# Inflation playbook

## Managing through an inflation cycle

## Speed read

- After the 2021-2022 inflation shock, we enter 2023 with signs that cyclical inflation is easing, especially in the US. We anticipate inflation stabilizing near central bank target levels over the next one to three years, but recognize there are risks to this outcome.
- Higher inflation and greater inflation volatility, for example, remain long-term risks driven by structural factors, including globalization slowing as the world is factionalizing, inadequate investment in the commodities supply chain and potential public debt monetization.
- As a result, portfolios should remain positioned to weather various economic and inflationary scenarios by including a diversified mix of inflation-sensitive asset classes, while being conscious of current valuations..

## A year to (not) forget

Last year was challenging on most fronts. Inflation, already an issue due to constrained supply chains failing to meet stimulus-aided re-opening demand, was exacerbated by geopolitical shocks.[1] In response, most central banks in developed markets embarked on a rate-tightening cycle – the most aggressive since the 1980s.[2]

There were few places to hide as both equity and bond markets produced negative returns through their shared exposure to discounted cash flows (duration). Due to persistently higher-than-expected consumer price inflation (CPI), the 2022 rate-hiking cycle was extraordinarily aggressive. This made markets more sensitive to the inflation outlook than the outlook for economic and earnings growth. For that reason, the equity market's response to US CPI announcements was negative throughout 2022 (see **figure 1).**

What 2022 has demonstrated is that in a more volatile inflation environment, portfolios cannot be constructed around the business cycle alone. The inflation cycle must also be factored in.[3]

While inflation remains high in the early stages of 2023, there are signs that headline and core inflationary pressures are easing as rate increases take effect (see **figure 2**).

Given economic growth can often lag behind the effect of rate rises, we believe inflationary pressures will continue to ease. This is implied by the decline in break-evens since mid-2022 (see **figure 3**).

**Figure 1. Average MSCI World reaction to US CPI announcements**

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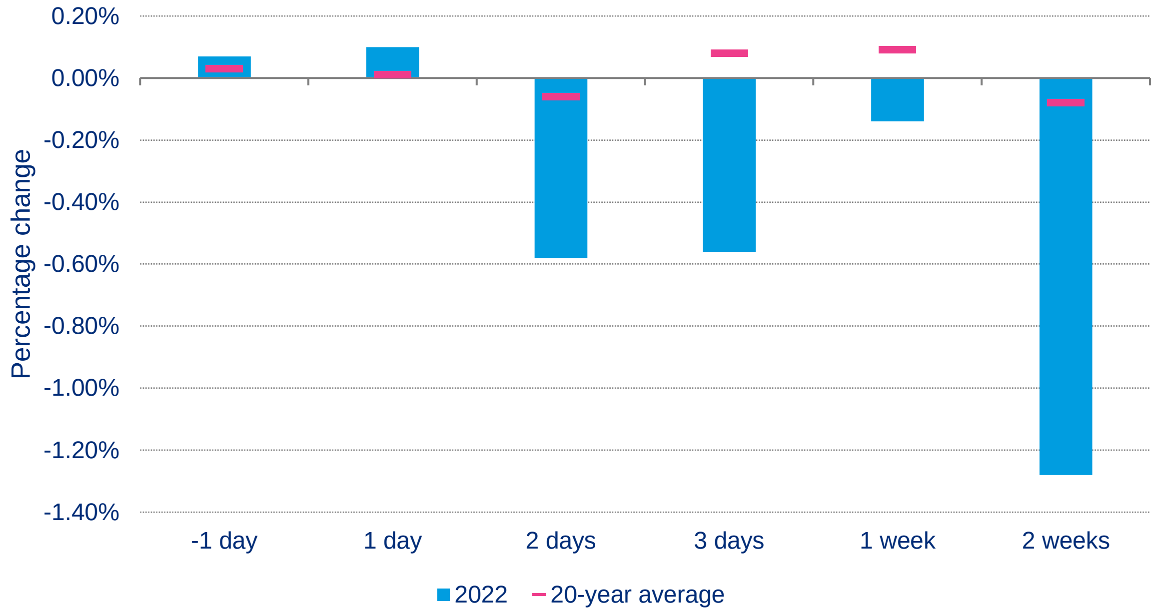
[1] [Inflation – turning up the heat (Mercer: 2022)]

