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Insight INVESTMENT

INFLATION UPDATE

A STRUCTURAL DETERIORATION IN THE OUTLOOK FOR INFLATION

AUGUST 2024

BNY | INVESTMENTS

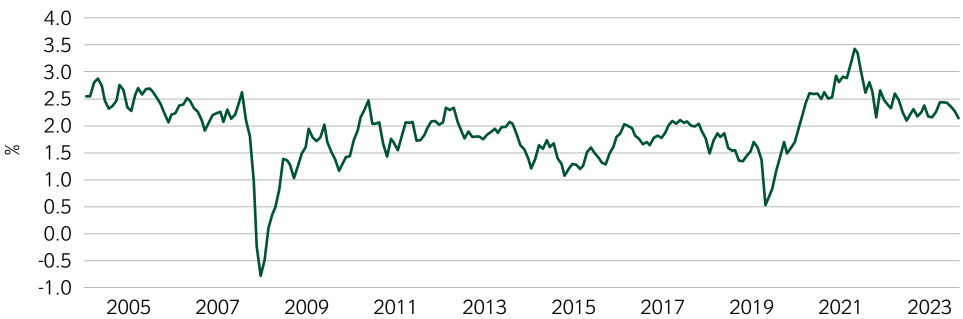
EXECUTIVE SUMMARY

- The outlook for inflation appears to have structurally deteriorated around the world.
  - The demographic outlook is a problem. Aging populations and rising dependency ratios mean economies will be ever more driven by consumers rather than producers, pushing inflation upwards.
  - In an increasingly bi-polar world, the era of ever-cheaper goods imported from China is over. Deglobalisation and the reshoring of production is the new trend and it's going to mean less efficient production and higher costs of production are here to stay.
  - Big government has become psychologically embedded. Politicians, voters and even central banks have become used to spending money to counter problems, artificially boosting aggregate demand and preventing the natural role of capital markets in bringing periodic change.
  - The energy transition and higher defence spending are two structural problems that will further boost demand and compound fiscal deficits.
- Artificial intelligence (AI) could save the day, but the uncertainty is high. AI is a revolutionary new technology which could result in huge productivity gains, but it may take decades for the full impact to become clear.
- Structurally higher inflation would be uncomfortable for central banks and politicians. If central banks stick to current inflation targets, then a structural rise in underlying inflationary pressures would require interest rates to be maintained at higher levels than seen since the global financial crisis. This is likely to bring politicians and central bankers into conflict and we think pressure will grow to weaken inflation targets.
- In this scenario, holders of inflation-linked assets are likely to do well.

INTRODUCTION

Investors are increasingly confident that global central banks have tamed inflation and can begin cutting rates aggressively. US inflation expectations for the next five years, based on the yield gap between five-year US Treasury yields and five-year Treasury Inflation-Protected Securities (TIPS), have moved into alignment with the Fed's 2% inflation target (see Figure 1). This suggests US investors aren't interested in paying a premium to guarantee real returns, a sentiment that is shared globally.

Figure 1: US five-year breakeven inflation rate[1]



With the post-pandemic inflation spike still fresh in investors' minds, we believe many are underestimating the medium-term inflation risks. We note that President Trump may be re-elected, and he has committed to a significant increase in trade tariffs, and global geopolitical risks remain heightened, with potential consequences for world energy prices whoever is elected.

We hold a more pessimistic view than the broader market. While inflation may drift downward in the very short term, we worry that an underlying structural shift towards higher inflation is occurring. With the disinflationary forces of recent decades fading, an era of higher inflationary pressures may lie ahead.

If inflation remains structurally high, central banks will need to maintain interest rates within higher ranges to control it. Finance ministers and politicians seem largely unaware of this shift and the fiscal implications of a sustained period of high long-term interest rates. If we are correct, central banks are likely to face growing political pressure, threatening their independence and the inflation-targeting regimes they adhere to.

