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Inflation siren songs. Be careful what you wish for

- Lots of people are predicting higher inflation.
- It's almost uncharted waters if it happens: we've only had one inflation period in the past 90 years.
- That was awful for everyone except for wage earners and people who had net debt.
- Equities were especially badly affected.
- Inflation badly affected Price Earnings (PE's) ratios which collapsed over the decade.

Headlines

It's the investment theme du jour that inflation is coming back, but you don't need to worry, your investments won't go down in value. From a recent news article:

Expectations of a return to above target levels of inflation could prompt some weakness in the high-flying growth names but allow cyclicals and value stocks to flourish. Cyclicals are stocks exposed to the economy and therefore likely to prosper as global growth picks up.

''If we do get inflation up to 2 per cent and the fiscal stimulus comes through, the market is already telling you the deep value [stocks] and cyclicals will benefit,'' says UniSuper chief investment officer John Pearce. ''You've got financials, resources and small caps all rallying while the momentum stocks, tech and bond proxies are falling away.''

To be fair to John Pearce, he is only talking about inflation going back to 2% and not higher. However, lots of people are talking about higher levels. Unfortunately, for data heads, there has only been one inflationary period (outside of Zimbabwe) since the 1920's, and we don't think it was anything to be looking forward to.

What did what in the 70's

There were several reasons inflation was high in the 70's (think: higher oil prices, Vietnam war etc). The global trend of c2% inflation rates throughout the 50's and 60's increased dramatically in the middle of the 1970's with double digit figures recorded for both the US and Australia for a period of around 2 years. Later in the decade, monetary and fiscal policy turned restrictive and inflation fell. The chart and table overleaf show the path of a raft of investment related data through the decade. US and Australian inflation are highlighted and it's apparent that only 3 things did better than AUD inflation; wages, Sydney house prices and the Nikkei. All the lines down at the bottom of the chart are equity type factors. Bonds/cash almost did as well as inflation, but you still had negative real returns (welcome to 2021). All in all, a lost decade for investors.

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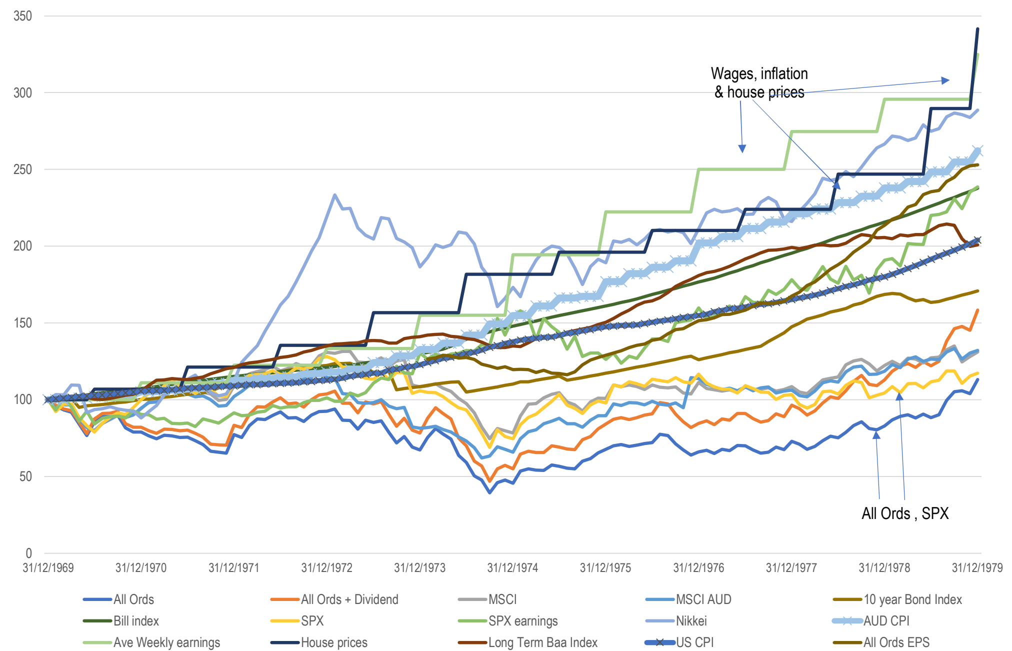