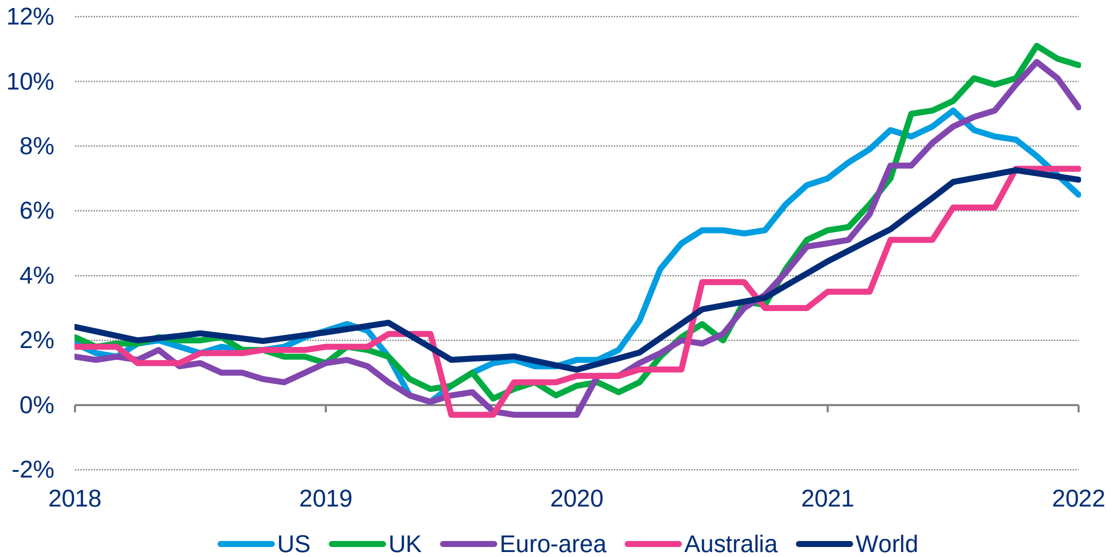
[2] The Bank of England started the hiking cycle in November 2021, the Federal Reserve and Reserve Bank of Australia began increasing rates in the spring of 2022 (having started tapering asset purchases in late 2021). The European Central Bank began raising interest rates in mid-2022. The Bank of Japan was the only major developed market central bank to maintain loose policies. In many emerging markets, the hiking cycle had already begun in 2021 – except in China where a slowing economy actually led to some moderate easing measures by the People's Bank of China.

[3] Positioning a portfolio around the business cycle ('GDP beta') means building it around equities and bonds, with the former doing better in an expansion than the latter and vice versa, and overweighting one over the other depending on what environment the allocator expects in the medium term. Adding the inflation cycle to the equation also means positioning for different inflation scenarios ahead, such as TIPs for a financial repression environment or commodities for stagflation. Going forward, allocators may need to consider both business and inflation cycles when constructing portfolios.



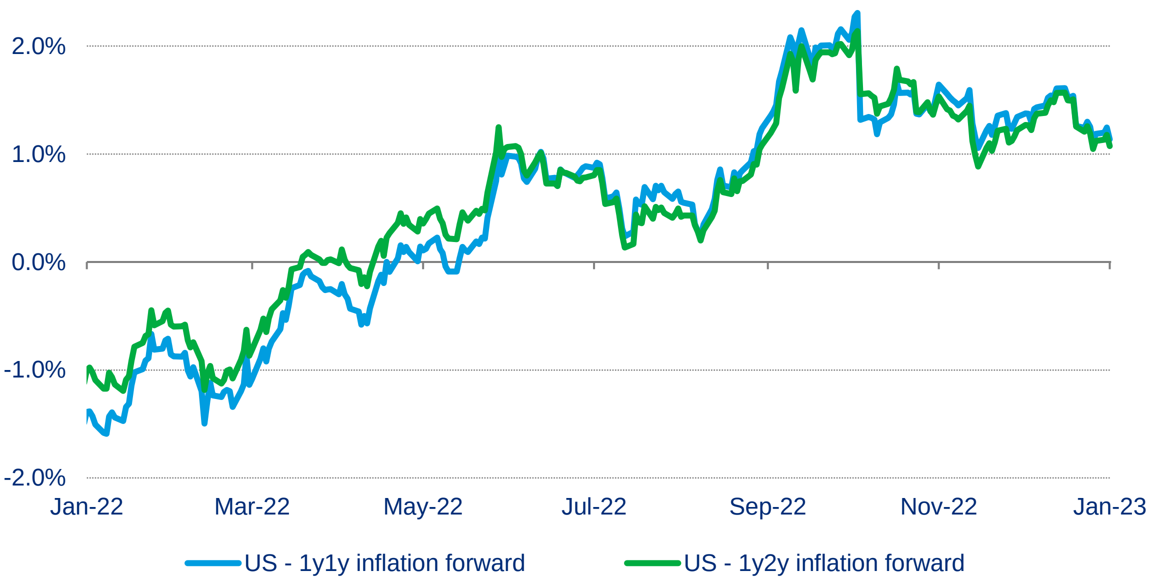

Source: Bloomberg. Data as of January 12, 2023.