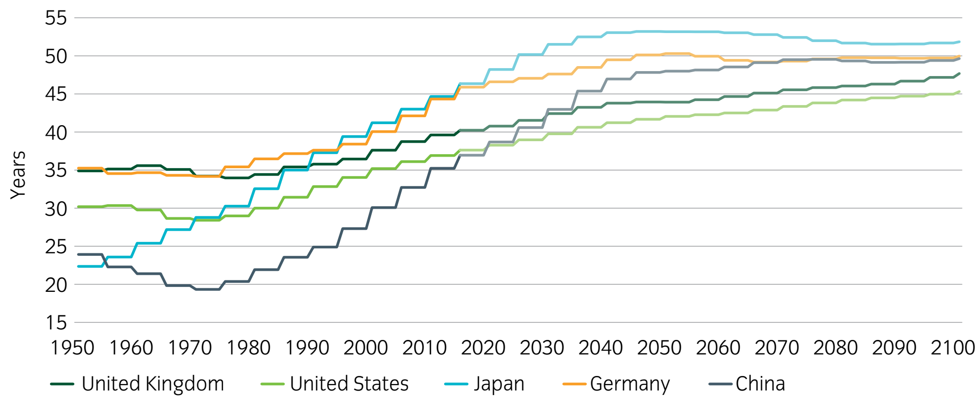
[1] Source: Insight and Bloomberg. Data as at 31 July 2024.

THE DRIVERS OF A STRUCTURAL SHIFT IN INFLATION

THE DEMOGRAPHIC OUTLOOK IS A PROBLEM

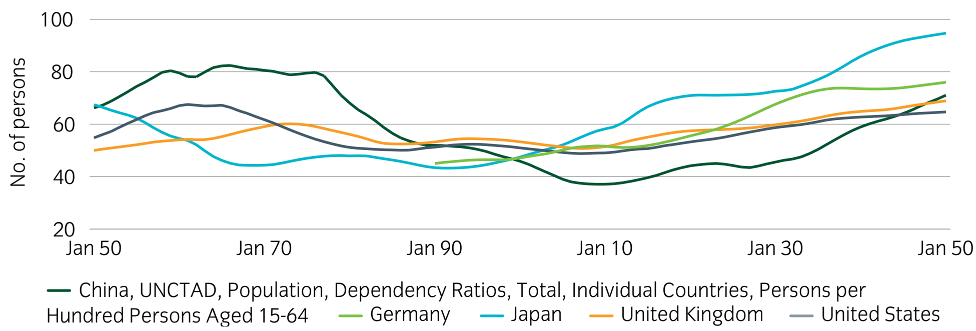
The global population is aging (see Figure 2), driven by longer life expectancy and declining fertility rates. According to UN projections, the population has peaked in 63 countries, including China, Germany, Japan and the Russian Federation. In 1995, only 17% of the world's population lived to 80 years or more, but this is expected to rise to over 50% by the late 2050s.

Figure 2: Median age in major countries has trended upwards[2]



This is driving up dependency ratios (see Figure 3), a measure of the number of dependents (those generally not economically active) aged below 14 years and over 65, compared with the total working aged population (aged 15 to 64). In Japan, the dependency ratio is now approaching a level where there is one dependent for every working-age person.

Figure 3: Dependency ratios in major countries are rising[3]



We believe this will increase inflationary pressure over time as dependents are net consumers rather than producers of goods. Higher levels of consumption increase aggregate demand, especially for services where inflation tends to be higher.

THE ERA OF EVER-CHEAPER GOODS IMPORTED FROM CHINA IS OVER

Over recent decades, this rebalancing of economies towards higher levels of consumption has been facilitated by the import of cheap overseas goods. The boom in global trade saw millions of Chinese workers move from rural areas to factories after China joined the World Trade Organization in 2001, and the disinflationary impact of Chinese goods offset high domestic service inflation in many countries. But China now faces demographic decline, and security and supply-chain concerns are shifting the focus from globalisation to deglobalisation.