The table shows that not much provided a positive real return for the decade. Bond and cash indices did better than equities, but still didn't keep up with inflation. For the technically minded, there was an obvious duration effect with cash/bonds being relatively short duration, and quicker to receive the benefit of reinvestment at higher rates.

Lost decade	Value in 1979 (base 1969=100)	Nominal return p.a	Real return p.a.
All Ords	113	1.2%	-8.9%
All Ords + Dividend	158	4.7%	-5.4%
All Ords EPS	253	9.7%	-0.4%
MSCI	131	2.7%	-4.6%
MSCI AUD	132	2.8%	-7.3%
AUD 10 year Bond Index	171	5.5%	-4.6%
AUD Bill index	238	9.0%	-1.1%
SPX	117	1.6%	-5.8%
SPX earnings	239	9.1%	1.7%
Long Term Baa Index	201	7.2%	-0.2%
Nikkei	289	11.2%	3.8%
US CPI	204	7.4%	0.0%
AUD CPI	262	10.1%	0.0%
AUD Ave Weekly earnings	325	12.5%	2.4%
Sydney House prices	342	13.1%	3.0%

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Anybody rooting for inflation?

Conversely, the 70s's were great for wage earners and people who owed money. Wages did materially better than inflation, interest servicing was easier and principal repayments were a lot less in real terms. Effectively, it was a transfer of wealth from those people who had money to those who didn't. One of the positive side effects was that debt/GDP ratios looked a lot better at the end of the decade than at the start. That's why we think there is a secret ambivalence among policy makers to manufacture a few years of above trend inflation, as it quickly solves high debt/GDP problems. Policy makers don't like inflation in general, but in the words of St Augustine "Lord make me chaste, but not yet".

Why did equities do so badly?

Equity market levels are a function of 2 factors; EPS and PE ratios, so changes in either dominate short, and medium term, return outcomes (we can hear the noise from Omaha that dividends drive long term equity returns. Shorter term returns matter; we don't know of any investors who would happily sit and wait for a decade and watch their mark to market fall 50%: in any case there is an opportunity cost issue). What happened in the 70's is that it looks like EPS in both Australia (albeit with dodgy data) and the US (with ok data) kind of tracked inflation. Not good for those who think there is always real growth in earnings (EPS growth was probably 2% less than GDP growth), but in the 70's beggars couldn't be choosers.

Watch that PE collapse

The inverse of the PE ratio is the earnings yield so a PE of 10 equates to an earnings yield of 10%. If earnings grew, but equity markets did badly, by definition it means that PE ratios fell/yields rose. The US PE ratio at the start of the decade was 16X (or c6% yield) and it ended the decade at 7.5X (or c15% yield). That partly makes sense when you understand that bond yields also increased.

But does that quite make sense?

So, equity yields went from 6% to 15%, but bond yields only increased from 7.6% to 10.3%; (i.e) the equity yield increased by much more than the bond yield. The answer is that equity yields/PE multiples include 2 other factors; expected earnings growth and a risk premium (the equity risk premium). If investors expect higher earnings growth or they become less risk averse, the yield will fall (PE increases) producing an increase in the equity market level. But you can't actually measure risk tolerance or growth expectations, so it is the difference between the equity and bond yields. The chart overleaf shows the risk/growth premium over the 1970's. At the start of the decade, in the US (blue line) it was actually negative (equity yields were less than bond yields) which implies that investors thought there would be strong growth in EPS, or they thought things weren't going to be particularly risky. By the end of the decade that optimism had been beaten out of equity investors with the risk/growth premium back to levels last seen during the Great Depression after a period in the mid 70's when the risk premium hit its highest level ever.

