



This is a financial promotion. Your capital is at risk, the value of investments may fall and rise and you may not get back the full amount you invested. Past performance is not indicative of future returns.

### **What is the outlook on inflation in the context of record levels of both fiscal and monetary stimulus?**

In our base case scenario, developed market inflation is expected to increase from 0.7% in 2020 to 2.0% in 2021 and carry on at 2-3% in the US and 1.5-2% in Europe through to 2025 which is slightly above consensus estimates. The main factors supporting our base case view of moderately higher inflation are consumption increases resulting from the easing of mobility restrictions (which will mainly impact 2021), combined with aggressive (but not excessive) fiscal stimulus aimed at infrastructure and green investments which will persist over time.

However, there is a more severe high inflation scenario over the next five years which could result from an even more progressive political agenda across developed markets. Such an agenda would be characterised by persistent fiscal largesse aimed at income support rather than investment, continued easy monetary policy, increased supply chain frictions as a result of both greater protectionism and post-pandemic supply chain localisation, and finally policies aimed at income redistribution. Investment implications of moderately higher inflation include favouring inflation-linked bonds over nominals, equities over liquid credit, real assets over cash, and discretionary active strategies over quantitative strategies. The more severe upside inflation scenario is lower in probability due to likely checks and balances from resulting tighter monetary policy. This would result in lower returns in both fixed income and equity-linked assets.

### **Inflation Outlook**

Perhaps the biggest macro question on investors' minds today is whether inflation will rise quickly enough to cause interest rates to rise sharply and derail both the nascent economic recovery and the valuations underpinning growth stocks that have buoyed portfolios through the pandemic.

It is already known that near-term inflation measures will rise temporarily in Q2 2021 (e.g. US CPI to rise by 3.2% YoY), mainly due to base effects from low inflation in Q2 2020. Such near-term spikes should be disregarded as they are expected and will have little policy impact. Our focus is more on the medium term (3-5 years) corresponding to our tactical investment horizon. Over this period, a variety of expert forecasts shown in Exhibit 1 point to relatively subdued inflation (well below 2%) across developed markets, with the exception of the US (which is only just above 2%). Data from inflation breakeven markets are broadly consistent with these forecasts. Finally, Fed Chairman Jerome Powell announced on the 24th of February that it may take more than three years before the Fed would reach its inflation goal of 2%.

**Exhibit 1**

**Within the major developed economies, the US is expected to experience the highest inflation levels and Europe and Japan the lowest**

Source	Global	US	Eurozone	UK	Japan
IMF (2021-2025 ave.)	3.7%	2.2%	1.2%	1.6%	0.6%
JP Morgan (2021-2022 ave.)	2.0%	2.0%	1.0%	1.7%	0.1%
Goldman Sachs (2021-2023 ave.)	2.2%	2.1%	1.2%	1.8%	0.1%
Deutsche Bank (2021-2023 ave.)	n/a	1.8%	1.0%	1.8%	0.1%
Capital Economics (2021-2022 ave.)	2.5%	2.4%	0.8%	1.6%	0.1%
<b>Average</b>	<b>2.6%</b>	<b>2.1%</b>	<b>1.0%</b>	<b>1.7%</b>	<b>0.2%</b>

Source: IMF, JPM, Goldman Sachs, Deutsche Bank, Capital Economics

Despite these relatively benign base-case forecasts, more cautious views from experts such as BCA suggest that medium-term risks to inflation are likely to be skewed to the upside as output gaps across the developed world collapse. BCA sees risks of DM inflation averaging between 3% and 5% in the second half of this decade.

Forecasting any economic variable is never an exact science and inflation is certainly no exception. To the same extent that inflationary risks were vastly underestimated in the 1970s, they tended to be overestimated in subsequent decades through to the present. This more recent overestimation occurred in the context of ultra-low interest rates post GFC putting into question the basic tenets of monetarist economic theory and weakening the link between money supply and inflation. In the post-pandemic world, more accommodative fiscal policy is expected to turbocharge rather than offset monetary policy by accelerating money velocity and potentially catalysing higher inflation.

Our base-case scenario calls for developed market inflation to recover rapidly from 0.7% in 2020 to 2.0% in 2021 and carrying on at 2-3% in the US and 1.5-2% in Europe through to 2025. This relatively benign outcome would result from the checks and balances that exist across advanced economies in the form of independent central bank policy with inflation control as a formal mandate, as well as the lack of a clear legislative majority for extreme fiscal spending. Such an outcome would be supportive of economic growth and equity markets.

For example, in the US which currently has the largest fiscal spending packages under consideration, incremental fiscal spending over the next 10 years (excluding the 2021 “Relief Act” proposal) is expected to amount to \$1.8T, including about \$700B in new outlays for infrastructure, subsidies for electric vehicles, subsidies for R&D related to climate change, additional Federal procurement funds to purchase products made in America, nearly \$800B to expand health care coverage, and \$250B in savings from reducing drug prices. Much of this spending will be offset by incremental tax revenue estimated at \$1.5T over the same period, thereby reducing inflationary pressures (Exhibit 2). Moreover, much of the spending is aimed at investments in infrastructure and green technologies which are likely to boost potential growth over the period, also limiting inflationary pressures.

Conversely, while not our base scenario, there is a meaningful risk that a more fiscally expansive political agenda takes hold over the coming years, and in particular the focus of such an agenda is less geared towards investing in growth infrastructure, but rather in direct transfers to households thereby increasing consumption and not growth potential. In such a scenario, inflation could rise above 3% and provoke interest rate rises that lead to a faster but shorter economic cycle compared to the long and slow burning 12-year post-GFC expansion. This scenario would more closely resemble the boom/bust cycles that were more commonplace prior to the Great Moderation.

