An Inflation Opportunity

Commentary May 2021

SA equities produced an outsized USD return in May, extending an already dominant performance for the year-to-date relative to other major markets. A summary of major market equity returns is set out in Table 1 below.

Table 1. South African and global equity returns for May 2021

		May-21	YTD 2021
FTSE/JSE ALSI	ZAR	1.6%	16.0%
FTSE/JSE ALSI	USD	7.4%	24.2%
MSCI World	USD	1.4%	11.4%
MSCI EM	USD	2.3%	7.3%
MSCI Value	USD	2.2%	15.2%
MSCI Growth	USD	-0.6%	6.3%
S&P 500	USD	0.5%	11.9%
Nasdaq 100	USD	-1.3%	6.2%

Source: Factset

This month we discuss the recent US inflation numbers and some of their investment implications. The sharp increase in the US money supply in 2020 was discussed in the February 2021 commentary and the results are now demonstrating themselves as new inflation data comes out with corresponding dramatic global headlines. While a great deal of commentary appears focussed on the components of inflation and which sectors of the economy are most affected, this note focusses on investment aspects and an asset class which rarely receives attention – inflation-linked bonds.

Money supply

First we revisit the US money supply growth data set out on Chart 1 below.

Chart 1. Percentage increase in US Money Supply (M2)

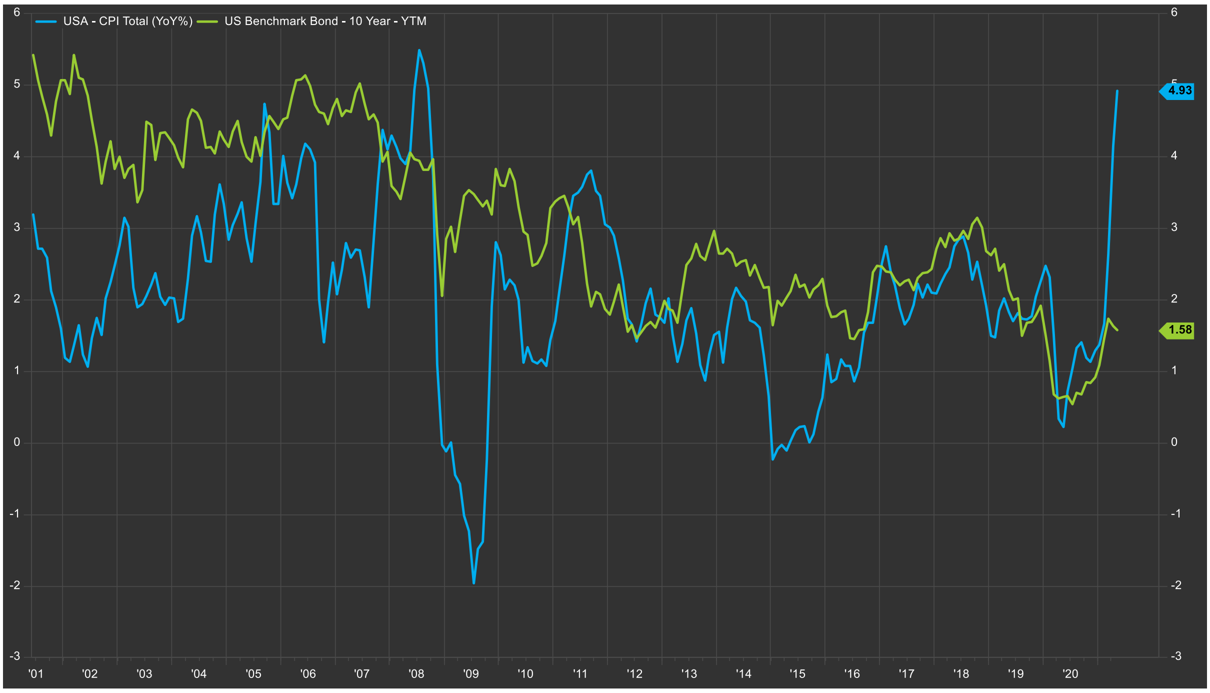
Source: Factset

Encouragingly the rate of increase in money supply has almost halved since last year. At a time when some media commentary is proclaiming a new era of inflation, Chart 1 above suggests the current increase may indeed prove to be transient.

US Treasury market

Should the increase in inflation prove temporary, this suggests the US bond market may be correct in not adjusting for longer term inflation. Chart 2 below sets out the US 10 year Treasury yield against inflation.

Chart 2. US Treasury 10 year yield and inflation



Source: Factset

From Chart 2 above it can be seen that the US bond yield remains under 2% while inflation is closer to 5%. The US bond market still appears to be looking through the current rise in inflation. Should rates and inflation remain at current levels US nominal bond investors would experience a real return of -3.4% p.a. – hardly sustainable, therefore it can reasonably be expected either for inflation to decline in future, or for US longer term yields to rise.

Inflation-linked bonds

Finally we consider inflation-linked bonds, or US TIPS – Treasury Inflation-Protected Securities. Chart 3 below sets out the yield on US 10 year TIPS, an indication of *real* yield. US TIPS do not have a long history, however even the limited available history is indicative. Following issue in early 2003, real yields were close to 2%. After the financial crisis these declined relatively steeply, eventually becoming negative and bottoming close to 0.75% in 2012. The decline, reflective of strong demand, was mostly likely driven by the Fed's quantitative easing program at the time and associated expected inflation, which never materialised. A negative real yield indicates, of course, that an investor buying into the asset at the time and holding to maturity would realise a negative real yield of -0.75% p.a. – again hardly sustainable. It is, therefore, perhaps also unsurprising that real yields rerated sharply in 2013, although partly also upon the realisation that expected inflation would not materialise. It is worth nothing that at the time the gold price fell sharply for the same reason, after several years of strength.

Chart 3. US 10 year TIPS yield

Source: Factset

Following their rerating in 2013, real yields on US TIPS then hovered close to 0% for several years before being pushed into negative territory again early 2020. At the time of writing in June 2021, real yields are again close to -0.75%.

Notwithstanding negative-yielding long bonds in Europe, it is likely that much like in 2012 real investors may not be willing to tolerate negative real yields for very long. Should this view be correct, the real yield would be expected to rise above 0% again, giving rise to a decline in the nominal price of the 10 year US TIPS. This, of course, represents an investment/trading opportunity in the form of shorting the 10 year US TIPS, or, more practically, shorting a US TIPS ETF. Shorting US TIPS would certainly be considered an unusual move, and not very popular – this is always a good sign for an investment decision. Yet the risk-reward ratio appears to be in favour of the view. If inflation persists, what level of the current negative returns would be tolerated by investors? If it does not persist or investors lose their willingness to hold negative real return assets, the position would pay off. An uncertainty of course would be timing i.e. how long the view might take to materialise.