**Figure 2: Year-on-year headline consumer price inflation**




Source: Bloomberg, Goldman Sachs. Data as of December 31, 2022.

**Figure 3: US inflation break-even rates**




Source: Bloomberg. Data as of January 26, 2023.

The expectation of a more benign inflationary outlook should not lead us down the route of complacency though. Inflation could take years, rather than months, to revert to more ‘normal’ levels. Further, there is the potential of higher levels than in the pre-pandemic period. Looking longer term beyond 2023, even as cyclical inflation pressures subside, structural pressures remain.

The key principles underpinning our guidance on managing inflation risks[4] are as applicable to the current inflationary climate as they have been in previous outbreaks.

- **Robust portfolios are positioned to withstand different economic environments. Scenario analysis is critical to deliver this.**
- **Scenario analysis highlights that there is no silver-bullet asset class or strategy suited to all inflationary environments. A diversified approach is required.**

However, our inflation scenarios and their respective likely outcomes have changed.

The ‘overheat’ scenario is potentially behind us. But stagflation risks remain, if inflation turns out to be more resilient than growth as rate rises take effect. Alternatively, we could see a ‘return to stimulus’ where central banks take their foot off the brake early and inflation runs modestly above target for some time.

While the asset classes expected to perform well in these two scenarios are very different, both scenarios allow for inflation to remain a feature of markets for some time. Further, both scenarios demand a shift in focus from protecting against a short-term inflation surprise like

[4] Inflation protection – building robust portfolios (Mercer: 2021)

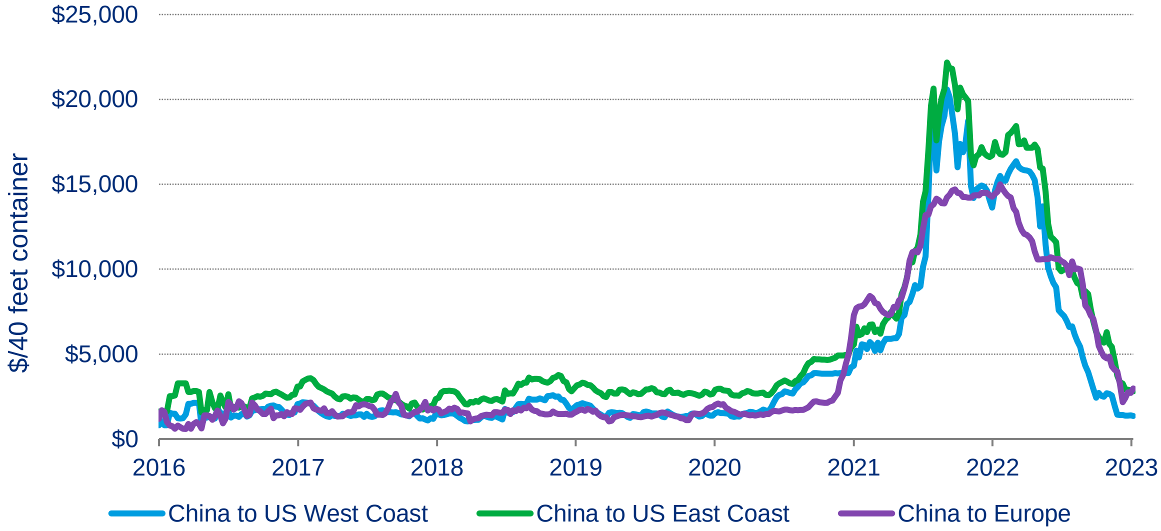
we had in 2022[5] to managing a higher inflation regime through assets with longer-term inflation revenue linkage.

## Inflation outlook has evolved

Cyclical inflation pressures appear to be declining in many areas. Supply chain pressure has eased. This is demonstrated by the normalization in the cost of shipping goods from China to the United States and to Europe (see **figure 4a**). Energy prices have also seen a significant drop (see **figure 4b**).

Inflation is also decreasing in parts of the economy that tend to bear the brunt of higher rates. Looking at the US, for example, house price growth has been slowing[6], and rental inflation[7] and used car prices[8] are also declining.