## The Output Gap - A framework for assessing inflation risks

To assess the potential for higher inflation, we lean heavily on the output gap framework detailed in previous editions of Partners Capital Insights. At its most basic level, inflation simply represents the rate of change of overall price levels across an economy. It is nothing more than a macro-level aggregation of all the micro-level price changes. Hence, the basic supply/demand framework that informs price changes of individual goods and services can be extended to the level of the overall economy. The most fundamental measure of supply and demand imbalances at the aggregate level is the output gap, which represents the difference between actual and potential output in the economy. Potential output is not fixed, but generally grows over time in conjunction with increases in productivity and demographics. These effects tend to evolve slowly, while actual output varies more dynamically in response to immediate economic developments, including both shocks and stimulus. One can think of potential output as the capacity for the economy to grow (a supply function of labour force and productivity) and actual output as demand. As demand spikes stretch the bounds of potential output, prices rise. The more actual output exceeds potential, the more inflation.

Potential output has expanded rapidly since the 1980s via technologically driven productivity gains combined with improving global demographics (in particular developed economies being able to access cheaper Asian labour supply). Actual output was adversely impacted by last year’s COVID-19 pandemic which created both a demand and supply shock as consumers stayed home and many businesses were forced to shutter their doors. However, the demand shock far outweighed the supply shock, reducing

### Exhibit 2

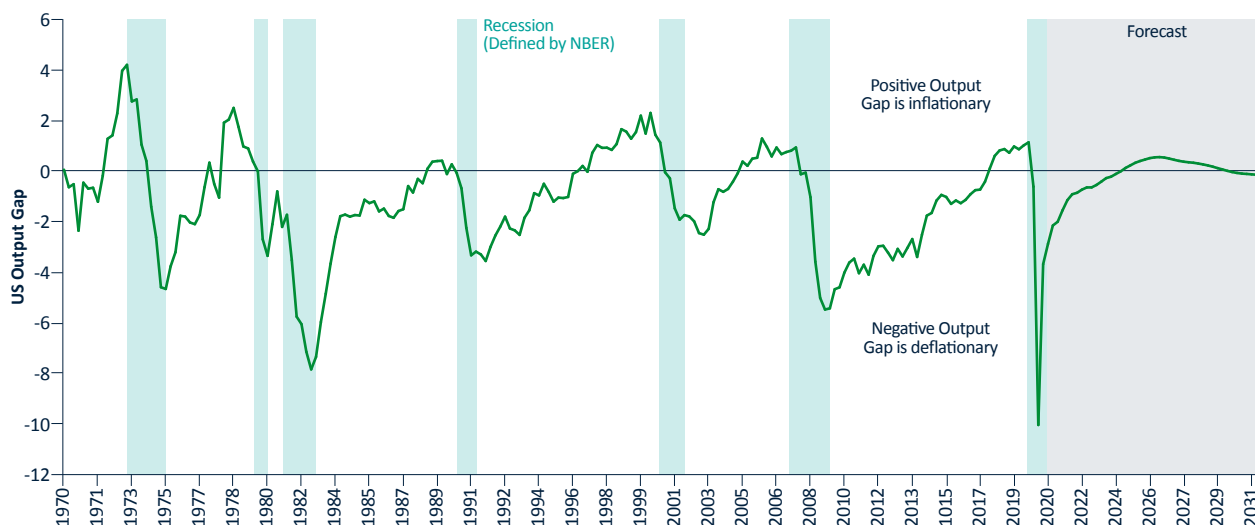
#### Biden Incremental Spending & Taxation -- tax revenues expected to offset incremental spending by 2026

	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	Total
Incremental Spending (\$B)	26	283	330	378	227	158	119	97	83	83	79	1,863
Incremental Taxes (\$B)	-49	-20	40	66	118	225	201	215	226	236	241	1,498
<b>Total Incremental Impact on Deficit (\$B)</b>	<b>-75</b>	<b>-304</b>	<b>-290</b>	<b>-312</b>	<b>-109</b>	<b>67</b>	<b>82</b>	<b>118</b>	<b>142</b>	<b>153</b>	<b>163</b>	<b>-364</b>

Source: Cornerstone Research

### Exhibit 3

#### Output gaps widen in recessions and narrow in expansions



Notes: Blue, Grey shading shows recessions

Sources: US Congressional Budget Office, NBER

economic output and creating a strong but temporary disinflationary impulse as shown in Exhibit 3 – along with other trends in inflation over the past few decades for context. As can be seen, current projections post 2021 suggest the output gap will temporarily turn mildly positive before it turns negative again, increasing then decreasing inflationary pressures.

### Historical context shows fiscal stimulus is a big driver of inflation

Looking back on the past 90 years of US inflation history in Exhibit 4, we see two periods of exceptionally high (double-digit) inflation. The first of these was in the early 1930's in the aftermath of the Great Depression when President Roosevelt initiated the "New Deal", which helped bring the US economy out of severe deflation. While a very different context from today, there were similarities in terms of greater fiscal spending, public works investment, public health care programmes and redistributive tax policies. Today the US administration has proposed a \$1.9T COVID-19 "Relief" programme with plans for another \$1.5T-\$2.0T infrastructure "Recovery" programme – the last of which is meant to include tax "Reforms" aimed at higher bracket taxpayers.

