Inflation? Rampant Inflation? Deflation? Depression?

Adapting Asia's Portfolios to an Uncertain World

The one certainty the world has right now is that we all face an uncertain world ahead. Will the pandemic run its course, and expire as rapidly as it arrived? Will an effective vaccine, or vaccines, be launched, and if so, by when? Will treatments advance sufficiently so as to effectively mitigate the dangers we all face from the virus? How soon will more normalised business, social, and family lives resume across the globe? Does this spell the end of globalisation, at least for the foreseeable future? What does this all mean for global economic activity, for government, corporate and personal finances, and for the world of investments? A starting point perhaps is to gauge the potential for inflation or deflation ahead. And that is the subject of this Hubbis mini-survey, in which we asked wealth management experts for their predictions for either outcome, and for their preliminary views on how they might react, and indeed what they are recommending for the portfolios of their HNW and UHNW clients today. Inflation, they said, appears the more likely scenario, given the tsunami of Western government support packages and central bank largesse, with some predicting rampant inflation. But they also acknowledge the real potential for deflation ahead, with some fearing a deflationary spiral. In short, the two extremes of rampant inflation or persistent deflation appear realistic outcomes, and so too some sort of more benign return to the relative normalcy of the recent years But whatever the outcome, the wealth management community must be ever more agile, imaginative, forward-thinking and strategic in helping position their clients' portfolios for both wealth preservation and, if all were to go very well, even wealth accumulation

The experts we polled in our short survey appear to anticipate inflation as the most likely scenario in coming years, but they are also currently somewhat hedging their bets by positioning clients in a somewhat neutral position, possibly more slanted towards a deflationary scenario in the nearer term ahead. This is hardly surprising, as the world vacillates between hope for a global economic recovery – predicated on beating the virus back – and fears of a sustained period of economic and possibly social chaos ahead, in whatever form those take.

Nobody in Western economies, and indeed in most emerging market economies – aside from certain countries such as Argentina, Venezuela of Zimbabwe – have experienced serious inflation since the mid- to late-1980s, when interest rates peaked, since when rates have fallen constantly, we have been in a fixed income and equity bull market, but also one in which end prices have been largely under control.

Modern portfolio management theories are therefore predicated on the world we have faced in the past 40 to 50 years, since the end of the high growth and high inflation era of the 1970s and much of the 1980s. Neither have we faced a deflationary ecosystem, although Japan has garnered some experience of investing in an extremely low growth, deflationary, negative rate environment.

There is a school of thought also that predicts the world might first face a deflationary collapse in economic activity – tantamount to a depression – followed by rampant inflation determined by the unprecedented levels of

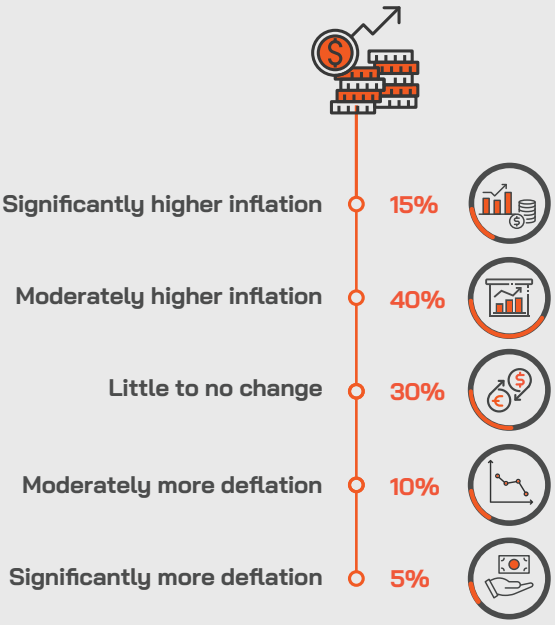
55% BELIEVE INFLATION WILL RISE, AND 15% PREDICT IT WILL SURGE HIGHER, ONLY 15% EXPECT DEFLATION

The wealth management professionals Hubbis canvassed for this exercise clearly believe there is a significantly greater probability of inflation in the months and years ahead. Why? The US Federal Reserve has paid out in the region of USD180 billion in grants to every single US household since the pandemic hit, and similar abundance is seen across the EU, Japan, the UK and other G20 economies. In the UK, for example, the equivalent of more than USD112 billion of support for businesses and employees has been paid out since March.