### Figure 4a: Supply chain constraints are easing




Source: Bloomberg, Freightos Baltic Index. Data as of January 18, 2023.

[5] Sensitivity to changes in the inflation rate

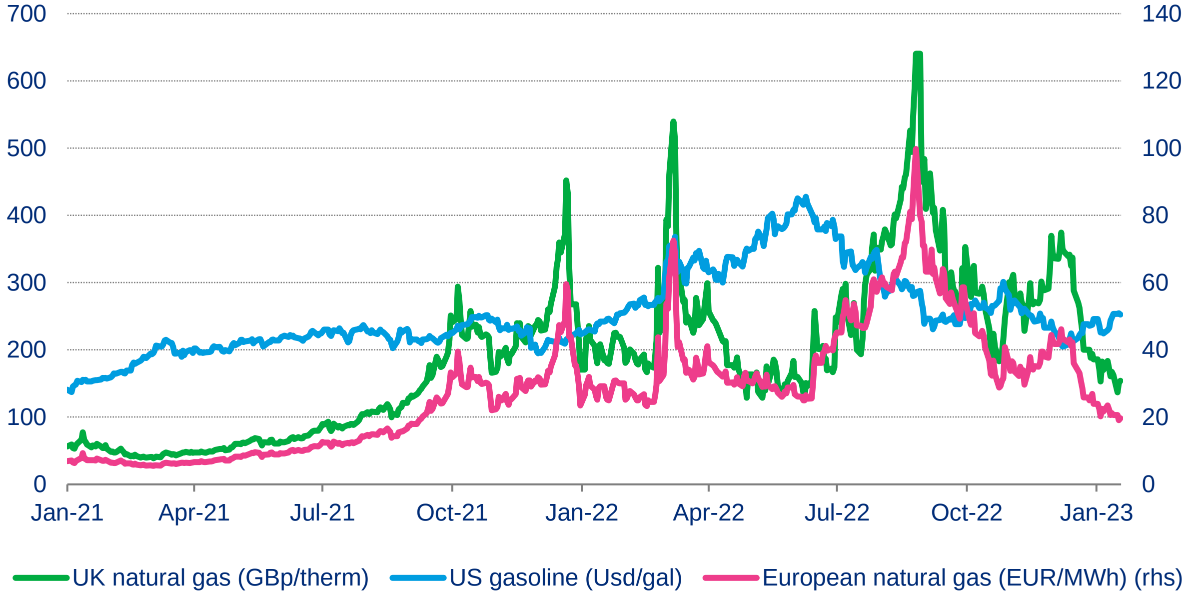
[6] Federal Reserve Bank of St Louis (https://fred.stlouisfed.org/series/CSUSHPISA) As of November 2022. Published in January 2023, accessed in February 2023

[7] Source: Realtor.com (https://www.realtor.com/research/november-2022-rent/) Published in December 2022, accessed in February 2023

[8] Source: Kelley Blue Book (https://www.kbb.com/car-news/used-vehicle-prices-falling-sales-slowing-inventory-stabilizing/) Published in December 2022, accessed in February 2023

**Figure 4b: Falling energy prices**




Source: Bloomberg. Data as of January 18, 2023.

Despite tentative[9] signs of cyclical inflation subsiding and the monetary tightening cycle reaching its peak, there remains significant potential for further inflationary shocks driven by structural factors, including:

- Factionalization, reversing some of the gains from globalization[10].
- Persistently tight labor supply.
- Inadequate investment in commodity production over the last decade.
- The continued push for an energy transition (green-flation).
- The precedent set by fiscal-monetary coordination in 2020/2021.

Investors would be wise to stay alert and not assume a rapid return to the low, stable inflationary regime of the post-GFC world even if it is a possibility.[11]

[9] The apparent peak of cyclical inflation is very recent, fragile and could be easily disrupted. For example, as China's full reopening is going ahead at the same time as its housing market is recovering, there could be renewed global supply constraints in 2023 as Chinese demand for commodities, especially energy, which had been dampened by suppressed economic activity over the last two years, comes back.

[10] For more details see 'The future of globalization' (Mercer: 2022)

[11] For more detailed analysis of why current conditions may be different from the post-2009 environment, see 'Beware of inflation' (Mercer: 2020), page 3

## How quickly will inflation come down?

This is the key question that everyone is looking for an answer to in the current cycle.