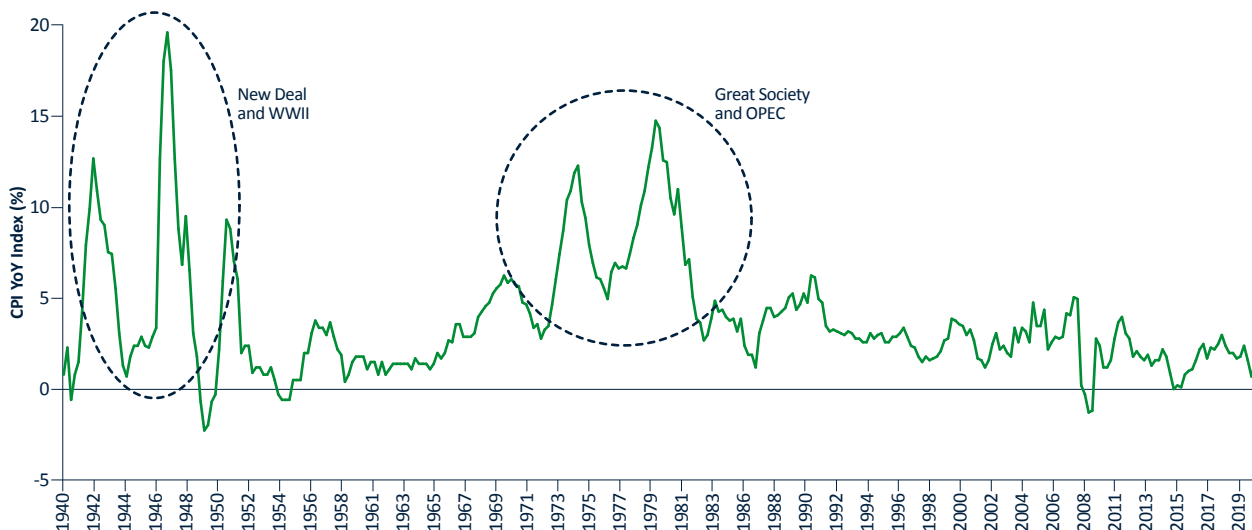
The second period of high inflation was in the late 1960's to late 1970's. Despite popular belief that this was all linked to 1970's OPEC prices rises, inflation started to rise sharply

as early as 1966, seven years before the OPEC oil shock of 1973. The root cause was greater fiscal spending needed to fund both the Vietnam War and President Johnson's Great Society programmes. These two "guns and butter" policies led the US budget deficit to expand from near zero in the early 1960's to 4% of GDP in the mid 1970's and overall fiscal spending to expand from 24% of GDP in 1965 to 30% of GDP in the early 1970's.

While fiscal spending can play an outsized role in generating inflation, other factors can contribute as well. The last thirty years have seen relatively moderate and steady inflation, despite a massive easing of monetary policy. Much of the more subdued inflationary cycles of this recent period can be explained using the output gap framework. While the globalisation trend of these three decades helped increase the supply of low-cost labour (boosting potential growth), the contraction of the GFC created a disinflationary impulse that was then offset by China's investment boom (fiscal spend narrowing the output gap). Subsequently, the end of the super-cycle (fiscal contraction) led to a collapse in commodity prices, but as unemployment levels fell from 2016 onwards (output gap narrowing) **inflation was on an uptrend** until COVID-19 hit (output gap widening). Interestingly, while the absolute level of inflation varies across major economies, the directional trends have been similar suggesting global forces are at work. We examine some of the drivers of the output gap further below, with fiscal stimulus being the most influential.

### Exhibit 4

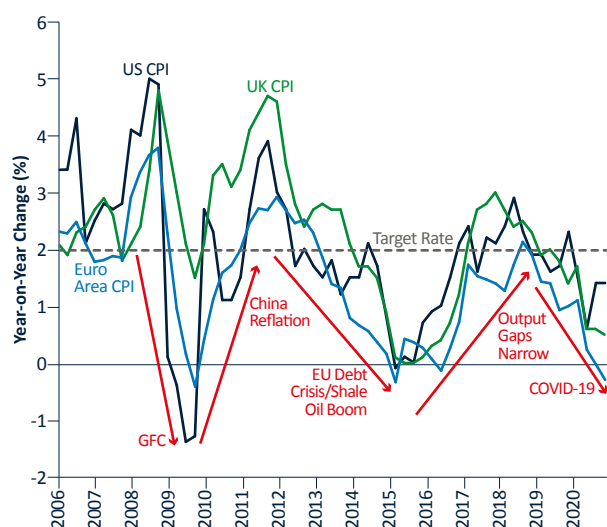
Since the 1930's, the two periods of double-digit inflation in the US coincided with large increases in fiscal stimulus combined with geopolitical crises.



Sources: Bloomberg

### Exhibit 5

The broad trends in inflation are similar across major western economies



Source: Partners Capital Analysis - data sourced from Bloomberg

## Assessing the main factors driving the output gap

There are three main factors cited as potentially leading to output gap compression and higher inflation. In order of relative importance, these are:

1. Massive fiscal stimulus, initially led by the US but swiftly extending to most developed economies. Policies also include a focus on income redistribution, reflected in tax policies and minimum wage increases.
2. An extended period of monetary stimulus including a more tolerant approach to inflation target overshoots by central banks.
3. Income redistribution (higher labour cost and taxes), increased supply chain frictions as a result of both greater protectionism and post-pandemic supply chain localisation (“cost-push” inflation).

### 1. Fiscal Stimulus

Fiscal stimulus is generally seen as more conducive to creating inflation than monetary stimulus for the simple reason that fiscal spending increases the velocity of money. This can be seen in Exhibit 6 in the 1970s when high fiscal spending led to inflation peaking at 15%. Velocity of money is defined as the frequency at which one unit of currency is used to purchase domestically produced goods and services within a given time period, and can also be measured as GDP growth over money supply growth. Monetary stimulus in the form of liquidity injections and

low interest rates increases the money base, but on its own does not necessarily translate into greater economic activity and inflation, as seen over the last decade. Exhibit 6 illustrates how the effects of huge increases in money supply in the US appear to have been fully offset by record low velocity of money, leaving us with average inflation of c. 2% p.a. The current situation is a 2.5x version of the last decade with an explosion of money supply which is hardly being spent. The inflation concern we have over the next five years is when we expect to see significant fiscal stimulus driving relatively high velocity of money.

