Staying adaptive to an evolving recovery

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The world is settling into a new normal that is likely to look quite different from pre-COVID-19 norms. This includes different patterns of demand shaped by learning to live with the virus and an ongoing fiscal thrust with firm policy objectives. Unprecedented monetary policy is soon to be scaled back—a process that is likely to lift volatility as economies and markets adjust to the new normal, which will slowly reveal itself over time.

Still-easy monetary policy coupled with ongoing fiscal support bodes well for reflationary growth. However, as uncertainty continues with the Delta variant and the gradual withdrawal of easy monetary policy, any negative growth surprise could cap reflationary prospects over the near term. Inflation appears mostly transitory, but with sticky characteristics to watch closely.

We believe the recovery will continue, which is positive for growth assets. However, the combination of improving growth and the gradual withdrawal of easy monetary policy is likely to lift bond yields from extraordinarily low levels. We are cautious on duration, selective on defensive assets and employ a barbelled strategy toward growth assets to accommodate the changing contours of growth.

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Navigating to the new normal

The reflation trade gathered pace after October of 2020 following a “blue wave” election result giving control to Democrats in the US, which was quickly followed by promising test results for several vaccines to fight COVID-19. Through a combination of new stimulus and a global vaccine rollout, it appeared that the COVID-19 crisis would eventually end, with large quantities of stimulus and liquidity left to boost growth well into the future. However, by 2Q21, an uneven vaccine rollout and then the Delta variant made the outlook less clear.

Not surprisingly, outside of a short-term release of pent-up demand, consumers and investors have grown cautious on the outlook and the prospects of negative growth surprise. So, what comes next? It depends. Some nations are still adhering to zero tolerance to the spread of the virus, while others are hoping that high vaccination rates will sufficiently manage current and future outbreaks. In either case, clearly it will take time before demand returns to more normal levels.

Even before COVID-19 struck, there was already much change afoot in the global economy. The reconfiguration of supply chains that began with the US-China trade war has accelerated, as tensions remain high and COVID-19 lockdowns exposed a fundamental weakness in supply chain dependence. Nations are not just adjusting their mix of trade partners; in many cases, they are seeking to bring some manufacturing back home in the name of national security and job creation. Call it "reverse globalisation", which has broad implications for capital flows and resolution of final demand.

Fighting climate change has long been a global objective, but political appetite and newfound comfort in running ever larger fiscal deficits has deepened the commitment. We have seen the implementation of both direct fiscal initiatives and indirect incentives to drive capital away from fossil fuels toward renewable energy, while every nation is focused on technological innovation as a means of reaching a sustainable future. Again, this shift has broad implications for demand.

These multiple dynamics of change make it difficult to assess future growth in the context of a normal economic cycle. That said, gradual normalisation as the world learns to live with the virus, coupled with firm fiscal commitments to prop up demand, bodes well for a continued recovery whatever shape its final form takes.

Positioning for different outcomes

Our base case is that a combination of demand normalisation and fiscal stimulus will prove to be reflationary, benefiting cyclical assets and supporting higher growth through investment and robust final demand. Reconfiguring supply chains brings more investment and incentives to invest in efforts to rein in climate change.

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> **A combination of demand normalisation and fiscal stimulus will prove to be reflationary, benefiting cyclical assets**

Cyclical equities should benefit, including even those "less green" commodities that are necessary inputs toward reaching ultimate green objectives. Growth stocks including technology could suffer over the near term as reflation lifts yields. While this environment tends to be less kind to equities with rich valuations, we believe that technology is core to future growth and therefore its long-term earnings prospects remain strong.

Close behind our reflation thesis is a return to lower levels of growth, which is a familiar experience over the last decade. While fiscal policies may be seen to power investment and final demand, the global commitment is uneven and may dissipate as the world exits the crisis. There is also the problem of capital misallocation, where expenditure and investment fail to boost productivity and demand, while higher levels of debt can add to uncertainty.

Lower growth is less favourable to cyclicals, but secular growth assets can still perform, much like they did over the last decade. Rates will lift to more normal levels as the US Federal Reserve (Fed) normalises monetary policy. Although this could prove a near-term headwind to growth equities, they should ultimately find stability on continued strong earnings prospects.

The outlier risk is that growth moderates while inflation remains stickier than hoped, requiring further tightening by central banks to keep inflation expectations anchored. Fiscal policy may also have to be pulled back, where tight policy and inflation both weigh on demand and growth. Such an outcome is remote, but one to watch, requiring a more defensive posture with selective low duration and commodity assets.

Keeping an eye on inflation

So far, inflation looks transitory. While inflation prints have been quite high, most of the drivers were related to supply disruptions, such as used autos in which production of new cars suffered from shortage of semiconductors, shifting demand to the used car market where rental car companies were competing for inventory to replenish their fleets. Already, supply and demand pressures are normalising and used car prices are coming down, bringing broad measures of inflation down with it.

Still, the debate over the relative stickiness of inflation has not ended. Wage pressures are currently elevated, perhaps partly driven by high levels of unemployment assistance that is due to end in September. Still, job openings are at record highs and unemployment is coming down quickly, so it is possible that some wage pressures may prove more persistent.

There are also policy-driven factors that could keep inflation elevated, including easy fiscal policy. While globalisation efficiencies helped to drive disinflation over the last 20 years, deglobalisation is less efficient and arguably could add to inflation pressures. Policies designed to reduce emissions could also prove inflationary. Already, investment in fossil fuels is in decline but it will take decades to fully shift to renewables, which means energy prices could stay elevated.

While these sources of potential inflationary pressures are well noted, technology, the key disinflationary driver, may be the most powerful force to keep inflation at bay. Technological innovation brings efficiency and depresses prices in its wake. Exponential advancements in areas such as computing, artificial intelligence and robotics have the potential to deliver new efficiencies that are inherently disinflationary.

Innovation is likely to outpace inflationary forces over the long term, but we do keep a watchful eye on inflationary pressures over the near term, which drives central bank policy. The Fed has demonstrated its willingness to let inflation run "a little hot", but at some point, if some inflationary pressures remain sticky, the Fed will need to respond more aggressively to keep inflation expectations anchored. This would be a firm negative to the growth outlook.

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An adaptive barbell portfolio strategy

The outlook remains varied but overall positive, favouring a barbell strategy toward growth assets—a combination of cyclical exposures that benefit from the recovery, as well as secular growth that will continue to benefit from ongoing innovation and strong earnings. It is key to remain adaptive to the shape of the recovery as it unfolds, whether it be reflationary, low growth or (remotely) more inflationary.

On the defensive side, we continue to favour a short duration on the premise that the combination of returning growth and the withdrawal of easy monetary policy is likely to lift long-term rates. We like China bonds for their still-healthy yields and defensive characteristics. Depending on the contours of reflation versus inflation, commodities could prove to be a more defensive asset class than fixed income assets.

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