These vast government and central bank economic and monetary stimulus packages across the globe, with money printing on an unprecedented scale to pay for fiscal deficits, will inevitably conspire to create inflation, possibly even hyper-inflation, as this is effectively the only avenue to managing national debts.

If so, the world will see an inflationary spiral not witnessed since the 1970s, although at that time there was very strong inflationary growth. Since then the world has experienced declining inflation or disinflation all the way to the early 2020s. This could turn accepted portfolio allocation theories upside down.

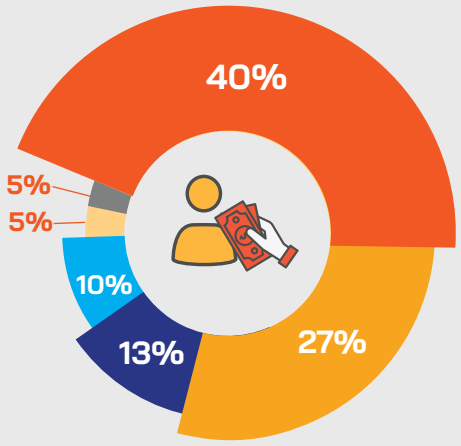
What is the outlook for inflation or deflation in the post-pandemic world?



27% BELIEVE GOLD TO BE A CORE HOLDING IN TIMES OF INFLATION, WHILE FIXED INCOME WILL BE PARED BACK

Gold is the big winner in the inflationary scenario, as a natural hedge against inflation combined with US dollar weakness. Equities would feature as the core holdings at 40% but, based on the associated comments from respondents, pared selectively to those corporations likely to survive or thrive in a world of inflation. Fixed income holdings would be both reduced in size, and at the same time, refocused on government and other top-flight credit, including inflation-linked debt.

If you think there will be a significant increase in inflation - which asset classes, products, will you use to offset this?



Equities
Gold
Fixed income
Property
Commodities
Alternative assets (like hedge funds)

government support packages, government borrowing and central bank monetary stimulus.

"The initial impact is clearly a deflationary shock," said one of those experts we polled. "Later, if there is inflation, it would be in response to the vast amount of stimulus poured into the system."

Additional flesh was added to these bones in a reply that observed that the lower consumer and corporate spending levels today are partly driven by fear, and therefore the savings mentality, and partly due to limited spending opportunities. However, they anticipate a surge in demand for basic materials, services and goods, although the decline is so severe during lockdown that it will take a long time to get fully back to normal. He concludes that the mid- to long-term outcome is rising inflation.

"I personally feel that inflation and deflationary pressure would be sectoral rather than all-round," came another view. "Real assets may see deflation and investment assets in some sectors, such as tech or pharmaceuticals, may see inflationary pressures and rising share prices."

The moderate deflationary outlook was articulated in one reply that noted that the closure of so many retail, leisure, food and entertainment outlets globally should hit the commercial real estate and rental market remarkably hard, and result also in significantly weakened family finances and lower residential property prices.

In favour of higher inflation, the experts we surveyed focused on the stimulus packages and, yet again as in the aftermath of the 2008-2009 financial crisis, excessive liquidity deployed into financial assets. In essence, free money results in a free-for-all, they fear.

But for those anticipating deflation, the survey highlighted the fear of unemployment, higher precautionary savings, weaker consumer and corporate expenditure, lower risk investment, weaker or falling property prices, and the prospect of rising taxes as government realise that fiscal excesses must be addressed.