The trend towards greater fiscal spending across developed markets stands in stark contrast to the fiscal austerity that was in vogue following the GFC. Lessons learned in that period by policymakers included not only that low interest rates on their own were not sufficient to boost economic growth and inflation, but also that the social inequalities that were exacerbated by the QE-fuelled asset-price inflation led to well-documented social and political instabilities.

Hence, beyond simple fiscal expansion, policymakers today are erring on the side of implementing policies favouring greater wealth and income distribution. Aside from proposals to converge tax rates on ordinary income and capital gains, both the US and the UK have floated plans to increase the minimum wage (from \$7.25 to \$15/hour in the US). Clearly, lower-income households tend to be more liquidity constrained, hence have higher marginal propensities to consume the additional unit of income.

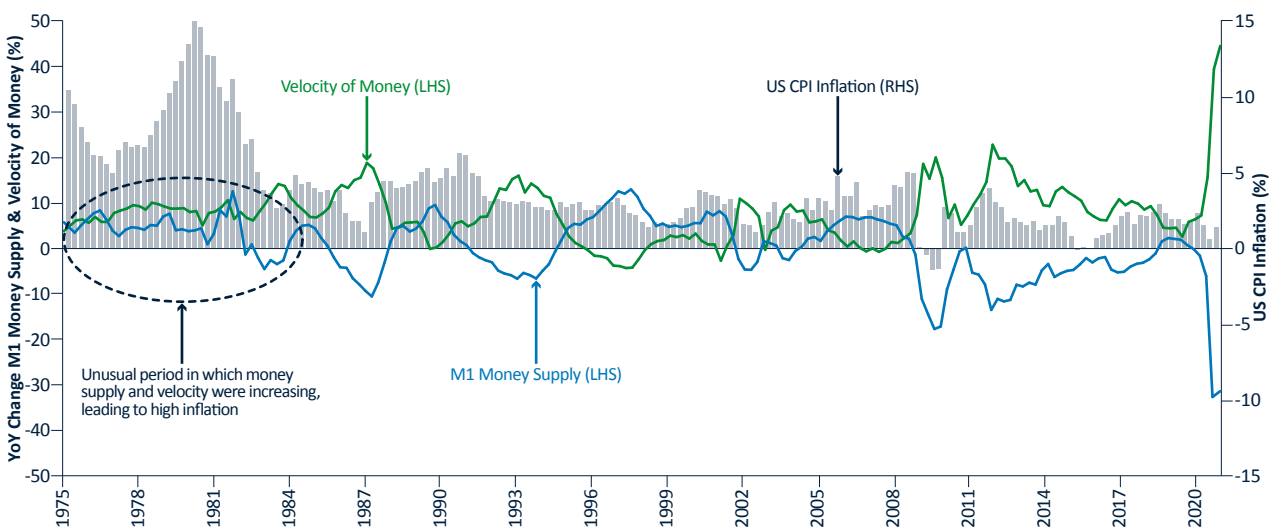
While some of these measures will be diluted and others may not ever become policy, in aggregate the progressive agenda has many inflationary aspects to it and appears likely to persist for many years to come. Ultimately, the level of inflation may depend on how far and for how long the political pendulum swings towards the progressive agenda.

**Base Case Scenario:** In the near term (i.e., 2021) the US is the country most prone to large-scale fiscal spending that is likely to eliminate the output gap and contribute towards inflation. The new administration is proposing c. \$1.9T of fiscal relief programmes in 2021, on top of the \$0.9T that was approved in December 2020 for spending in 2021. These unprecedented fiscal spending budgets include weekly transfers of \$400 directly to households just as rising mobility levels lead to increased consumption concurrent with the release of elevated levels of household savings (currently running at 14% of disposable income, or 11% of GDP, c. 2x average levels). The US output gap is currently estimated at c. \$50B/month and the combined effect of the above is estimated to contribute c. \$150B/month to economic activity, or c. 3x the current output gap resulting in a sharp spike in inflation to c. 3.2% in Q2.

Over the longer-term (next 5-10 years), more fiscal spending is being planned across developed markets. Once again the US currently has the largest fiscal spending packages under consideration, including incremental fiscal spending over the next 10 years (excluding the 2021 “Relief” spending detailed above) of another c. \$1.8T for economic recovery and infrastructure investment. Much of this spending will be

## Exhibit 6

### Increase in money supply only leads to inflation if it enters real economy (US data, through Sep 2020)



Source: Bloomberg, Partners Capital Analysis

offset by incremental tax revenue estimated at \$1.5T over the same period, thereby reducing inflationary pressures. Moreover, this spending is primarily aimed at investments in infrastructure and green technologies which are likely to boost the potential growth rate over the period, also limiting inflationary pressures. Longer term estimates point to a gradual decline in inflation from the 3.2% peak in mid-2021 to the 2-3% range. In Europe, member states have agreed an EU-wide fiscal budget of €1.7T for the next seven years, which includes a €750B recovery fund, under which Brussels will gain unprecedented powers to borrow hundreds of billions on the markets and hand it out as budgetary support to the most stricken member states. European inflation estimates over the longer-term remain more subdued in the 1.5-2% range due to structurally high unemployment.

**High Inflation Scenario:** The upside inflation scenario is mainly a concern if it persists over the longer-term. Such a scenario could result not only from a larger quantum of spending, but more likely from the qualitative nature of that spending, particularly if, after the immediate recovery from COVID-19, the political agenda continues to favour spending on direct income transfers (which boosts consumption demand and inflation) rather than investment in infrastructure and economic capacity (which boost potential growth and hence less inflationary). However, as long as the Fed and other central banks remain independent with inflation limiting charters, any associated rise in inflation is unlikely to exceed the mid-single digits. At present, there does not appear to be legislative support for such a shift, so this remains a low probability scenario.

