MORNING ESPRESSO

Interview with Asbjørn Trolle Hansen, Head of Nordea's Multi Assets Team

Nordea Multi Assets solutions

Please note that the conference call occurred on the 2nd of June 2021. All market commentary and information refers to the period before then.

Key takeaways

- Inflation risk needs to be considered in asset allocation: bonds are not yet fully reflecting the current inflation risk.
- Inflation is not a bad thing for equities, generally, where nominal earnings growth typically accelerates with inflation.
- "Value" equities tend to benefit first from rising inflation (as tail/downside risks are mitigated) but it then broadens out across equity markets.

We have seen huge jumps in various commodity prices, leading now to rising inflation. How does wage inflation contribute to wider inflation?

Economies have rebounded from their Covid-induced economic problems and some areas have jumped straight into inflationary concerns. US consumer prices are sharply up - the CPI is now around 4%. US wage inflation is being driven, in part, by stimulus cheques and Covid-related social programs, but these will eventually drop out of the numbers. US hourly pay is up around 5% – for those in work – and it is outstripping productivity increases, which indicates inflation is passing into wages. This typically means unit labour costs are rising, potentially squeezing company profit margins. So the real question is whether companies are price-takers or whether they can drive through price increases to reflect their rising costs. At this point, many companies CAN push price increases (selectively).

How do you see inflation expectations reflected in bond valuations?

US CPI has reached 4%. Longer-term inflation expectations, however, have risen to around 2.5%. This implies the market currently expects inflation to be manageable, falling from the current 4% towards these 2.5% longer-term expectations. Inflation is typically reflected in rising bond yields, but only partially. We feel that the risks of rising inflation – and rising yields - may not yet be fully reflected in bond prices. Inflation risk is certainly something to consider within one's asset allocation. We are using equities for our "inflation play".

How do equities fare against inflation?

Equities typically do well in an inflationary environment, since nominal earnings growth tends to rise with higher inflation as companies do pass through at least some of their rising costs. A year ago, market expectations for 2021 earnings growth was sub-2%: the higher expectations we are seeing now reflects the success of the stimulus packages. Looking specifically at the S&P500, companies are showing stable-to-strong gross margins (reflecting the ability to pass through rising variable costs) even though the net margins may be under a little pressure. As far as the outlook for growth vs value stocks goes, we tend to see cost pass-through for both. Inflation is beneficial for the earnings growth of both types of stock, but value stocks tend to perform better first. Furthermore, value stocks have a lot of potential for price recovery. We certainly always favour companies with strong business models that can include price stability, and in this case, the possibility to pass through price increases. Overall, we are seeing greater ability to pass through rising costs than we have seen for the last 20 years.