Why institutional investors should be wary of inflation

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In the wake of the coronavirus crisis, the stock market has recovered to pre-pandemic levels for various reasons, but institutional investors shouldn’t be overly optimistic and must keep risks top of mind, said Campbell Harvey, a professor of finance at Duke University, when speaking at the Canadian Investment Review’s 2020 Global Investment Conference in September.

Some reasons for the stock market recovering include fiscal stimulus, expectations for a robust recovery, the growth of technology stocks, the resurgence of retail investors and the rise of momentum investors, he said. “All of these reasons for the stock market being high are valid reasons, but what I worry about is the downside . . . . I see the risk of people being overly optimistic, people essentially downplaying information that they shouldn’t be discounting.”

Further, a debt overhang is a risk. “That is essentially [when] there’s just so much debt that it’s really hard for companies to go out and finance viable projects that could lead to robust growth.”

But the primary risk facing the economy is a surge in inflation, Harvey said. While inflation didn’t manifest following the global financial crisis, this time is different. “I really worry about extrapolating from a single data point. The [quantitative easing] this time is unlimited. That’s a lot different than in the past. And again, just because we haven’t seen inflation in the past, we cannot assume that we will not see it. And it is true that the bond market has completely ignored this.”

Investors are facing an environment fraught with risk, he said. “You’ve got a stock market that could be exhibiting irrational exuberance. You’ve got bond prices that are very high. Nothing is really safe. You buy a 10-year government bond, you think that’s safe? No way. If there is a pop in inflation, that is a very risky investment.”

Despite the unusual times, Harvey believes the economy will recover, but there has been damage done. “Some of the damage is just accelerating what we already thought was going to happen. Many of the firms that have gone bankrupt are firms that were going to go bankrupt anyway. But there’s another level of damage. And that is the small- and medium-sized businesses that have gone out of business that don’t make the headlines in the media, yet account for half of the employment in the U.S. and probably a similar amount in Canada.”

To think no structural damage has been done to the economy is naïve, he added, encouraging investors to look at history and notice the differences, not the similarities. For instance, the coronavirus recession is short with more certainty about a resolution. “However, we can’t be wearing rose-coloured glasses. There is damage. And that needs to be taken into account.”