## 2. Monetary stimulus impact on inflation

Many point to the surge in money supply (see Exhibit 6) as a precursor to inflation, but the data suggest a secular cycle of inflation (as opposed to just a cyclical increase) would require the combination of higher money velocity as well as much less labour market slack. We expect monetary policy will facilitate the impact of fiscal policy, but not contribute to inflation on its own. As we learned post-GFC, massive liquidity injections do not automatically directly add inflationary pressure, but rather add liquidity to the financial system. Without liquidity, fiscal stimulus may not have its desired effect. So indirectly, monetary stimulus can contribute to inflation through its impact on fiscal policy as the effects of money supply growth and money velocity acceleration caused by massive fiscal spending programmes are combined.

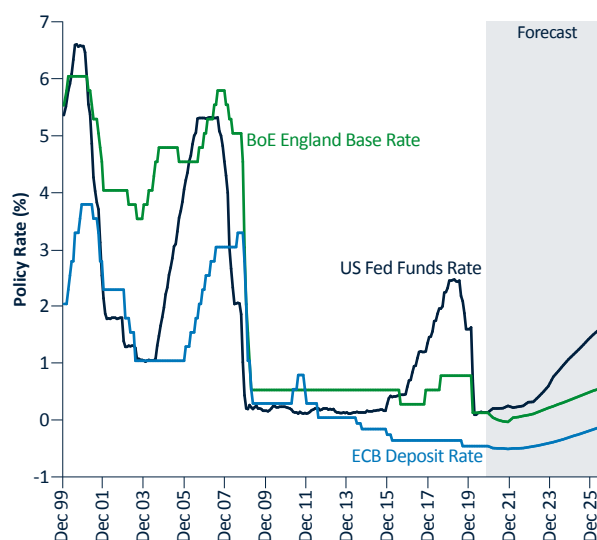
The more relevant stand-alone monetary policy lever that can more directly impact inflation is of course interest rates. Central banks have clearly signalled their policies with respect to average inflation targeting at the 2% level in most countries. Recent history suggests the major central banks can only make small mistakes of timing interest rate

moves, with such mistakes only having a temporary impact on inflation. There is little debate about the interest rate policy of any central bank leading to high sustained inflation on its own. Accordingly, we cannot see monetary policy contributing to the high inflation scenario other than through its accommodation of fiscal policies that are the major drivers of the high inflation scenario.

**Base Case & High Inflation Scenario:** Central banks will adhere to their guidance and continue with large scale asset purchases throughout 2021 which increases money in circulation. Most recently, the US Federal Reserve explicitly committed to purchase at least \$80 billion per month of Treasuries and agency mortgage-backed securities until "substantial further progress" has been made towards its inflation and employment goals. The European Central Bank indicated in December that, amongst other measures, it will continue to purchase approximately €20 billion per month until March 2022.

Furthermore, we envisage central banks will keep policy rates accommodative even in the face of moderately rising inflation, i.e., slightly above the 2.0% target. This tolerance of higher inflation will help support fiscal spending in generating inflation. First, despite ongoing asset purchase (QE) programmes, bond yields are starting to rise in anticipation of inflation and an increasing amount of debt issuance needed to fund the fiscal spending mentioned above. So regardless of what central banks are doing at the short end (as shown in Exhibit 7 below), rates on longer dated bonds are expected to rise and to dampen inflation over all time frames.

**Exhibit 7**  
Central Banks are expected to keep interest rates low until at least 2023



Source: Bloomberg

If, in the high inflation case, inflation rates were to rise above 3% in the US and above 2% in Europe, central banks will be faced with a stark choice of whether to raise rates to contain the rise, or to allow the value of household income to be inflated away. Many experts believe that even a populist central banker will opt for the former as per their official charters, but in the meantime they are content to allow markets to think otherwise. In the case of inflation much above target, we have little doubt central banks will eventually act to raise interest rates to contain inflation in line with their mandates. However, if they delay for too long in the face of rising inflation, they will be forced to raise rates more aggressively, creating economic instability and impacting asset prices.

### 3. Input cost inflation

Our focus here is on the effect of the following global trends which could be inflationary by increasing the cost of goods and services, i.e., cost-push inflation:

- Onshoring and diversification of supply sources in response to the pandemic during which producers that were overly dependent on one source suffered the most. This will logically diversify sources away from China and potentially to higher cost sources with lower economies of scale from concentrated sourcing.
- Protectionist policies from nationalist political elements or from trade tensions aimed at balancing out inequities between trading partners. Again, the focus here is on China but could also apply to the UK leaving the EU.
- Wealth redistribution where corporate and consumption taxes rise and minimum wages are increased.
- Labour unions regaining power and raising the labour costs.

To the extent that these movements raise average household incomes, we should see this cost-push inflation result in more demand-based inflation.

**Base Case Scenario:** This is an oft-cited potential source of price pressure that will probably have the least long-term impact on inflation. The earlier question on COVID-19's long-term impact outlines how many companies are looking to onshore and/or diversify parts of their supply chains to prioritise logistical reliability over just-in-time cost benefits. While the short-term effects of such moves could indeed be inflationary, there are three limiting factors on how much this could increase inflation over the longer-term. First, such changes may produce one-off rises in costs, but once a certain amount of capacity is localised for insurance purposes, there is no reason for prices to continue to rise significantly over multiple years, particularly if the cost differential grows too large. Second, increases in productivity will eventually dilute the impact

of higher labour costs. Finally, China is also expected to see its cost advantages continue to erode over time as labour rate differentials converge suggesting a smaller amount of inflation relative to a case of no onshoring.

