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Could reflation lead to a full 'taper tantrum' – implications for markets

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During the COVID-19 pandemic, investor confidence, growth, and prices of almost all goods and services plummeted to record lows[i]. To correct this, developed market central banks stepped in with massive amounts of stimulus to keep bond yields low and offer support to ailing businesses and unemployed workers. The Fed, ECB and BoJ increased their balance sheets by 50% from $15trn to $23trn and cut interest rates to zero and even below in some instances. These extremely loose monetary and fiscal policies, in conjunction with the vaccine rollout and re-opening of economies, have succeeded in stabilising the global economy. Investor confidence has improved dramatically as commodity prices and equity returns have reached all-time highs. However, global bonds have sold off due to market fears concerning reflation risk and a taper tantrum. The reduction in asset purchases by central banks is what markets term a 'taper tantrum' and was responsible for the mid-2013 sell-off. Rhetoric from the Fed suggests that they will taper assets when the US economic objectives of growth, employment and inflation have normalised and reached their respective targets. The Fed's new average inflation targeting policy also supports this view, whereby the Fed will allow inflation to temporarily move above target so long as average inflation over the medium term remains around 2%.

So, where does reflation feature? Reflation can be defined as the recovery in prices when it has fallen below its long-term trend line. Inflation is the main driver of bond yields and if it gets out of control, central banks will react decisively by hiking interest rates and tapering asset purchases. To determine if reflation risk is a threat to financial markets, we will focus our attention on US inflation as it is the key driver of US Treasury bonds which forms the base rate when pricing global assets.

Investment view

To formulate our investment view, we need to identify what has been priced into the market and whether inflation or deflation will dominate. According to our analysis, inflationary forces will be transitory and dominate over the next 12 months due to base effects, raw material backlogs and increased consumer and investor activity. This means that inflation may spike well above the Fed's target but is unlikely to remain high for a sustained period. This is due to structural deflationary trends from aging populations, technological advances, indebted nations, and a low velocity of money. Because of this, the Fed will likely look past this inflation spike and gradually tighten financial conditions with as little market disruption as possible.

The sharp increase in global bond yields and the US term premium has meant that most of this initial reflation risk has been priced in but there are still major nations (e.g., Europe, Brazil, and India) that are experiencing severe COVID waves which is halting global growth. Once G20 nations have reached herd immunity with a successful vaccine rollout and exhibit low infection rates, the world will experience synchronous growth leading to another bout of reflation risk. At Sentio, we believe this will occur in late 2021 or early 2022 but markets are forward-looking so investors will need to be vigilant for this renewed reflation risk.

It must also be stated that rising US nominal bond yields should be positive for economic growth, the risk lies with rising US real yields. If real yields were to increase substantially, this would be a clear sign of tighter financial conditions which would lead to a market correction. Given that inflation will initially increase, low real yields will persist and keep the bullish growth environment intact until deflationary forces begin to emerge over the medium term.

Market implications

The longer the Fed delays tightening and tapering, the greater the inflation risk premium and market uncertainty. This uncertainty will lead to a risk-off environment and a market correction as investors will reduce exposure to risky assets in favour of cash and DM bonds. South African bonds and equities are classified as risky or high-beta assets and will significantly underperform in a taper tantrum scenario. For now, the risks of a taper tantrum are low, but we remain vigilant and monitor US inflation, growth, and employment data for signs of reflation.

Domestic inflation will remain low for the first half of 2021, but we can expect an increase during the second half as electricity tariffs, medical aid premiums and services inflation start to accelerate. This will bring about a change in the SARB's accommodative narrative with imminent interest rate hikes on the horizon. Domestic growth is improving with high frequency data suggesting that the rebound in GDP for 2021 will be better than expected. Tax collections have surprised on the upside and continue to increase but the chink in the armour is whether government will be able to limit public sector wage growth. For this financial year, wage freezes might be acceptable by unions and members, but there is bound to be pushback in the years to come, resulting in increased fiscal risk.

Portfolio positioning

At Sentio, we believe that South Africa's fiscal position will improve over the next few months and thus we maintain an overweight position in ultra-long SA bonds that are offering attractive real yields of 7-8%. The global and domestic growth outlook will support commodities, SA equities and a strong ZAR. In equities, we favour Value above Growth, but have become cautious about the currency and have started to increase offshore equity and DM bond exposure. In terms of asset allocation, we hold an overweight position in equities, neutral position in

domestic bonds and underweight in cash and offshore assets. As valuations begin to deteriorate and reflation risks become prominent, we will begin to reduce risk and favour an overweight position in cash and offshore bonds, and underweight in domestic equities and domestic bonds.

Glacier Research would like to thank Sanveer Hariparsad for his contribution to this week's Funds on Friday.

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Sanveer has 14 years of investment experience with a focused background in Actuarial Science and Financial Engineering. He is a CFA and CAIA Charter holder and is currently pursuing his PhD in Actuarial Science at the University of Tshwane on a part-time basis. He started his career as a fixed income quantitative analyst at Old Mutual Investment Group and then joined Futuregrowth when the fixed income teams merged for a total of 5 years. Thereafter, he joined Prescient Investment Management as a Fixed Income Portfolio Manager where he was responsible for managing specialised bond funds for a period of 6 years. Sanveer has since been with Sentio Capital Management for 3 years where he is Head of Fixed Income and co-managers the multi-asset funds.

[i] April-20 oil futures were trading at negative prices meaning investors would pay you to take oil of their hands as they did not want to take delivery and pay storage costs due to depressed demand levels.