

# Is inflation good for equities?

In this chapter, we draw upon the discussion about low returns in a “low-return world” and the 2011 Yearbook, in which we focused on inflation and asset returns to examine the prospect that a rise in inflation, or at very least a rise in inflation expectations, could have for investment strategy. The 2011 Yearbook drew on observations of different types of inflation to show that, when inflation is rising at a modest level, equities tend to perform well and bonds much less so. In the aftermath of the credit crisis, the critical distinction we make is – what type of inflation will we witness in coming years?

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The chapter on “low returns” makes it clear that there is a strong association between low real interest rates and low equity returns. However, we show that in the context of modest inflation with rising inflation expectations, there is scope for equity multiples to re-rate higher. As the global business cycle begins to move toward a firmer recovery, this is important for investment strategy and could well drive a reversal in fund flows from bonds into equities.

## Should we worry about inflation?

Since 2009, nascent recoveries in the global business cycle have been cut short. With the Eurozone crisis in remission and the US fiscal cliff debate partly behind us, 2013 offers the prospect of a more firm and durable economic recovery globally. Should this occur, it may also lead to concerns that, in the context of quantitative easing by a number of central banks, inflation will rise and significantly affect asset prices.

Our view is that inflation is a good thing if it is “demand pull” inflation, i.e. companies have pricing power and thus selling prices are rising more than input prices (commodities or wages). On the

other hand, inflation is bad if it is “cost-push” inflation, when companies face higher commodity prices or wage costs rise, which in turn squeezes margins as they are unable to pass them on.

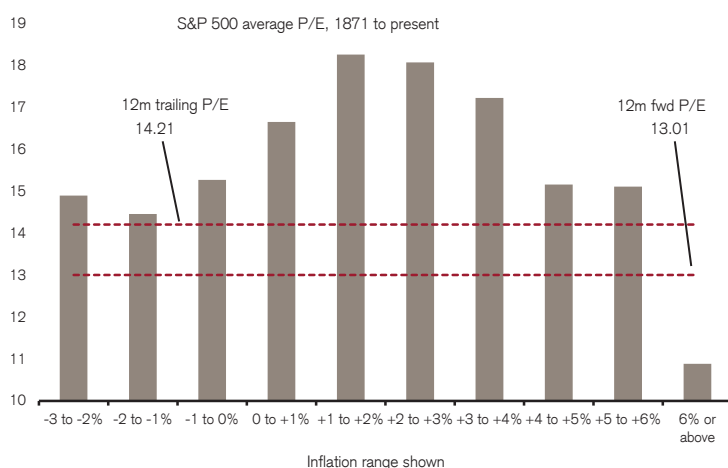
In a sense, inflation is like eating – too little or too much can be problematic. We find that, historically, moving from deflation to mild inflation leads to a re-rating of equities, while moving from moderate inflation to high inflation leads to a de-rating of equities. The tipping point between the two outcomes, on the basis of US data back to 1871, has been inflation of around 3%–4%.

Perhaps the most critical issue is the response of real yields to higher inflation. If high inflation comes as a shock and there is no financial repression (i.e. there is no deliberate effort on the part of governments or central banks to push down real bond yields), then real bond yields are likely to rise dramatically, something which has historically been very negative for financial assets.

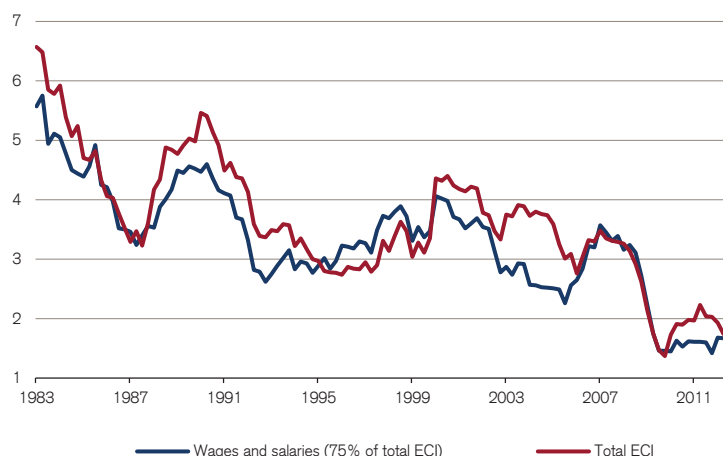
If, however, higher inflation is part of a deliberate policy of financial repression, then rising inflation expectations actually lead to lower real bond yields, which should in turn re-rate financial assets. We continue to believe that real bond yields need to fall to minus 1.5% to minus 2% to both

**Figure 1****Equities do not tend to de-rate significantly until inflation expectations rise above 4%**

Source: Dimson-Marsh-Staunton data, Credit Suisse research

**Figure 2****Growth in the wage component of the Employment Cost Index is close to a 30-year low...**

Source: Thomson Reuters, Credit Suisse research



stabilize government debt to GDP and unemployment. This time around, therefore, higher inflation and inflation expectations are part of this process.

