

# A (7) trillion-dollar question: Is inflation coming back?

Published 16 July 2020

**Mobeen Tahir**

Director, Research

*Source: WisdomTree, Bloomberg. Data as at 30/06/2020.*

**Historical performance is not an indication of future performance and any investments may go down in value.**

## **Then why is everyone talking about inflation?**

One of the reasons why investors may feel that bond markets have got the inflation outlook wrong is the impact of US Federal Reserve (Fed) policy accommodation. Figure 02 illustrates how sharply the balance sheet of the Fed has grown this year on account of the central bank's sizeable asset purchases. Such aggressive accommodation from the Fed also came during the 2008 global financial crisis. Inflation did return, but only at modest levels. The Fed's attempts at tightening policy in subsequent years were met by 'taper-tantrums' by the market, i.e. collective panic in the market over the potential withdrawal of liquidity.

The Fed, therefore, continued to expand its balance sheet in the years following the crisis. Its balance sheet has grown from under USD 1 trillion in 2008, to over USD 7 trillion in July 2020. Despite the strong liquidity infusion since the global financial crisis, inflation has not reached very high levels. Liquidity alone will probably not be enough to cause high levels of inflation going forward either.

## **Let's envisage an inflationary scenario**

Let us outline one possible combination of factors that could join forces to elevate the level of inflation, probably in 2021. Let's assume a potent vaccine is developed and distributed widely and the pandemic is all but over as we enter the new year. Life returns to the old normal. A large proportion of jobs lost this year are restored. The so-called 'pent-up' demand, i.e., people holding back from spending this year, causes demand-pull inflation next year. An increase in economic activity could cause energy prices to rise back to pre-pandemic levels creating cost-push inflation. Further support may come if governments follow through on their recent pledges to employ infrastructure spending to induce growth.

The above scenario, however, is not our base case. Question marks exist on a number of the aforementioned variables. A vaccine is yet to be developed and energy demand has a long way to go before it pulls oil prices back to pre-pandemic levels. Similarly, with bankruptcies and lasting damage to businesses, unemployment will only decrease gradually, and it will be a while before wage pressures start to pinch

again. In our base case, we expect inflation to rise moderately in 2021 and reach 1.5% for the US around the middle of next year. This is closely aligned with the International Monetary Fund's forecast.

### **What should investors do?**

Is it too soon to be thinking about inflation? We don't think so. Even if inflation rises only to moderate levels, for the US as well as the global economy, it is very likely to increase from where it is today. If investors think in terms of their 'risk budget', they should consider which risks their portfolios are exposed to, and whether they are well-compensated for taking those risks. If investors don't actively want inflation exposure, they should consider hedging some of that risk.

One effective way to hedge against moderate levels of inflation may be to use a broad basket of commodities (See Figure 03). Broad commodities provide a natural hedge when the global economy starts to grow. Cyclical commodities are needed to produce things – even more so when governments introduce infrastructure programs.

## Important Risks Related to this Article

### Important Information

**Marketing communications issued in the European Economic Area (“EEA”):** This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

**Marketing communications issued in jurisdictions outside of the EEA:** This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as “WisdomTree” (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

**For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.**

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.