**High Inflation Scenario:** A number of income redistribution measures could raise costs. The Biden administration is proposing a plan to “encourage and incentivise unionisation and collective bargaining”. It has also proposed more than doubling the current federal minimum wage of \$7.25/hour to \$15/hour. In this scenario, we see a combination of rising labour costs from direct social policies and the inflationary consequences of protectionism and supply chain onshoring as described in the base case. Additionally, the more aggressive fiscal spending programmes would likely result in higher priced commodities related to certain infrastructure programmes. We would struggle to put a figure on these input-cost rises on inflation but see them as meaningful contributors to our 3-5% estimated inflation in this high inflation scenario.

## Conclusion

We summarise our inflation assumptions in Exhibit 8 over the two different time frames and for the base case and high inflation scenarios. We stress that as we look out to 2023-25, we naturally have lower confidence in narrow range estimates, and emphasise simply that there are potential fiscal spending, monetary policy and input cost outcomes that could drive inflation up above 3%. These outcomes are less likely to cause inflation to exceed 5% for sustained periods as we have not seen sustained multi-year inflation anywhere near 5% p.a. since the 1980s. Today, we feel governments are far more sophisticated in their use of fiscal and monetary tools to manage inflation within desired ranges. That being said, the scale of stimulus combined with a bold economic recovery and the “could be” effects of deglobalisation and income redistribution is a dangerous cocktail of inflation drivers.

## What signals may point to the high inflation scenario emerging?

If our base case scenario is realised, inflation expectations will rise slowly as deficits and government indebtedness increase, and central banks have sufficient time to rein in inflation threats with moderately higher interest rates. However, the complex dynamic systems that drive financial markets do not always react linearly to increasing stimulus. Instead, there are transitions where nothing happens for a very long time and then very suddenly the system accelerates in one direction or another with little or no prior warning. Deficit spending can work very well for many years until suddenly trust in the government disappears and inflation skyrockets. Students of the financial history



from the hyperinflation of 1920's Weimar Germany to the milder inflation of the 1970's across the developed world will know that inflationary periods can materialise within months and without warning, or in reaction to one seemingly innocuous policy move. Key signals to watch for potentially higher than expected inflation include:

- A more extreme political shift in developed economies towards progressive, expansionist and distributive policies resulting in fiscal excess beyond expected levels
- Successive months of upside inflation target 'misses' being ignored and dismissed by central banks
- Sharp price rises in economic sectors not originally impacted by COVID-19
- Producer price movements (generally portent consumer price moves to follow)

## Investment Implications

**Base Case Inflation:** Moderately rising inflation is not necessarily a negative for equities and other risk assets. According to a recent study by Goldman Sachs, inflation is positively correlated with earnings because rising prices translate into faster nominal revenue growth. Although input costs also rise, the boost to nominal sales more than offsets inflation-driven margin compression. All else equal, a 100bp increase in average annual core CPI would boost 2021 S&P 500 EPS by around \$1/share (on top of the current \$174 forward EPS forecast for 2021). Wage cost pressure on margins should also be muted in the near term.

From a valuation standpoint, history shows that multiples can remain high or continue to expand when inflation rises from a relatively low starting point. Early in the economic cycle, inflation is low and rises as economic growth

## Exhibit 8

### Summary of our Base Case and High Inflation Case Scenarios<sup>1</sup>

Scenario	Base Case Inflation Scenario	High Inflation Scenario
<b>Near Term Inflation (2021-22)</b> — product of "V" recovery + fiscal support	<ul style="list-style-type: none"> <li>— US: 2.4%</li> <li>— UK: 1.7%</li> <li>— Europe: 1.8%</li> </ul>	<ul style="list-style-type: none"> <li>— US: 3%</li> <li>— UK: 2.2%</li> <li>— Europe: 2.3%</li> </ul>
<b>Longer Term Inflation (2023-25)</b> — product of fiscal, monetary policies and cost-push inflation (from de-globalisation and income redistribution)	<ul style="list-style-type: none"> <li>— US: 2-3%</li> <li>— UK: 1.5 – 2.5%</li> <li>— Europe: 1.5 – 2%</li> </ul>	<ul style="list-style-type: none"> <li>— US: 3.0 – 5.0%</li> <li>— UK: 3.0 – 5.0%</li> <li>— Europe 2.5 – 4.0%</li> </ul>
<b>Primary long-term drivers</b>	<ul style="list-style-type: none"> <li>— <b>Fiscal policy:</b> Moderately rising fiscal stimulus in US and Europe. Focus on infrastructure and decarbonisation investments which are slow</li> <li>— <b>Monetary policy:</b> Slow increase in yields initially at the long-end from the tapering of QE; followed by short rate increases</li> <li>— <b>Cost-push</b> inflation from income retribution and onshoring largely offset by tech-driven productivity growth</li> </ul>	<ul style="list-style-type: none"> <li>— <b>Fiscal policy:</b> Excessive fiscal stimulus; investment focus on income support and transfers vs investment</li> <li>— <b>Monetary policy:</b> Slow to adjust in 2021/22, forced to raise more sharply later.</li> <li>— <b>Cost-push</b> inflation from on-shoring and diversifying supply chain. Labour cost rises from higher min wage, rising union power.</li> </ul>
<b>Interest Rate Assumptions</b>	<ul style="list-style-type: none"> <li>— <b>10 year Treasury yield:</b> 1.7% end 2021, 3.0% end 2025 (vs 2.5% 5Y forwards today)</li> <li>— <b>10 year Bund yield:</b> 0.2% end 2021; 1.5% end 2025 (vs 0.18% 5Y forwards today)</li> </ul>	<ul style="list-style-type: none"> <li>— <b>10 year Treasury yield:</b> 1.9% end 2021; 3.5% end 2025</li> <li>— <b>10 year Bund yield:</b> 0.5% end 2021; 3.0% end 2025</li> </ul>
<b>US Dollar Assumptions (2023):</b>		
vs Euro	— \$/€ Small downside bias	— \$/€ Lower initially, then higher when Fed raises aggressively
vs Yen	— \$/Y Higher	— \$/Y Lower
vs £	— \$/£ Within recent ranges	— \$/£ Lower, then higher when Fed raises