**What is inflation?**

We believe that the best proxy of underlying inflationary pressure is prevailing wage growth, as roughly two thirds of corporate costs are from the labor market. Thus the key determinant of inflation is the direction of wage growth or, more precisely, unit labor costs. Higher wages also enable corporates to partly pass on these higher costs due to the concomitant improvement in consumers' disposable income.

At present, there is little evidence of inflationary pressure based on the current growth in rates in US wage costs or average earnings growth, with both of these measures at the bottom end of their historical ranges. According to the Congressional Budget Office (CBO), the NAIRU is around 5.5%–6% and, for demographic reasons, the rate of growth in the labor force will accelerate as growth recovers (this keeps the unemployment rate higher than it otherwise would be) and thus GDP growth of 3.5% for at least more than a year is required before wage growth starts to rise.

There also still appears to be significant external dis-inflationary forces: improvements in industrial automation (robot density in emerging markets is just 5% of developed markets), growth of the internet (5.8% of retail sales in the USA and growing at a 23% CAGR, which pushes down retailers' margins), and less supply-constrained commodity markets (with the capex to depreciation ratio for both oil and mining companies being over 3x).

The "wrong" sort of inflation is commodity-led inflation. This is inflationary in the short term as headline prices rise (food and energy equate to a third of emerging market CPIs). If higher commodity prices are not associated with a rise in wage growth, then clearly the purchasing power of the consumer falls and that in turn ends up being dis-inflationary. So commodity-led inflation is only sustainable if wages are able to rise by a similar amount.

**Market inflation expectations can rise even when headline inflation is well controlled**

We believe one of the key developments in 2012 was that, in spite of headline inflation falling, inflation expectations actually rose.

The critical issue is that markets are (correctly in our view) starting to price in the probability of a policy error. If there is "too much" quantitative easing (QE) over the next few years, then on a 5–10 year view, inflation could spike upward. We believe that central bankers are much more likely to end up being too dovish than too hawkish, given the experience of the Great Recession, and thus eventually tighten policy too late rather than too early!

## Implications for asset classes

We have found that, historically, equities tend to have a binomial distribution between P/E and inflation. As inflation falls below 2%, equities tend to de-rate. This is because, as we move to deflation, pricing power becomes much harder to come by (and often periods of deflation, particularly the 1930s, have been periods of very poor GDP growth).

Historically, when inflation rises above 4%, equities also start to de-rate (see Figure 1). This is for two principal reasons: first, the rise in inflation leads to a rise in real bond yields (see below) and, second, the rise in inflation is often associated with economies overheating, which leads to a rise in short-term interest rates. This rise in short rates not only tends to raise the discount rate for equities, but, if an economy overheats, there has to be a period of below-trend growth (thus earnings fall while the discount rate rises).

At some point the rise in inflation means that equities do worse than bonds (after all, equities are long-duration assets); typically, we find this occurs when inflation is above 8%. The key issue for us is that, historically, the more the inflation rate rises, the more uncertainty there is about future inflation (as proxied by inflation volatility) and thus the higher the real bond yield becomes.

This used to particularly be the case when central banks were not independent (for example, the Bank of England was only made independent in 1997). So, historically, if inflation rose, there was considerable uncertainty about the willingness of central banks (or rather politicians, prior to central bank independence) to bring down inflation and, as a result, the real bond yield would tend to rise.

In our view, a high real bond yield is bad for equities. Not only does it push up the discount rate, but it also impedes the financing of government deficits. If the real bond yield rises by 2%, then with government debt to GDP at 100%, this adds 2% of GDP a year to the government's cost of debt servicing. The less sustainable the government funding arithmetic appears to markets, the more the real bond yield will rise.

## Impact of the credit crisis

Today, we believe that any rise in inflation will not be associated with a rise in the real bond yield. This is the key difference. We believe that central banks will seek to keep nominal rates from rising through further asset purchases and that rising inflation will be associated with a fall in the real bond yield. This is because of the need for financial repression. We believe, in the long run, governments will have to stabilize government debt to GDP and unemployment.

