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The Return of Reflation: Time to Move?

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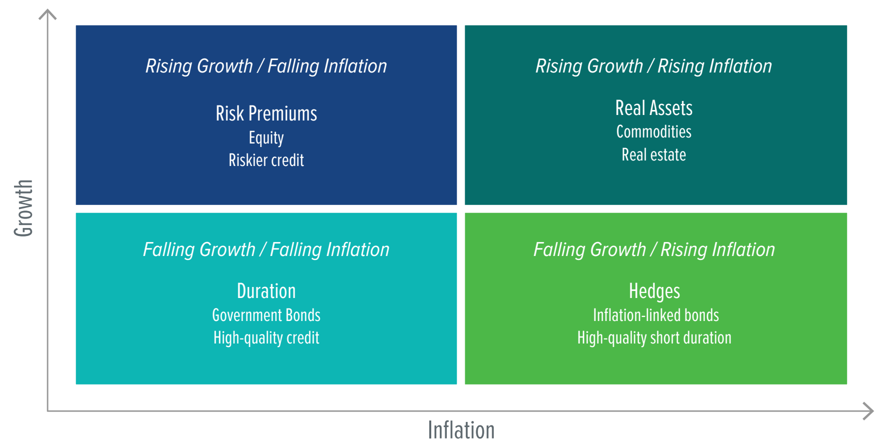
By Portfolio Strategies Group

Snapshot

- SEI does not generally believe investors should try to broadly tailor a strategic (long-term) portfolio to any specific growth/inflation environment.
- Yet, there are times it might be prudent to tilt portfolio allocations toward assets that are expected to do well given a compelling view of the economic outlook.
- SEI believes we are now at a point where such a tilt makes sense, given our view that the US is likely to see stronger growth and higher inflation once the world economy is able to move beyond the COVID-19 pandemic.

Recent chatter about "reflation" may have some investors wondering just what reflation means. In economic terms, reflation refers to inflation rising from a below-average level back toward its long-term trend. At SEI, we typically view reflationary periods as economic regimes where both growth and inflation are accelerating. Exhibit 1 provides a model framework that highlights asset performance during various environments, with a reflationary environment shown in the top right quadrant. In such as environment, we would expect real assets like commodities and real estate to perform well. There are some important nuances to consider, however.

Exhibit 1: Economic Regimes Tend to Favour Certain Assets



For illustrative purposes only.

About those nuances...

The framework is stylised, a term that describes a simplified model of reality. This has some important implications. First, it is rare than any given investment environment lands squarely in just one quadrant, as economic growth and price inflation trends are naturally volatile. Second, many factors beyond growth and inflation—such as valuations, regulatory changes, investment product innovations and investor behaviours—can impact relative asset class performance.

As a result, individual asset or sub-asset classes might be better thought of as "orbiting" one or more economic regimes. Gold, for example, has not fit neatly into the real assets quadrant in recent months, as the precious metal has exhibited real asset, hedge and duration characteristics at different times

since mid-summer. Similarly, while value stocks typically fall into the risk premiums quadrant, we believe they are likely to do well if stronger growth is accompanied by higher (not runaway) inflation.

Most importantly, we do not believe investors should try to broadly tailor a long-term (strategic) portfolio to any specific growth/inflation environment. Rather, we use this framework to help design strategic portfolios that incorporate a variety of diverse asset class exposures in order to help investors manage/mitigate the downside effects of different market environments on their portfolios.