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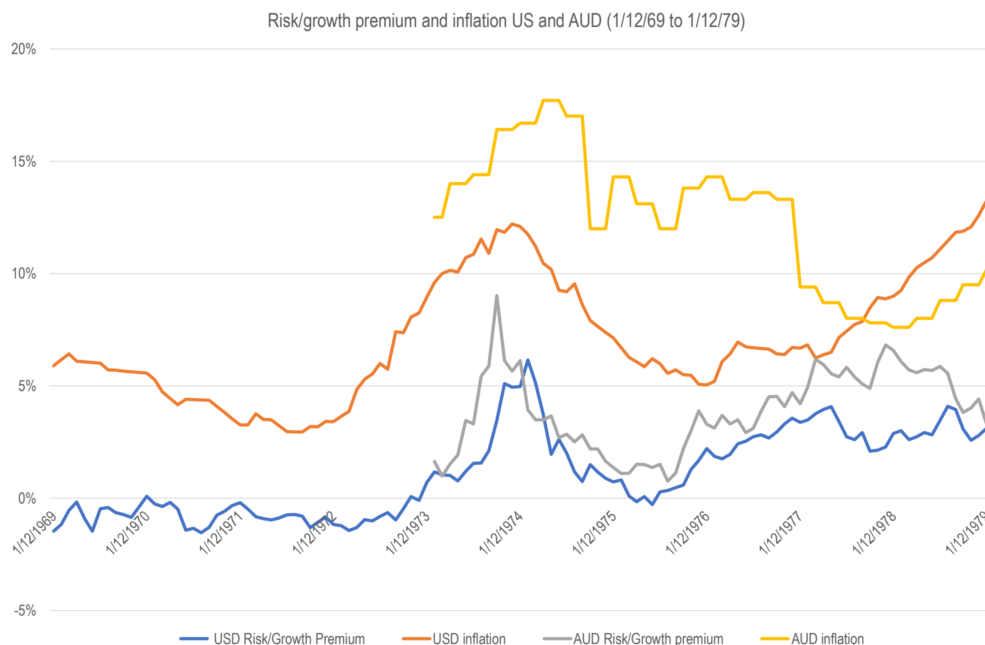

That risk premium got big didn't it?

The risk/growth premium in the early 70's displays an uncanny correlation to inflation, but not so much in the late 70's. We're not certain of causes and effects, but we're comfortable with the argument that unexperienced outcomes are going to affect investors risk premiums. Investors had never seen inflation before, had no idea what it would do to earnings and volatility, so they shot first (i.e) sold equities and asked questions later. The experience of the US in the late 70's was more muted with the risk/growth premium still rising in line with inflation. This was more due to an increase in bond yields rather than equity yields, but it's still not pretty in equity markets. The S&P 500 PE ratio fell from 11 in 1975 to 7 in 1979.

So, are we going to do it again?

Generals (and investors) often fight the last war, but clearly, we're not going to see exactly the same factors. There's no OPEC, no Vietnam war, no unwinding of Bretton Woods etc. However, if we do see inflation spike above its 2% long term average for whatever reason, we think the consequences will not be dissimilar; interest rates will rise, risk premiums will widen, PE's will compress leading to generally negative real returns for investments.

Hybrids?

If we get 70's style reactions, bonds and cash will always do better than equities due to central banks increasing interest rates to curb inflation. Cash returns will react more quickly than bonds. One of the squiggles on the first chart is USD "Baa" bonds which matched inflation over the decade rather than the small/medium negative real returns of bonds and cash. Although credit margins increased, the additional carry and reinvestment benefits (i.e reinvesting at higher rates) meant that it was the best of the investment classes (ex Nikkei) that we measured. We suspect that the combination of credit margins and floating rates will mean that hybrids will be one of the least worst asset classes during inflationary periods.

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