Source: Partners Capital Analysis

<sup>1</sup>These estimates of performance returns are based upon certain assumptions which should not be construed to be indicative of actual events that will occur. There is no assurance that the performance presented will be achieved. Please see important Disclaimers at the end of this document

---

accelerates and consumer demand increases. Later in the cycle, higher real yields and margin pressure push inflation higher as companies combat higher input costs and respond to strong demand by raising prices. As a result, valuations have historically declined when core PCE has climbed higher than 2%. Looking forward, that negative impact on valuations from rising inflation will likely occur at higher levels of inflation than in the past given the Fed's recent adoption of flexible average inflation targeting (AIT). The AIT strategy means the Fed will temporarily lift its inflation target to roughly 2.25-2.5% when core inflation has fallen short of its standard 2% target. As a result, the headwinds to valuations from inflation should also only occur near the new target inflation rate.

From a sector perspective, rising inflation has been most positively correlated with the earnings and performance of cyclical and value stocks. Because inflation generally rises when economic growth accelerates, stocks that are most levered to economic activity outperform most during periods of rising inflation. Inflation also lifts commodity prices and nominal interest rates, so it is unsurprising that, at the sector level, financials and commodity-exposed sectors perform best when prices rise. Inflation typically poses a particularly large risk for growth stock valuations, but the Fed's new strategy reduces this risk somewhat. Equities with high long-term growth prospects have a higher share of their present value derived from cash flows expected far in the future, making them more sensitive to changes in interest rates, all else equal. However, in this lower-for-longer interest rate environment, investors will continue to prize growth in the medium term.

**High Inflation Scenario** – A scenario where inflation exceeds 3% for sustained periods and central banks are slow to react before being forced to tighten monetary policy sharply would be unequivocally negative for most asset classes, including public and private sector debt, as well as equities and related assets. Two potential winners in this scenario could be discretionary macro hedge funds as well as certain commodities sectors.

## DISCLAIMER

Copyright © 2023, Partners Capital Investment Group LLP

Within the United Kingdom, this material has been issued by Partners Capital LLP, which is authorised and regulated by the Financial Conduct Authority of the United Kingdom (the “FCA”), and constitutes a financial promotion for the purposes of the rules of the Financial Conduct Authority. Within Hong Kong, this material has been issued by Partners Capital Asia Limited, which is licensed by the Securities and Futures Commission in Hong Kong (the “SFC”) to provide Types 1 and 4 services to professional investors only. Within Singapore, this material has been issued by Partners Capital Investment Group (Asia) Pte Ltd, which is regulated by the Monetary Authority of Singapore as a holder of a Capital Markets Services licence for Fund Management under the Securities and Futures Act and as an exempt financial adviser. Within France, this material has been issued by Partners Capital Europe SAS, which is regulated by the Autorité des Marchés Financiers (the “AMF”).

For all other locations, this material has been issued by Partners Capital Investment Group, LLP which is registered as an Investment Adviser with the US Securities and Exchange Commission (the “SEC”) and as a commodity trading adviser and commodity pool operator with the Commodity Futures Trading Commission (“CFTC”) and is a member of the National Future’s Association (the “NFA”).

This material is being provided to clients, potential clients and other interested parties (collectively “clients”) of Partners Capital LLP, Partners Capital Asia Limited, Partners Capital Investment Group (Asia) Pte Ltd, Partners Capital Europe SAS and Partners Capital Investment Group, LLP (the “Group”) on the condition that it will not form a primary basis for any investment decision by, or on behalf of the clients or potential clients and that the Group shall not be a fiduciary or adviser with respect to recipients on the basis of this material alone. These materials and any related documentation provided herewith is given on a confidential basis. This material is not intended for public use or distribution. It is the responsibility of every person reading this material to satisfy himself or herself as to the full observance of any laws of any relevant jurisdiction applicable to such person, including obtaining any governmental or other consent which may be required or observing any other formality which needs to be observed in such jurisdiction. The investment concepts referenced in this material may be unsuitable for investors depending on their specific investment objectives and financial position.

This material is for your private information, and we are not soliciting any action based upon it. This report is not an offer to sell or the solicitation of an offer to buy any investment. While all the information prepared in this material is believed to be accurate, the Group, may have relied on information obtained from third parties and makes no warranty as to the completeness or accuracy of information obtained from such

third parties, nor can it accept responsibility for errors of such third parties, appearing in this material. The source for all figures included in this material is Partners Capital Investment Group, LLP, unless stated otherwise. Opinions expressed are our current opinions as of the date appearing on this material only. We do not undertake to update the information discussed in this material. We and our affiliates, officers, directors, managing directors, and employees, including persons involved in the preparation or issuance of this material may, from time to time, have long or short positions in, and buy and sell, the securities, or derivatives thereof, of any companies or funds mentioned herein.

Whilst every effort is made to ensure that the information provided to clients is accurate and up to date, some of the information may be rendered inaccurate by changes in applicable laws and regulations. For example, the levels and bases of taxation may change at any time. Any reference to taxation relies upon information currently in force. Tax treatment depends upon the individual circumstances of each client and may be subject to change in the future. The Group is not a tax adviser and clients should seek independent professional advice on all tax matters.