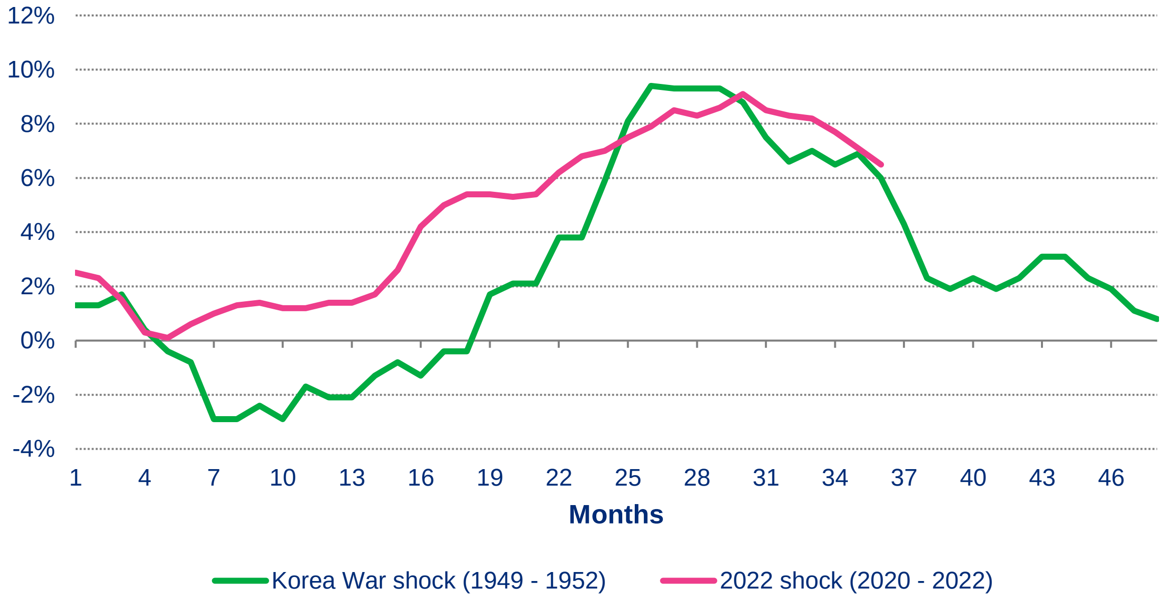
The market view is quite sanguine on this. It expects inflation to return to central bank targets within a year. Based on our own dynamic asset allocation view, we also expect inflation to stabilize close to central bank targets within the next 3 years.

Historically, however, after inflation has reached levels above 8% (noting that most of these events occurred in the 1970s and 1980s), it has taken around 10 years to drop below 3%.[12] This means there may be significant risks around our base case scenario.

As a potential lens into the future trajectory of inflation, we can look to a couple of examples of prior inflation episodes[13] for guidance.

The first is a relatively benign example: the Korean War in the early 1950s (see **figure 5**). Like in 2020, there was a sudden demand shock as people went on a buying spree on the eve of the war, fearing a return of WWII rationing and shortages. This occurred amid accommodative monetary policy (the Federal Reserve was still monetizing the debt accumulated during WWII) and constrained labor supply as US troops were deployed in Korea. However, from its peak, it took less than twelve months for inflation to fall back to 2%. Another notable factor was the absence of a major interest hiking cycle. Inflation fixed itself.

