Positioning for reflation

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Coordinated fiscal and monetary stimulus is likely to support global demand and therefore reflation in the years ahead. We see this opening up broader growth opportunities, and ultimately better scope for portfolio diversification.

By Robert Samson, Deputy Head of Global Multi-Asset

After a decade of sub-par growth, global demand may soon be on the mend on the back of large amounts of monetary and fiscal stimulus and an eventual normalisation in demand as the world learns to manage Covid-19.

Since the Global Financial Crisis (GFC), output around the world never quite rose to full capacity despite aggressive monetary policy, partly because fiscal stimulus was comparatively weak. However, this time around, we see a better policy mix on a global scale that is likely to support reflationary growth in the years ahead.

The outlook is promising for risk assets with a broadening opportunity set. However, reflationary pressures tend to lift bond yields and given the compression in yields year-to-date, we are cautious on bonds and remain selective in choosing defensive assets to construct a balanced portfolio.

The changing contours of growth

For the better part of the last decade, the US was deemed the "least dirty shirt" and given its dominance in disruptive technologies, strong capital flows to the US came at the expense of the rest of the world, including Europe, Asia and the rest of the emerging markets (EM). These inflows to the US also kept the dollar strong, which remained a key headwind to growth for the rest of the world.

While central bankers kept monetary policy easy since the GFC, fiscal easing was notably absent. Austerity reigned over Europe, the US kept its fiscal belt relatively tight and China suffered boom and bust cycles where stimulus never made its way to the real economy. As a result, global demand remained subdued.

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This time is different: nearly every government around the world has issued large amounts of fiscal stimulus in response to Covid-19, and China's targeted stimulus response is finally reaching the real economy. Importantly, the large global fiscal stimulus is complemented with unprecedented monetary easing, allowing for synchronised growth.

In the wake of stimulus injections that accelerated into the end of March, the dollar is also weaker as capital is finding its way to new opportunities around the world. In our view, the dollar is likely to remain weak given the reflationary forces which is self-reinforcing for demand improvement.

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Broader opportunities

Technology is likely to remain a key source of growth in a post-Covid world. Changed behaviours driven by the pandemic have offered an added boost to tech demand, further accelerating the ongoing disruption. Still, while we continue to favour technology, reflationary forces offer broader opportunities for allocating risk.

Already, we are witnessing a shift in capital flows from the US to the rest of the world, which is a trend that we see continuing. Europe is so far a beneficiary of such inflows and so is North Asia. The rest of EM stands to benefit from a weaker dollar and increased demand for commodities, and eventually more persistent capital flows.

Importantly, broader growth opportunities offers better scope for portfolio diversification, which will be increasingly important as reflation takes hold. While technology has delivered exceptional performance over the several decades, part of its outperformance is attributable to very low interest rates that tend to support higher valuation multiples. As reflation lifts rates, the technology sector will look increasingly expensive.

Outside the US, China still features as the strongest growth story, for consumption and now also for infrastructure. Investment has accelerated given the supply chain disruptions attributable to the US-China trade war and then Covid-19. Notably, Beijing has pivoted its growth focus from the public to the private sector, finally coming to realise that the latter is more efficient in deploying capital for sustainable growth.

Healthy China demand also supports better demand elsewhere, through the China supply chain including Asia and Europe, as well as through its demand for raw materials that come from various parts of the world including Latin America and Africa.

Europe may have the most to gain from opening the fiscal spigots. Its austerity over the last decade was clearly the wrong medicine given the deflation it inflicted on the periphery. More importantly, the European Union has made an important step to a fiscal union, and while far from complete, it is an important psychological shift toward a sustainable future.

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Growth at a cost and how to be defensive

While the global growth outlook is certainly improved, it is important to recognise the cost and related risks. The unprecedented fiscal cost is certainly one to watch but is probably a longer term risk. However, the extent of the monetary stimulus is also unprecedented and while central banks have promised low rates for an extended period, reflation ultimately will test such policies.

Since Covid-19 struck, US Treasury yields collapsed to record low levels. They have so far remained anchored both by ongoing economic weakness and central bank assurances that rates will remain at zero for a very long time. However, as demand normalises and reflation takes hold, it will be increasingly difficult for central bankers to keep rates steady at such low levels.

In a multi-asset portfolio, developed market bonds are typically deemed defensive, but not necessarily when yields are already quite low. Reflation on the horizon typically lifts yields, causing bond prices to fall. Central bankers may adopt new policies to tame long-term yields, but such policies introduce new risks of lesser-known variety.

We are cautious on sovereign risk across most developed markets, but we do like China bonds for its defensive characteristics and the healthy yield it offers, which is supported by fairly orthodox policies. Investment grade bonds are also attractive as a defensive asset given the yield pick-up and room for spreads to compress to help offset any rise in yields.

We also look to gold as another form of portfolio defence. Gold broke to new highs partly for the compression of yields but also for rising inflation expectations. This dynamic looks set to continue, as demand (and inflation expectations) continue to normalise while the

US Federal Reserve aims to keep rates very low for some time. In this sense, gold is a good hedge in a reflationary environment.

Balancing opportunity against risk

Synchronised monetary and fiscal easing opens prospects for broader growth opportunities that collectively offer better diversification for achieving investment objectives. Because growth is never assured and shocks can be just around the corner, a balanced portfolio includes defensive assets. In this space we favour China bonds, investment grade credit and gold, which we believe are best-equipped for mitigating downside in a variety of market outcomes less favourable to growth assets.

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