CAPITAL ECONOMICS

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Inflation poses risks for Private Equity but policy backdrop should continue to be supportive

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Inflation will remain elevated in the near-term as temporary price pressures continue to gather steam

According to BofA ML's widely followed survey of global fund managers, inflation is now considered to be the greatest "tail risk" to markets, ahead even of the pandemic taking another turn for the worse and asset price bubbles. Are they right to be so concerned?

A rise in inflation was always likely to happen this year as economies re-opened and energy prices recovered from last year's sharp falls. Yet the increases seen since the start of the year have exceeded expectations, with price pressures continuing to mount across the global economy. In the United States, temporary supply bottlenecks stemming from the pandemic are still putting significant upward pressure on prices in some sectors, with headline inflation rising to 5.4% in June this year. This was the largest annual increase seen since August 2008. In the euro-zone, headline consumer price inflation jumped to the ECB's inflation target of 2% in recent months. And CPI inflation in the UK rose to its highest level in almost three years, reaching 2.5% in June, leaving it above the Bank of England's 2% target. Inflation has also risen across emerging market economies, with Central Europe, Turkey and Brazil most affected.

With commodity prices continuing to rise, supply shortages afflicting manufacturers, unprecedented levels of policy stimulus in the wake of the pandemic, and greater tolerance of higher inflation by policymakers, there is growing concern that these conditions could lead to a Great inflation 2.0, akin to the high inflation era of the 1970s.

The outlook beyond this year is mixed with some countries set to see more sustained price pressures

Central bankers around the world have been keen to stress that any pick-up in inflation this year will be transitory. Indeed, the boost from energy prices will soon fade as the anniversary of last year's slump in the oil price passes. And while shortages of inputs including semiconductors, metals and lumber may persist for a bit longer, they should ease in time as supply recovers and consumption patterns normalise.

However, the inflation picture is more nuanced than headlines suggest, and the outlook is quite varied on a regional basis. While transitory factors will drop out soon, some economies face greater risks of sustained inflation than others.

Among advanced economies, sustained price pressures are most pronounced in the US. There, spare capacity in the economy is likely to be eliminated soonest and labour market shortages will continue to drive an acceleration in wage growth. Australia and New Zealand are also experiencing significant inflationary pressure, and evidence of tightness in their labour markets suggest that this is quite likely to be sustained as well.

And while Canada and the UK's inflation risks seem somewhat less pronounced given that their recoveries have not been super-charged by fiscal policy to the same extent as that in the US, labour shortages in both countries may put upward pressure on wage growth in the near-term. Yet we do not expect these pressures in Canada and the UK to be as sustained as in the US.

We see a different story in the euro-zone and Japan, where inflation risks are far weaker. In the euro-zone, there are few signs of labour shortages or wage pressures, and once the temporary forces pushing up inflation fade, we expect prices to drop back sharply. And even though we expect headline inflation to rise further over the coming months in Japan, it is unlikely to experience significant re-opening inflation due to lower pent-up demand and far stickier inflation expectations.

Central bank policy responses will be determined not just by inflation, but by their expanding remits

Where inflation ends up settling in the medium term is ultimately a question for policymakers. Broadly speaking, the policy outlook from central banks will be determined not only by the outlook for inflation but by also other aims, whether explicitly or implicitly included in bank mandates.

Australia and New Zealand arguably have the most compelling reasons to tighten policy. Along with evidence that inflationary pressures are likely to be sustained there, the two central banks take account of house prices when deciding how to set policy. In both cases, housing markets seem to be overheating, particularly in New Zealand. We expect the Reserve Bank of New Zealand to be the first central bank in the developed world to raise interest rates, possibly as soon as August. By contrast, with a new set of lockdowns currently weighing on the economy, the Reserve Bank of Australia is still sounding quite cautious as it has pledged to keep rates on hold for longer. We expect them to follow suit with interest rate rises in early 2023.

Then there are the economies where inflation risks might warrant tighter policy, but other goals seem to prevent action. The US Fed is the most prominent here.
While inflation risks are higher in the US than in any other advanced economy, the Fed's broad and inclusive maximum employment goal is not in easy reach, with employment still 7.5 million below its pre-pandemic level. The bank's Flexible Average Inflation Target gives the Fed room to allow higher inflation periods in order to achieve its other goals and we suspect that it will use this flexibility. We expect the Fed will keep its policy rate at near-zero until 2023 and even when it does begin to raise it, we think the nominal rate will remain well below the rate of price inflation. Real short-term rates will stay below zero for most of the next decade.

The central banks of the United Kingdom and Canada have also both made clear in their rhetoric that they would overlook transitory rises in inflation in order to support their government's growth and employment aims.
This will require ongoing policy support, suggesting to us that monetary tightening is much further off than markets imagine. We expect interest rate rises in early 2023 in Canada and in early 2024 in the UK, with only gradual tightening thereafter.

On the other side, there are the economies where we see little reason to expect policy tightening in the foreseeable future, including Japan and the euro-zone. Inflation risks are low and other aims – including broad employment goals and support for lending – also imply a need for sustained ultra-loose policy.

Strong growth and low rate environment should be supportive for private equity

Still, with recent data announcements showing stronger price pressures, investor are concerned about the risk of inflation. There are two main routes in which rising inflation could impact private equity performance.

First, higher inflation could stifle earnings growth if it were accompanied by a substantial deterioration in the outlook for real economic growth. However, we think that growth should remain remarkably strong across developed market economies over the next few years as economies recover from the pandemic. That said, the impact of the pandemic will be longer lasting for some sectors, such as international travel and office and retail property.

Second, higher inflation could impact what investors are willing to pay for company earnings. If, contrary to our view, price pressures result in a meaningfully higher cost of debt, company valuation and deal making would be adversely affected. 'Growth' companies would be particularly vulnerable. Compared to other firms, the earnings of growth companies are expected to occur further in the future and the present value of those earnings are more effected by expectations of higher interest rates. Higher interest rates may make alternative asset classes more attractive, making fundraising more challenging. A higher rate of inflation may also introduce greater uncertainty about future growth and interest rates, making investors

more cautious about how much they are willing to pay for companies.

While supply constraints in some sectors are contributing to the increase in inflation, overall we are still anticipating a strong rebound in activity in most economies as re-opening continues and fiscal policy remains supportive. When central banks do start to respond to above-target inflation, we think that they will feather, rather than stamp, on the brakes. As such, debt servicing costs should rise only marginally in the years ahead. Private equity should continue to receive support from a strong growth and low interest rate environment.

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