**Figure 5: 2022 inflation shock vs Korean War shock**



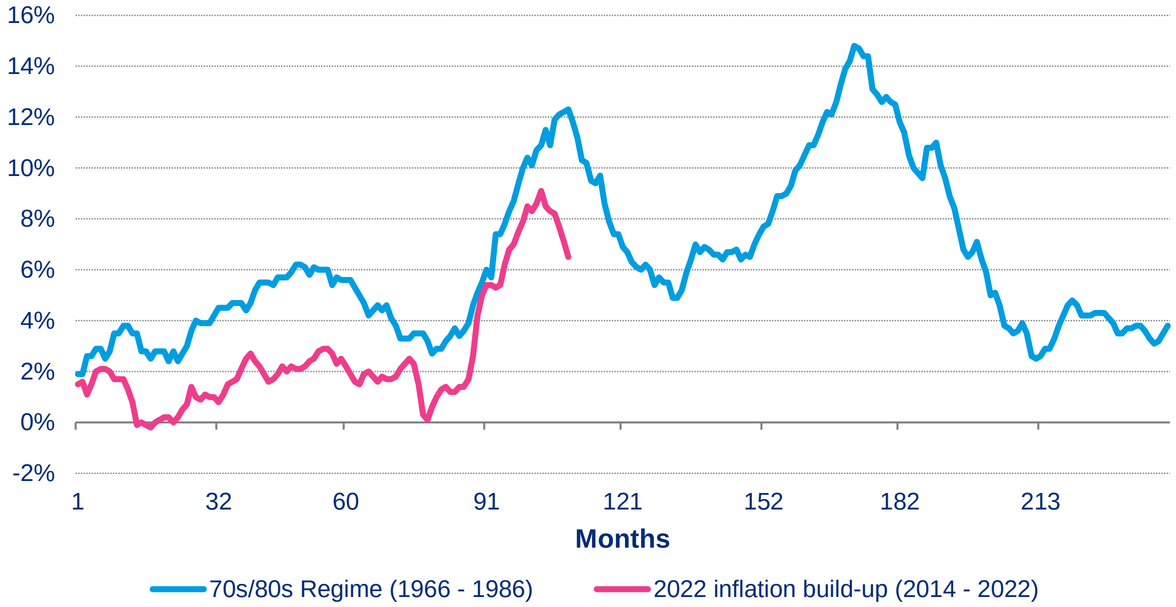

Source: Bloomberg. Data as of December 31, 2022.

[12] Research Affiliates (2022) 'History Lessons: How "transitory" is inflation?'

[13] It is important to acknowledge that while we highlight the similarities between the Korean War shock, the 1970s and the 2020s, there are also differences in terms of the general economic and monetary policy environment and tools. These two examples should therefore be seen as mere illustrations of benign and less benign outcomes following similar inflation shocks in the past.

The second and less benign example, is in the 1970s when it took three years for inflation to fall from its first peak to 5% before accelerating again and only returning to 2% in the 1980s (see **figure 6**). Like in the 2020s, this period was preceded by loose monetary policy and excessive ‘guns and butter’ government spending exacerbated by energy supply shocks.

**Figure 6: 2022 inflation build-up vs 70/80s regime**




Source: Bloomberg. Data as of December 31, 2022.

These past examples highlight that every inflation event is different. Critically, they also illustrate that future outcomes can end up quite different from that implied by the market’s relatively sanguine pricing of inflation risk today. For that reason, investors must prepare for any or all the following occurring:

- Inflation remaining higher for the medium term and more frequent inflation shocks over the medium to long term.
- Equity-bond correlations remaining positive, at least in the near future. As we saw in 2022, both equities and bonds, and by extension traditional 60/40 portfolios, can perform poorly when real rates rise and push down inflation. Equity-bond correlations have been positive for long periods in the past, particularly when inflation risks have driven markets.
- The potential for inflation to settle at a new (higher) normal.

## Mercer's Scenario Outlook

A scenario analysis is particularly useful when we are going through different stages of an inflation cycle.

**Figure 8** summarizes our scenario outlook today. These are forward-looking assessments set over a three-year time horizon. They span inflationary and disinflationary conditions, cost-push and demand-pull drivers of inflation (as shown in **figure 7**), and strong and weak growth, factoring in the influence of central bank and government policy.