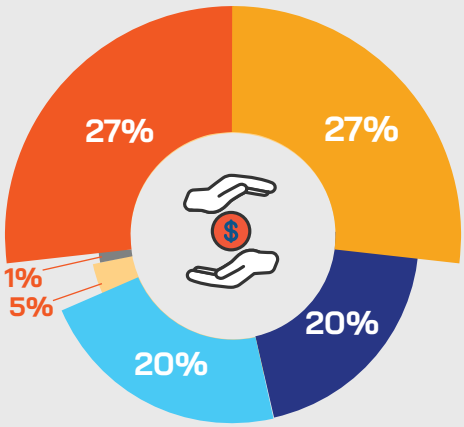
In the face of either inflation or deflation, duration risk escalates, and respondents call for greater imagination from the advisory

community in terms of portfolio construction and far greater agility. "Portfolio rebalancing must be adapted to the new investment environment, such as countries are becoming less global and more local or insular," said one expert. "And I for one fear a rising East-West dichotomy and trade war looming imminently."

94% ANTICIPATE BALANCED PORTFOLIOS ARE THE WAY TO WORK THROUGH A DEFLATIONARY ENVIRONMENT. ONLY 1% SEE A ROLE FOR PROPERTY IN THE FACE OF DEFLATION.

In a world of deflation, assets deflate as well as general prices, hence cash is more valuable, as its value is enhanced, instead of being eroded by inflation. At the same time, corporate profitability also weakens, hence the lower allocation of 27% to risk assets in the form of equities. Debt is more in favour than in an inflationary scenario, but again, credit must be selected for the debtors' ability to manage deflation without corrosion of their creditworthiness. Gold remains in favour, as one, but somewhat less so than in an inflationary world. There is a greater allocation of risk assets to alternative assets, including hedge funds, as they are viewed as a means of playing selectivity and of adapting rapidly to market nuances. Deflation is disastrous for properties of all types.

If there is to be persistent deflation ahead, which asset classes and products, will you use to offset this?

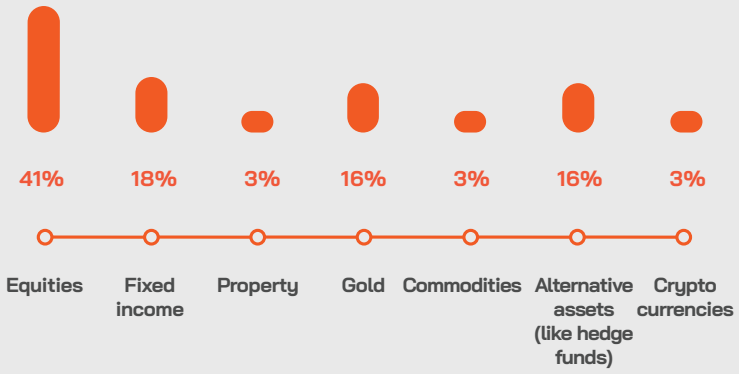


Equities
Fixed income
Gold
Alternative assets (like hedge funds)
Commodities
Property

94% TODAY FAVOUR A BROADLY BALANCED PORTFOLIO, WITH PROPERTY AND COMMODITIES OUT OF FAVOUR WHAT ASSET CLASS/ PRODUCTS ARE YOU RECOMMENDING CLIENTS INCREASE TODAY?

