Disinflationary Forces Outside the U.S.

Forces outside the U.S. that are weighing on the global economy could also be disinflationary. The European energy crisis, which appears to be coming to a head this winter, is likely to drive the eurozone into recession.

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Problems in China's housing market, ongoing regional shutdowns stemming from the country's zero-COVID policy, and China's own demographic challenges could also meaningfully slow the second-largest economy in the world, potentially helping to overpower inflationary forces in the U.S.

The U.S. dollar's remarkable run of strength in 2022 could continue as the U.S. becomes the clear driver of global growth. The strong U.S. dollar makes imports less expensive, naturally restraining inflation. It also makes U.S. exports more expensive and less competitive on a global basis, which can ultimately result in market share losses. This would be a drag on economic growth and inflation.

Fed Determined to Rein in Inflation

Federal Reserve (Fed) policymakers have clearly expressed the central bank's determination to rein in inflation. The Fed's resolve to address inflation could lead to structurally higher interest rates even when growth slows and inflation is contained. This could partially explain the benign market pricing of inflation. In late September, the two-year breakeven inflation rate was only around 2.25%, clearly implying that market participants expect inflation will be well under control by late 2024 due, in part, to structurally higher rates.

However, central bank efforts to limit wealth inequality by keeping credit affordable for the non-wealthy could limit the extent of rate hikes. In the longer run, the Fed's average inflation-targeting framework means that it would tolerate somewhat higher inflation to make labor market gains more inclusive.

Implications for Portfolio Construction

The interaction of these crosscurrents will vary at any given point, but the more important implication is that underlying forces have shifted from almost entirely disinflationary to mixed. We anticipate that inflationary pressures could eventually outweigh disinflationary forces.

This outlook for structurally higher inflation and interest rates means that we are unlikely to position the U.S. Ultra Short-Term Bond Strategy near the high end of its historical duration range going forward. A positive aspect of this year's higher Treasury yields is that they have pulled short-term corporate yields higher as well, providing a much more meaningful yield cushion that helps buffer the negative price impact of rising rates.

Another implication of structurally higher inflation for portfolio construction is that exposure to Treasuries will probably be a less consistent way to reduce portfolio volatility going forward. However, Treasuries should resume their traditional role as an effective diversifier against major sell-offs in risk assets such as corporate bonds and equities, particularly if growth concerns—not inflation—are driving the risk aversion.

WHAT WE'RE WATCHING NEXT

Along with raising interest rates, the Fed is also tightening monetary policy by not reinvesting the proceeds of an increasing amount of its maturing bond holdings. The central bank is likely to be limited in how much it can reduce the size of its balance sheet through this quantitative tightening process, keeping it from flooding the market with more duration than it can handle.

General Fixed Income Risks

Capital risk—the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

ESG and sustainability risk—may result in a material negative impact on the value of an investment and performance of the portfolio.

Counterparty risk—an entity with which the portfolio transacts may not meet its obligations to the portfolio.

Geographic concentration risk—to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk—a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

Investment portfolio risk—investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management risk—the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

Operational risk—operational failures could lead to disruptions of portfolio operations or financial losses.

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