**Figure 7. Demand-pull and cost-push drivers**

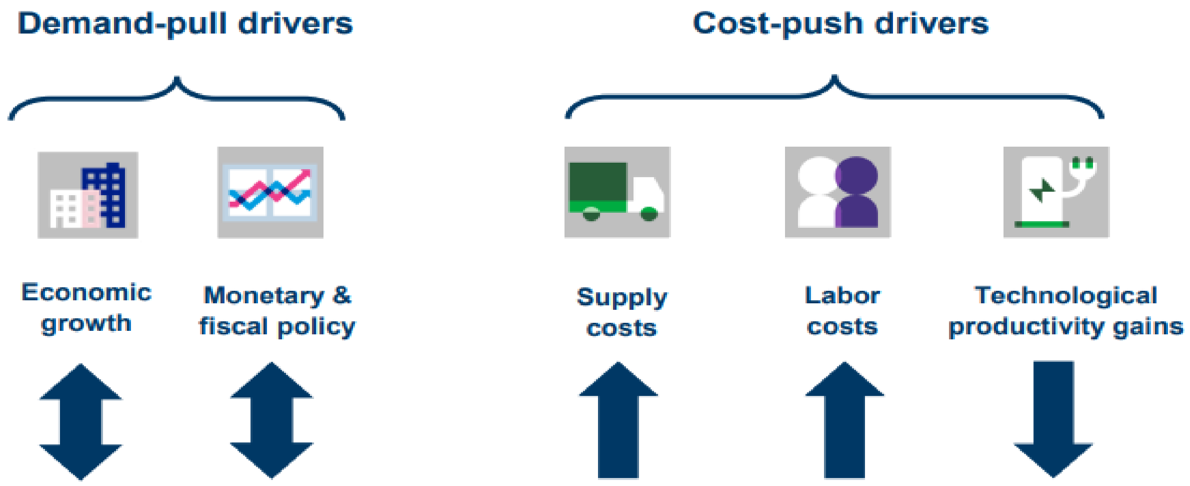
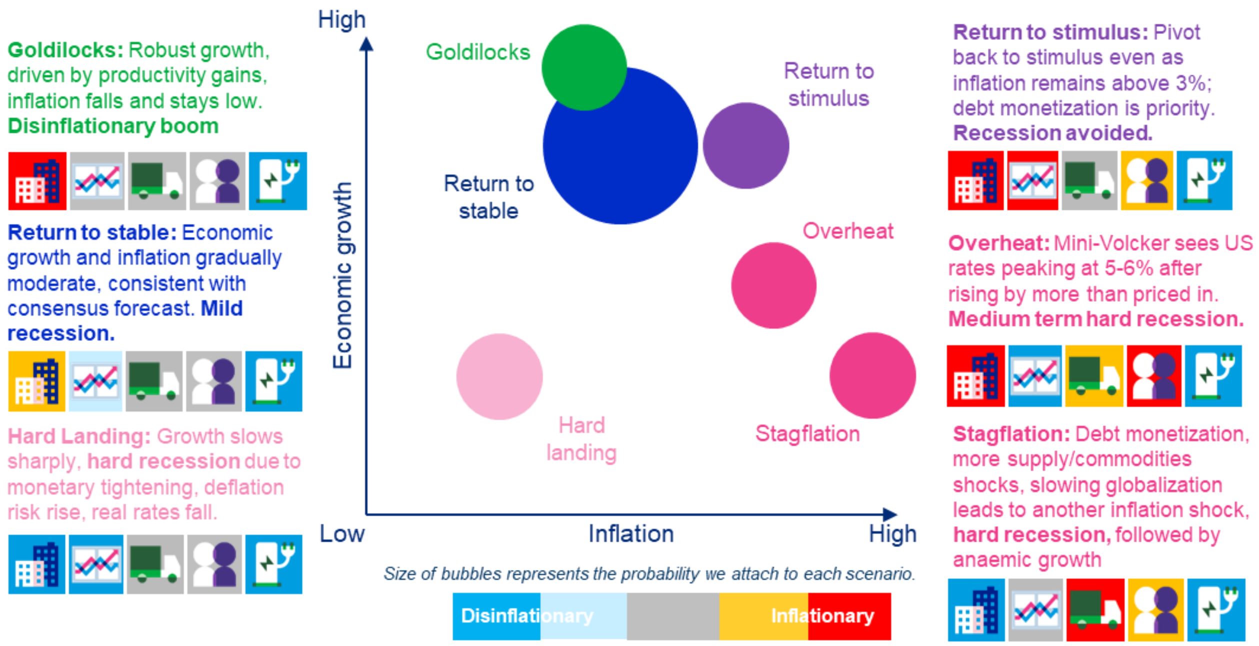



**Figure 8. How economies and markets could behave under different conditions**




Source: Mercer (2023). For illustrative purposes only.

**Figure 8** presents the range of possible scenarios we believe investors should consider today as part of their scenario-testing framework.

The framework is not designed, nor expected to be a complete, perfect tool. However, it highlights the possible portfolio outcomes of different scenarios. The size of the circular bubble provides an indication of the relative likelihood we attach to each of the different scenarios coming to fruition. And it is the combination of scenario and likelihood that is so important in the process. Low likelihood does not mean low impact.

The framework highlights that our ‘base case’ scenario is that rate rises deliver a **return to stable growth** with inflation trending down towards central bank targets. This is broadly consistent with the consensus view.

Our **‘overheat’** scenario sees a continuation of the tightening cycle beyond what is priced in, should inflation prove more persistent. More supply shocks driven by geopolitical events could lead to the **‘stagflation’** scenario.

The **‘return to stimulus’** scenario sees positive economic growth. However, this comes at the price of persistently elevated inflation as fiscal-monetary coordination continues, this time to monetize the public debt accumulated in 2020/21. This scenario is reminiscent of the post-World War II period.

Within our framework, only a ‘**hard landing’** scenario, which we consider a meaningful probability, would lead to inflation quickly returning to the very low levels seen prior to the Covid-19 pandemic.