[2,3] Source: Macrobond and United Nations. Data as at 31 July 2024.

The rapid breakdown of global supply chains experienced during the pandemic and the realignment of global politics after the war in Ukraine are prompting a deeper reassessment of production models.

This shift is happening alongside a growing emphasis on decarbonisation, with more sophisticated corporate carbon footprint assessments diminishing the appeal of long-distance transportation for goods. Many multinationals are faced with pressure from both politicians and investors to prioritise security and climate concerns into their business models.

These factors have led to a sharp increase in US jobs from companies' reshoring production. As a result, we believe we are witnessing the start of a long-term trend where the disinflationary force of globalisation gives way to the more inflationary force of deglobalisation.

BIG GOVERNMENT HAS BECOME PSYCHOLOGICALLY EMBEDDED

Activist and interventionist government policies became normalised during the pandemic and were reinforced following the invasion of Ukraine. Energy support schemes, furloughs and COVID relief programmes have created an environment where political intervention to mitigate the impact of global events on electorates feels more natural. Each round of support boosts aggregate demand beyond typical levels, fuelling inflation and preventing markets from undergoing the hard but necessary periods of turmoil that often sow the seeds of innovation and future productivity gains.

Defence spending and the energy transition compound the fiscal problems

There are two further structural factors that will add to fiscal deficits and :

- **Defence spending:** The invasion of Ukraine has been a catalyst for European countries to look more seriously at their defence budgets, with Finland and Sweden both joining the North Atlantic Treaty Organization (NATO). If President Trump is re-elected, the organisation, and the defence budgets of its members, are likely to come under close scrutiny. President Trump has previously stated that the US should leave the organisation, with the US only to offer support during times of actual crisis. Whatever happens, pressure for higher defence budgets is likely to grow across Europe. In Asia, a more assertive China is having a similar impact, with the Philippines launching a $35bn military modernisation plan and the Japanese government approving a record defence budget.
- The energy transition: At the 2015 UN Climate Change Conference (COP21), held in Paris, 196 countries entered into a legally binding international treaty on climate change known as The Paris Agreement. This agreement committed the world to holding "the increase in the global average temperature to well below 2°C above pre-industrial levels", while making efforts to "limit the temperature increase to 1.5°C above pre-industrial levels". The UN projects that the energy transition needed to implement these goals will cost around $5.8 trillion by 2030 across 48 developed economies, or 19% of GDP[4]. As governments and corporates work towards achieving climate goals, it represents yet another meaningful source of demand. Additional taxes on legacy energy sources to help pay for the transition and to incentivise the transition will compound the inflationary impact.

TECHNOLOGY COULD BE THE DISINFLATIONARY WILDCARD

Artificial intelligence (AI) is a groundbreaking technology that has the potential for huge productivity gains, but it's not guaranteed, nor clear how quickly productivity gains will occur. The introduction of electricity in the 1880 and 1890s took decades to generate productivity gains, as the old steam-driven technology was so integrated into pre-existing methods of production and design. Electricity did not prove transformative until factory designs and production processes adapted to take advantage of the new technology. It wasn't until 1913 that Henry Ford installed the first moving assembly line, which enabled mass production in an incredibly efficient way. So, even if AI does ultimately prove to be a revolutionary technology, its full impact may not be sufficient to meaningfully counter these inflationary trends in the decade ahead.