Figure 3

...as is average hourly earnings growth in the private non-farm sector

Source: Thomson Reuters, Credit Suisse research

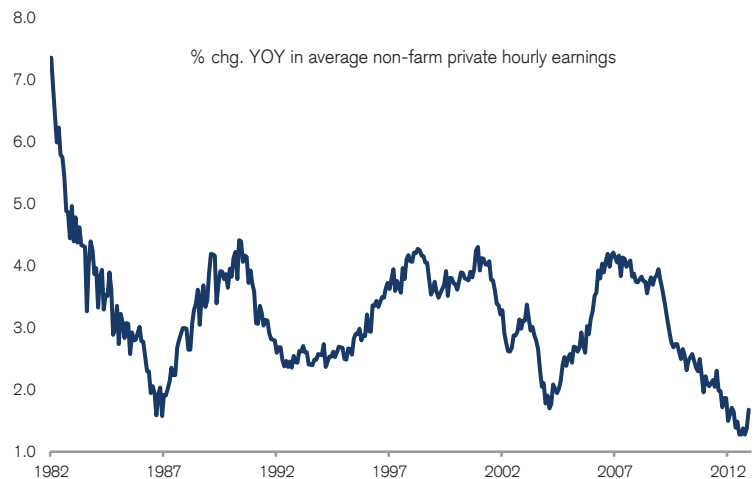
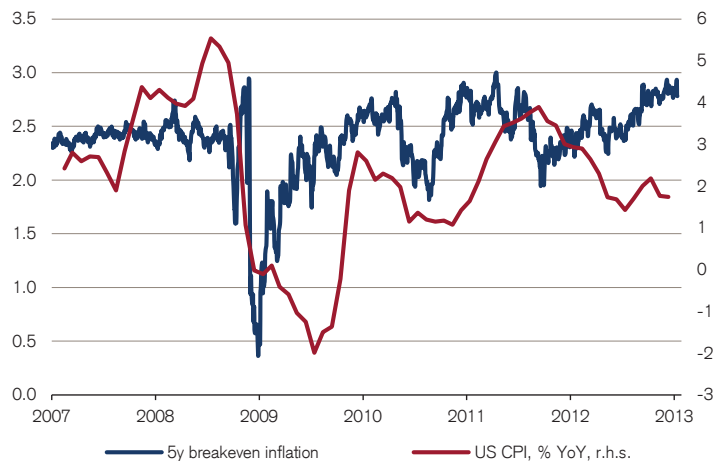


Figure 4

In 2012, US inflation expectations and headline inflation move in opposite directions...

Source: Thomson Reuters, Credit Suisse research

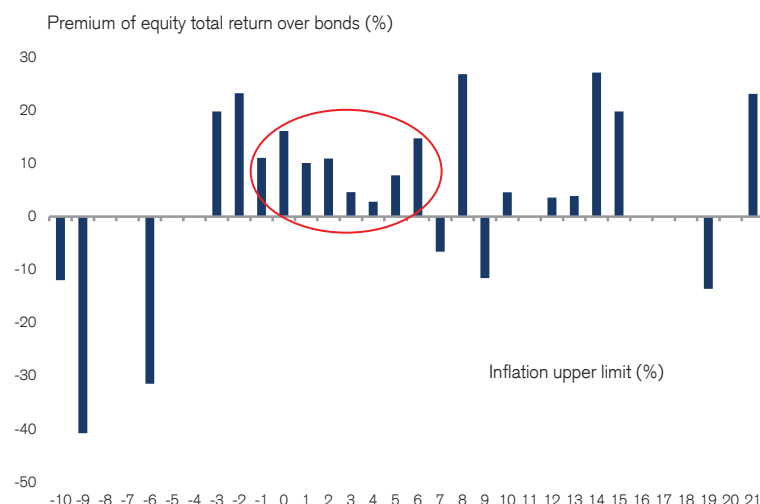


**Figure 5****...with the same occurring in the UK**

Source: Thomson Reuters, Credit Suisse research

**Figure 6****At inflation rates in excess of 8%, equity outperformance is much less consistent than at more moderate inflation rates**

Source: Dimson-Marsh-Staunton data, Credit Suisse research



Very simply, we believe that the biggest problem globally is that there is USD 8 trillion of excess leverage in the developed world and around USD 13 trillion more government debt than in 2008.

There are only four ways to reduce debt: improve the underlying growth rate, default, tighten fiscal policy or lower real rates. We estimate that 1% off real rates reduce the amount by which fiscal policy needs to be tightened by 1% (to stabilize government debt to GDP) and boost GDP growth by around 0.5%.