A smart approach to active asset allocation

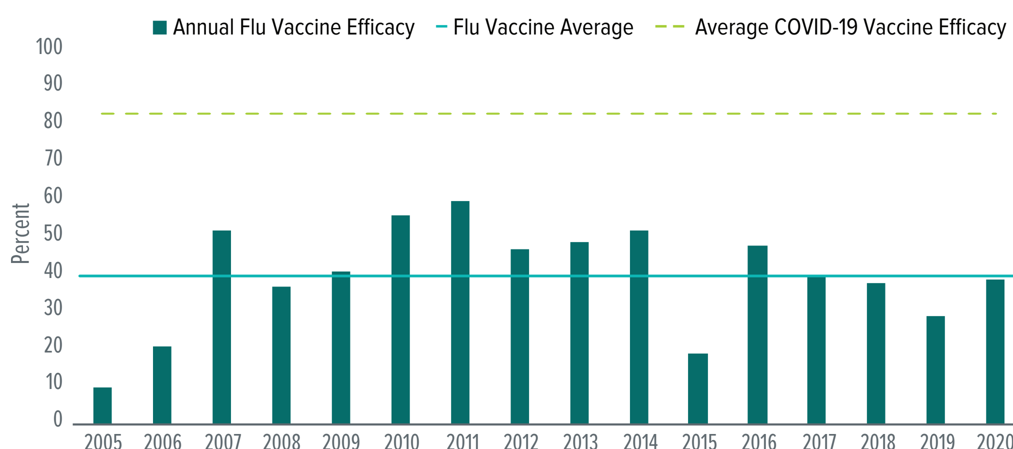
There are times it might be prudent to tilt a portfolio's strategic allocations toward assets that are expected to do well given a compelling view of the economic outlook; of course, this should be done within the constraints of an investor's risk budget, which defines how much performance divergence one is willing to accept from the expected behaviour of the strategic portfolio allocation. In other words, you may wish to consider deviating from your long-term plan if you are uncomfortable with short-term risk.

For investors in model portfolios that offer active asset allocation, SEI believes we may be now at a point where such a tilt makes sense, given our view that the US is likely to see stronger growth and higher inflation (accompanied by a weaker US dollar) once the world economy is able to move beyond the COVID-19 pandemic. We understand that the outlook is still challenging in the near term, with worsening infection rates, vaccine distribution challenges, new variants of the virus, political uncertainties, and below-trend economic activity. Despite the near-term challenges, we believe the markets will mostly continue to look ahead to better times in the latter part of 2021.

Supporting evidence

We believe the evidence for this view is compelling on several fronts, including the COVID-19 pandemic, economic policies, and recent market behaviour. On the pandemic front, in addition to more effective therapeutic regimens, we have seen the development of multiple vaccines that appear to be quite effective. As Exhibit 2 shows, reported efficacy rates for multiple coronavirus vaccines are higher than the historic effectiveness of annual influenza vaccines in the US (although it should be noted that the real-world effectiveness of vaccines tends to be somewhat lower than efficacy estimates from clinical trials).

Exhibit 2: Vaccine Appears Effective



Source: Centers for Disease Control and Prevention, US Food and Drug Administration, SEI. Data as at 31/12/2020. COVID-19 vaccine effectiveness is average of lower bounds of post-trial confidence intervals for Pfizer and Moderna vaccines.

We have also seen policymakers respond to the pandemic with levels of fiscal and monetary support that are unprecedented in the last 60 years (Exhibit 3).

Exhibit 3: Global Fiscal Deficits Grow

Sources: International Monetary Fund, SEI. Data as at 31/12/2020. Excludes equity injections, asset purchases, loans, debt assumptions and extra-budgetary funds.