So, what does this mean?

While a short-term ‘inflation surprise’ is behind us, there is potential for a medium- to longer-term inflationary cycle. Therefore, portfolios must evolve their inflation protections to reflect this possibility (see **figure 9**). This means shifting the focus from high ‘inflation beta’ assets (those with prices that exhibit a significant, short-term positive correlation with inflation) to those with inflation-sensitive revenues.

This shift may favor some of the asset classes so far adversely affected by the dramatic rate increases of 2022, for instance, TIPS, REITs and listed infrastructure. Natural resource equities (NRE) should also be considered even if unlike for TIPS and REITs, valuations for NREs have become less attractive over the past year. Each of these strategies offers inflation-protecting benefits through the positive relationship between its income and inflation, but valuations can be exposed to rate increases in the short term through the discount rate effect.

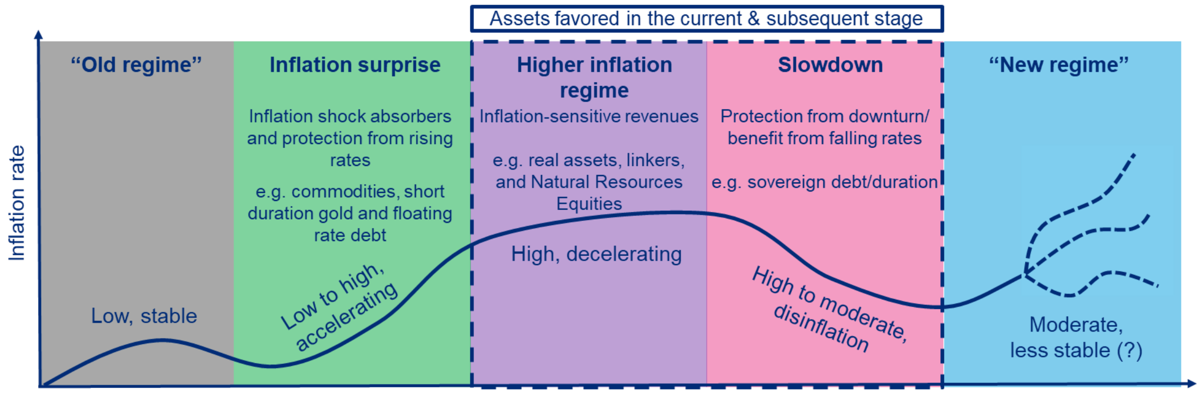
In 2022, rate movements were unusually steep and valuations were severely impacted. However, with the bulk of the rate hikes apparently behind us, the longer-term inflation linkage of these strategies should become more valuable.

That is not to say that inflation won’t surprise us again. The underlying structural inflation pressures – in particular, a factionalizing world – could facilitate a more volatile inflation environment, increasing the risk of additional inflation shocks in the future.[14] This is what

[14] For details on factionalization, see our ‘The future of globalization’ paper (Mercer: 2022)

happened in the 1970s. Therefore, maintaining a dynamic allocation to higher inflation beta strategies, such as gold and commodity futures, has merit.

**Figure 9: Illustrative example of an inflation cycle**




Source: Mercer

## Position portfolios for different inflation paths

The core tenets of Mercer's inflation advice remain unchanged. They are:

- **Portfolios must be able to withstand different inflation environments. Scenario analysis is critical to achieve that level of robustness.**
- **There is no silver-bullet approach to inflation protection. A diversified approach is required**.

What has changed is the positioning in the inflation cycle and what that means for the scenario outlook and for portfolio positioning.

Portfolios will need to withstand both higher inflation regimes and inflation shocks. Right now, we believe the focus should be on inflation regime management. To that end, asset classes with inflation-sensitive cash flows, such as listed or unlisted real assets, natural resource equities and TIPS, could play an important role in building more robust portfolios[15].

Investors should evaluate the assets currently held in their portfolios and add exposure, at the right price, to those missing. The good news is that market dislocations have led to more attractive entry opportunities for many asset classes. Furthermore, investors whose governance structures allow them to react opportunistically[16] may find opportunities to make their portfolios more robust against the risk that inflation pressures do not settle down as the market expects.

[15] For details on capturing inflation in private markets, see our 'Inflation playbook – capturing themes in private markets' paper (Mercer: 2022)

[16] For more details on more dynamic governance structures, refer to the 'degrees of freedom' in our 2023 Themes and Opportunities (Mercer: 2023)

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February 2023 346223