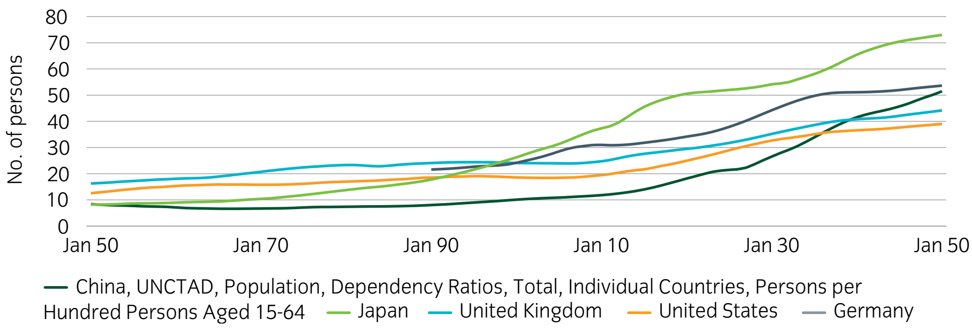
[4] Source: https://unctad.org/sdg-costing/energy-transition

AN UNCOMFORTABLE OUTLOOK FOR CENTRAL BANKS AND POLITICIANS

If we are to enter a period of stronger inflationary pressures, there are significant implications for central bankers and policymakers.

Maintaining inflation at close to target means central banks will likely need to maintain interest rates within higher ranges than we've been accustomed since before the global financial crisis. If central banks, and perhaps more crucially politicians, aren't prepared to accept higher interest rates and their implications for debt repayment, then they may need to accept higher inflation targets. Given that public sector debt-to-GDP ratios are already historically high (see Figure 4) and may worsen if predictions of worsening demographics and bigger government hold true, the goals of finance ministers and independent central banks may come into conflict.

Figure 4: General government debt as a percentage of GDP[5]



This situation is further complicated by the expectation that age-related costs will drive up government spending over the medium term, while tax revenues from employment may struggle to keep pace if the working-age population stagnates. Governments are likely to face large deficits to even maintain the status quo. With the elderly comprising an increasingly large portion of the electorate and unlikely to vote for parties with policies that would reduce their standard of living, fiscal restraint is likely to be politically impossible in this new era.

Structurally loose fiscal policies, coupled with high and rising debt-to-GDP ratios, will further complicate the tasks of central bankers, as ever-increasing debt levels make it increasingly challenging to control yield curves without direct intervention. Japan may offer a glimpse into the future for other major central banks. By the end of March 2024, the Bank of Japan owned 53.2% of the Japanese government bond market and approximately 7% of the Japanese equity market[6].

[5] Source: Macrobond and United Nations. Data as at 31 July 2024.
[6] Source: Insight and Bloomberg. Data as at 31 July 2024.

INFLATION PROTECTION COULD BE CRITICAL

Although headline rates of inflation have moderated from the highs and moved closer to central bank targets, the outlook for inflation remains highly uncertain. In our view, factors such as the shift from globalisation to deglobalisation will keep inflation at structurally higher levels in the years ahead. As it becomes clear that central banks are going to find it more difficult to hit their inflation targets on a sustained basis, we see a growing risk that current inflation targets will be raised or diluted over time.

After all, there is no reason why central bank's target 2%. This is simply a number chosen by the first central bank to target inflation – the Central Bank of New Zealand.

If, as we expect, inflation remains stubbornly elevated in the decade ahead, then holders of inflation-linked assets are likely to do well. If central banks raise their inflation targets or shift to targeting measures other than inflation alone then it would make inflation protection more important than ever.

IMPORTANT INFORMATION

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Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and costs incurred when purchasing, holding, converting or selling any investment, will impact returns. Costs may increase or decrease as a result of certain currency conversions, such as currency hedging, and exchange rate fluctuations.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialise or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed Income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Exposure to international markets means exposure to changes in currency rates which could affect the value of the portfolio.

Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

CONTRIBUTORS

David Hooker
Senior Portfolio Manager
Insight Investment

Simon Down
Co-Head Investment Content
Insight Investment

FIND OUT MORE

Institutional Business Development
businessdevelopment@insightinvestment.com

European Business Development
europe@insightinvestment.com

Consultant Relationship Management
consultantrelations@insightinvestment.com

company/insight-investment

www.insightinvestment.com

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