Thus, based on our models, in order to stabilize both government debt to GDP and unemployment, the USA needs to have real rates of minus 1.6%. When we run the same analysis for the UK and Japan, the required real rate is even lower.

Thus a rise in inflation expectations could be associated with a decline in the real bond yield. It is this that re-rates equities. Over the past five years, the prospective earnings multiple for the S&P 500 has been closely correlated with inflation expectations. Indeed, the single most important driver of valuations has been inflation expectations.

**Central case**

Our central case is firstly that inflation expectations rise (as markets price in the risk of a policy mistake), but that this will not be associated with a rise in headline inflation and, secondly, that real bond yields fall as inflation expectations rise (but nominal bond yields rise slightly as the rise in inflation expectations more than offsets the fall in real yields).

In this environment, we believe that the best hedges on inflation in the developed world are:

- (1) **Cheap real asset investments:** according to the OECD, US, Germany and Japanese real estate are among the cheapest globally. UK commercial real estate also looks attractive, with a record gap between the underlying property yield in the UK (from the Investment Property Databank) and the index-linked gilt yield.
- (2) **Companies with inflation-linked pricing formulae:** these de facto become cheap inflation hedges.
- (3) **Growth:** The more the real bond yield falls, the more investors should buy long duration assets as these should benefit more from a lower discount rate.
- (4) **Gold:** Gold stocks have underperformed the gold price significantly in 2012 and, the more real bond yields fall, the more gold should rise.

## Conclusion if inflation rises sharply

If investors really fear inflation will rise and that bond yields will rise more than inflation (i.e. real bond yields rise), then they should buy short-duration stocks (i.e. high dividend yield) with negative working capital (i.e. they are paid before they pay their creditors). This typically favors food, retailing and telecoms.

## What about commodity stocks as an inflation hedge?

There is a loose positive correlation between inflation and the relative performance of commodity stocks. The fit is clearly worse in absolute terms. This is of course a “chicken and egg” situation. Rising oil prices cause inflation and oil stocks to rise. We would warn that to some extent when we look at the integrated oil companies (IOCs), they have only outperformed when there has been a large upward spike in the oil price.

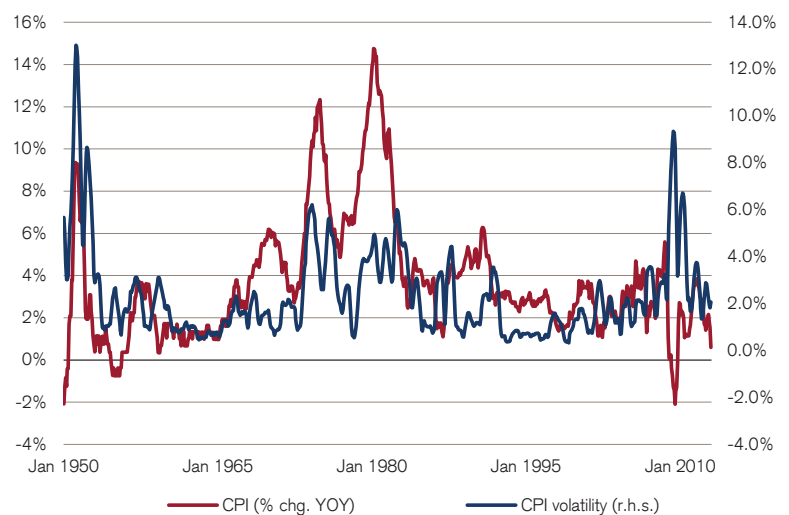
If there is only a modest rise in the oil price, then IOCs tend to underperform because they are defensive (the IOCs outperform 78% of the time the market falls or 88% of the time credit spreads rise). Hence, ironically, they do well when the equity market falls significantly (such as in 2008), even if the oil price falls at the same time. The other concern is that, in general, quoted IOCs tend to be the higher cost producers globally and are also vulnerable to changes in government policies, particularly windfall taxes.

From a global strategy perspective, we feel that commodity stocks are now a worse hedge on rising inflation, given the sharp increase in capital spending, which has been extreme relative to both history and other sectors. A sharp increase in capex tends to be bad for prices as it increases costs and is ultimately negative for free cash flow generation.

**Figure 7**

### Rising inflation tends to be associated with higher inflation volatility

Source: Shiller data, Credit Suisse research



**Figure 8**

### Since 2008, government debt to GDP has increased by around 30 percentage points

Source: Thomson Reuters, Credit Suisse research