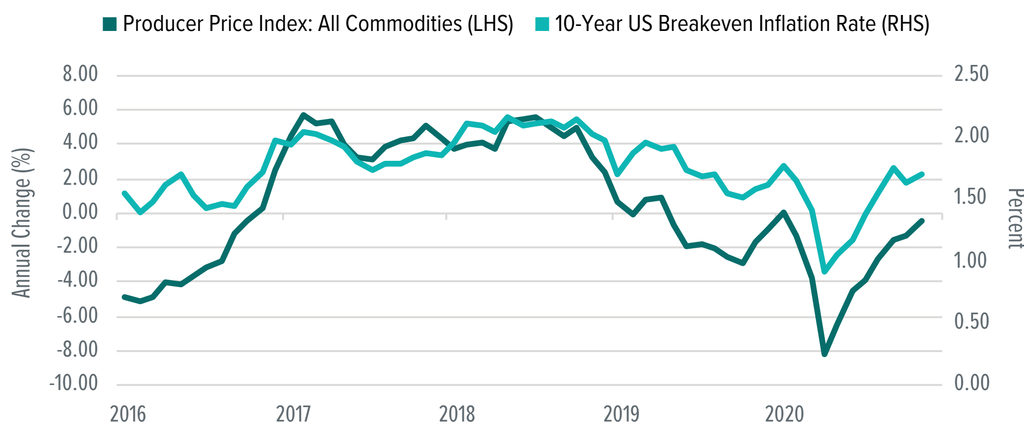
Additional fiscal support has been provided or is forthcoming in multiple countries, and central bankers in advanced economies have clearly signalled their intentions to allow inflation to run a bit higher than average to support a return to full employment. We believe the US dollar's current weakening trend (Exhibit 4) could still have a ways to go (these cycles have historically unfolded over 6-to-10 years), which should also support faster global growth and stronger inflation.

Exhibit 4: Weakening US Dollar Trend may Continue

Source: Board of Governors of the Federal Reserve System. Data as at 31/12/2020.

Finally, financial markets seem to be largely in agreement with this view, judging not only by US dollar performance but also by a historically strong small-cap equity market in recent months, as well as a steady rise in inflation breakevens and firming commodity prices (Exhibit 5).

Exhibit 5: Increasing Inflation on the Horizon



Source: St. Louis Federal Reserve, US Bureau of Labour Statistics, SEI. Data as at 31/12/2020.

Relevant positioning

In the SGMF Dynamic Asset Allocation Fund, we have expressed this view by implementing long positions in an equally-weighted S&P 500 Index, non-US developed market equities (MSCI EAFE Index), commodities (Bloomberg Commodity Index), and 10-year US inflation breakevens. Two options positions—on a steeper US Treasury yield curve and on a higher US 30-year Treasury yield—should benefit if our reflationary view unfolds as we expect. While the Fund's existing long position in gold would often be considered a reflationary asset, it has behaved somewhat differently in recent months, perhaps because markets have had to gradually digest the new highs in gold prices that were set in late July and early August.

Risks to the reflation view

The main risks to our broad reflationary view and active allocation positioning include negative surprises on the vaccine front, an unexpectedly severe worsening (or lengthening) of the pandemic, tighter-than-expected fiscal or monetary policies, and a significantly stronger US dollar. The certain uncertainty created by unanticipated events is one of the reasons we believe so strongly in the principles of diversification. The COVID-19 pandemic, which would have been almost impossible to expect just over a year ago, is a powerful reminder of the uncertainties that can sometimes wreak havoc on economies, financial markets and investment portfolios.

Glossary

Duration is a measure of a security's price sensitivity to changes in interest rates. Specifically, duration measures the potential change in value of a bond that would result from a 1% change in interest rates. Short duration bonds are less price-sensitive to changes in interest rates.

US Treasury yield curve represents differences in yields across a range of maturities of US Treasury bonds. A steeper yield curve represents a greater difference between the yields. A flatter curve indicates the yields are closer together.

Index Definitions

Bloomberg Commodity Index tracks prices of futures contracts on physical commodities on the commodity markets. The index is designed to minimize concentration in any one commodity or sector.

MSCI EAFE Index is an unmanaged, market-capitalization-weighted equity index that represents developed markets outside North America.

S&P 500 Index is a market-capitalization-weighted index that consists of approximately 500 publicly-traded large US companies. The index is considered representative of the broad US stock market.

S&P 500 Equal Weight Index is the equal-weight version of the S&P 500 Index. It includes the same stocks as the S&P 500 Index, but each company is allocated a fixed weight of 0.2% of the index total (instead of a weighting based on market capitalization) at each quarterly rebalance.

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