Within the United Kingdom, and where this material refers to or describes an unregulated collective investment scheme (a “UCIS”), the communication of this material is made only to and/or is directed only at persons who are of a kind to whom a UCIS may lawfully be promoted by a person authorised under the Financial Services and Markets Act 2000 (the “FSMA”) by virtue of Section 238(6) of the FSMA and the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (including other persons who are authorised under the FSMA, certain persons having professional experience of participating in unrecognised collective investment schemes, high net worth companies, high net worth unincorporated associations or partnerships, the trustees of high value trusts and certified sophisticated investors) or Section 4.12 of the FCA’s Conduct of Business Sourcebook (“COBS”) (including persons who are professional clients or eligible counterparties for the purposes of COBS). This material is exempt from the scheme promotion restriction (in Section 238 of the FSMA) on the communication of invitations or inducements to participate in a UCIS on the grounds that it is being issued to and/or directed at only the types of person referred to above. Interests in any UCIS referred to or described in this material are only available to such persons and this material must not be relied or acted upon by any other persons.

Within Hong Kong, where this material refers to or describes an unauthorised collective investment schemes (including a fund) (“CIS”), the communication of this material is made only to and/or is directed only at professional investors who are of a kind to whom an unauthorised CIS may lawfully be promoted by Partners Capital Asia Limited under the

Hong Kong applicable laws and regulation to institutional professional investors as defined in paragraph (a) to (i) under Part 1 of Schedule to the Securities and Futures Ordinance (“SFO”) and high net worth professional investors falling under paragraph (j) of the definition of “professional investor” in Part 1 of Schedule 1 to the SFO with the net worth or portfolio threshold prescribed by Section 3 of the Securities and Futures (Professional Investor) Rules (the “Professional Investors”).

Within Singapore, where this material refers to or describes an unauthorised collective investment schemes (including a fund) (“CIS”), the communication of this material is made only to and/or is directed only at persons who are of a kind to whom an unauthorised CIS may lawfully be promoted by Partners Capital Investment Group (Asia) Pte Ltd under the Singapore applicable laws and regulation (including accredited investors or institutional investors as defined in Section 4A of the Securities and Futures Act).

Within France, where this material refers to or describes to unregulated or undeclared collective investment schemes (CIS) or unregulated or undeclared alternative Investment Funds (AIF), the communication of this material is made only to and/or is directed only at persons who are of a kind to whom an unregulated or undeclared CIS or an unregulated or undeclared AIF may lawfully be promoted by Partners Capital Europe under the French applicable laws and regulation, including professional clients or equivalent, as defined in Article D533-11, D533-11-1, and D533-13 of the French Monetary and Financial Code.

Certain aspects of the investment strategies described in this presentation may from time to time include commodity interests as defined under applicable law. Within the United States of America, pursuant to an exemption from the US Commodity Futures Trading Commission (CFTC) in connection with accounts of qualified eligible clients, this brochure is not required to be, and has not been filed with the CFTC. The CFTC does not pass upon the merits of participating in a trading program or upon the adequacy or accuracy of commodity trading advisor disclosure. Consequently, the CFTC has not reviewed or approved this trading program or this brochure. In order to qualify as a certified sophisticated investor a person must (i) have a certificate in writing or other legible form signed by an authorised person to the effect that he is sufficiently knowledgeable to understand the risks associated with participating in unrecognised collective investment schemes and (ii) have signed, within the last 12 months, a statement in a prescribed form declaring, amongst other things, that he qualifies as a sophisticated investor in relation to such investments.

This material may contain hypothetical or simulated performance results which have certain inherent limitations. Unlike an actual performance record, simulated results do not represent actual trading. Also, since the trades have not actually been executed, the results may have under- or over-

compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any client will or is likely to achieve profits or losses similar to those shown. These results are simulated and may be presented gross or net of management fees. This material may include indications of past performance of investments or asset classes that are presented gross and net of fees. Gross performance results are presented before Partners Capital management and performance fees, but net of underlying manager fees. Net performance results include the deduction of Partners Capital management and performance fees, and of underlying manager fees. Partners Capital fees will vary depending on individual client fee arrangements. Gross and net returns assume the reinvestment of dividends, interest, income and earnings.

The information contained herein has neither been reviewed nor approved by the referenced funds or investment managers. Past performance is not a reliable indicator and is no guarantee of future results. Investment returns will fluctuate with market conditions and every investment has the potential for loss as well as profit. The value of investments may fall as well as rise and investors may not get back the amount invested. Forecasts are not a reliable indicator of future performance.

Certain information presented herein constitutes “forward-looking statements” which can be identified by the use of forward-looking terminology such as “may”, “will”, “should”, “expect”, “anticipate”, “project”, “continue” or “believe” or the negatives thereof or other variations thereon or comparable terminology. Any projections, market outlooks or estimates in this material are forward-looking statements and are based upon assumptions Partners Capital believe to be reasonable. Due to various risks and uncertainties, actual market events, opportunities or results or strategies may differ significantly and materially from those reflected in or contemplated by such forward-looking statements. There is no assurance or guarantee that any such projections, outlooks or assumptions will occur.

Certain transactions, including those involving futures, options, and high yield securities, give rise to substantial risk and are not suitable for all investors. The investments described herein are speculative, involve significant risk and are suitable only for investors of substantial net worth who are willing and have the financial capacity to purchase a high risk investment which may not provide any immediate cash return and may result in the loss of all or a substantial part of their investment. An investor should be able to bear the complete loss in connection with any investment.

All securities investments risk the loss of some or all of your capital and certain investments, including those involving futures, options, forwards and high yield securities, give rise to substantial risk and are not suitable for all investors.