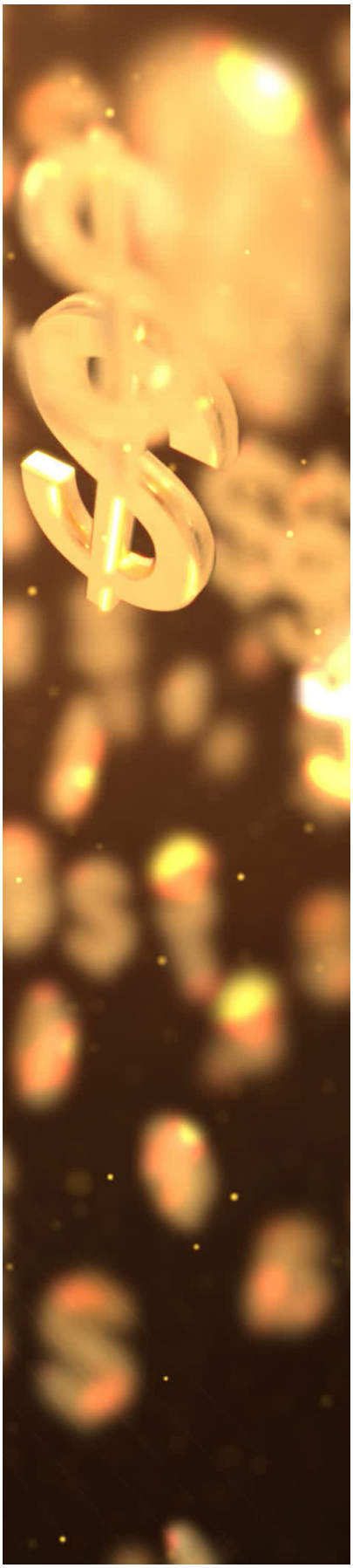
Interestingly, respondents appear to be largely hedging their bets, anticipating perhaps a deflationary weakness in the nearer term and the ability to react rapidly to changes and new signals ahead that flag rising inflation. Accordingly, they report that they are directing their clients to a portfolio strategy today that is more akin to their hypothetical stance in the face of a deflationary world ahead. This indicates that while they might expect more likelihood of inflation, there are many sitting on the fence, indeed in our first survey question above, 45% of replies anticipated little or no change to the inflation/deflation, of whom one-third expect deflation, either mild or severe. Nevertheless, agility is a keyword that many respondents used in the survey, indicating that change is virtually inevitable and that they and their clients must watch closely for the key signal ahead, and then react dynamically to the environments that might then unfurl ahead.

What asset class / products are you recommending clients increase today?



Interestingly, many of those we surveyed indicated that their client portfolios are somewhat more robust this time around than during the global financial crisis, although this might simply be because the significant market rebounds around the world are lulling everyone into a false sense of well-being currently.

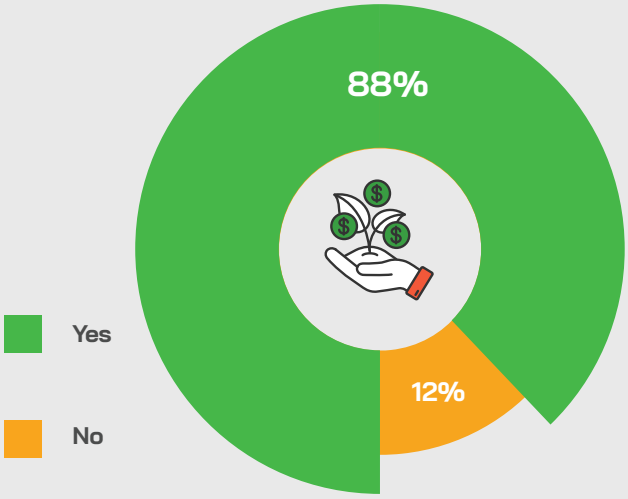
This mini-survey was sponsored by Saxo Markets, whose Asia Pacific CEO, Adam Reynolds, also features in an associated opinion piece on re-imagining and future-proofing Asia's investment portfolios.



88% BELIEVE CASH MUST BE DEPLOYED IN ORDER TO STAVE OFF THE INEVITABLE DANGERS OF INFLATION

In a world of raging inflation, the value of cash is eroded constantly. In that scenario, investors must invest, either to simply hold the value they had at the outset, or even to try to boost their wealth during the inflationary cycle. The key is whether growth coincides with high inflation, as in the 1970s and early 1980s, or whether it is stagflation ahead, which is even more pernicious.

Will clients be willing to invest a significant part of their (currently elevated) cash holdings in anticipation of a significant increase in inflation?



CONCLUSION

If there was a single overriding impression that we garnered from the survey, it was that the jury amongst our Asian wealth management community is still out. It comes back to the brutal reality that nobody knows what is coming next. The best the wealth management community can do is to adopt a stance, prepare portfolios and personal wealth planning for whatever outcomes they might anticipate, and then ensure that portfolios can be adjusted proactively and with great agility, and also that clients are attuned to the reality that they face a new and uncertain reality ahead. Oh, and their fingers must be collectively, and firmly crossed...