

Are central banks, asset prices, and inflation on a collision course?

Summary

What are the chances of meaningful inflation, and what tools to fight it are available to central bankers? In this Q&A, Reams Asset Management Chief Investment Officer Mark Egan delves into those questions and the risks they entail for investors, central banks, and economies around the world.

Reams Asset Management, an affiliate of Carillon Tower Advisers, was founded in 1981 and manages \$22.8 billion across a range of fixed income strategies for a predominantly institutional client base. Reams applies a time-tested opportunistic approach that seeks to maximize risk-adjusted total return by taking advantage of market dislocations and periods of heightened volatility while also focusing on potential downside risks.*

Mark Egan is the chief investment officer and a managing director at Reams Asset Management, with more than 30 years of experience managing fixed income portfolios. Before joining Reams in 1990, he was a portfolio manager at National Investment Services of America. Mark earned his master's in business administration from the University of Wisconsin-Madison and his bachelor's degree from Marquette University. He holds the Chartered Financial Analyst (CFA) designation and is a member of the CFA Institute.



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Looking ahead, how much inflation will we see and when will we see it?

Inflation is a misunderstood concept. When most people talk about inflation, they are usually talking about 1970s-style inflation that's running anywhere from 5% to double digits, or much, much higher if you look at extreme episodes like the Weimar Republic or Zimbabwe. If you look back over time though, the 1970s was a very anomalous period in terms of inflation in the U.S. post-World War II. But ever since the Global Financial Crisis of 2008-09, and really stretching back to the 1980s, all we have seen on a sustained basis is asset price inflation, which people don't find as pernicious or as destructive. Actually, it is.

What central banks around the world are looking for now is to transition away from asset price inflation to more traditional consumer price inflation. But this task has been very, very difficult to achieve. Exhibit No. 1 would be Japan, but you're also seeing this in continental Europe and even in the U.S., where you've had the deflationary demographic forces of aging populations and declining birth rates working against very loose monetary policy. But now I think that, in the U.S. anyway, with fiscal policy completely transformed over the past 12 months and probably for the foreseeable future, there's a solid chance that for a time we're going to see an acceleration of traditional Consumer Price Index-led inflation. And in the U.S. at least, it could be rather significant and perhaps shockingly so. The U.S. Federal Reserve has talked about being prepared for a transitory inflation level may be as high as 4% or even 5%.

If central banks successfully pump up inflation, will they be able to control it?

That's very difficult. In the '70s the demographics were really different, and you had this wage-price spiral plus some important currency and commodity factors at play. Now the critical issue is mounting debt and asset price inflation, with assets on one side of the balance sheet and debt on the other. We've seen a serial popping of bubbles where assets can deflate, but the debt remains. The bad debt never gets fully written down. And that was the fear in central bank policy: If you raise interest rates because of bad inflation as we did in the late '70s, it will cause a recession. But look at debt levels back in the late '70s and early '80s, they were a fraction of what they are today.

So central banks can raise interest rates in response to bad inflation, but the destructive effects that we've pushed off to the future time and time again are still there. You have asset prices at tremendous levels. You also have high levels of debt. If you attack inflation in the traditional means by removing liquidity and raising interest rates, the possibility of a systemic crash in asset prices is real. And I think it's

actually quite frightening. The consequences of a deep recession are much higher now and the margin of error in terms of policy mistakes is razor thin. Before when we went through the Global Financial Crisis or more recently the pandemic-induced recession, central banks had the tools, lowering interest rates and buying assets, to support markets and avoid a full-blown collapse. I think the real risk going forward is that if they're faced with inflation at the same time as an economic downturn or market correction, what are they going to do? How are they going to be able to pursue these counteracting strategies?

We are in a very treacherous time - a transition away from 40 years of declining interest rates and serial asset price inflation. I don't know if anybody here is old enough to remember the late '70's and early '80s, but I certainly do. It was a very difficult time and a very difficult transition. We think this upcoming transitional period will be different, it will have its own unique character, but it's going to be very, very difficult to make that transition without a significant amount of pain.

If we should prepare for a return to some form of normality, what would that look like? Could it be similar to, for example, what we saw back in 2005-'06?

It depends on what you define as normal. We always look to real interest rates, which are nominal interest rates less inflation. Not that long ago, you had positive real interest rates that were high enough that they acted as a kind of a brake on risk assets, because if you can earn a risk-free 2% after inflation, that establishes a floor in terms of what kind of return on investment you need, and it also raises the cost of financing and leverage. But since real interest rates have been at zero for some time, or even negative more recently, this naturally makes asset prices inflate and you can see how difficult that becomes, how this introduces all sorts of distortions into the pricing mechanisms. So I think one of the primary goals for central banks would be to get real interest rates somewhere in positive territory. That normalization process, which we believe will occur over the next three to seven years, is going to be difficult, however. Difficult to achieve, perhaps, but difficult to experience for sure. And the idea that you can get from the current situation to a more normalized one without any difficulty along the way is simply not realistic.

One theory that seems to be gaining popularity is Modern Monetary Theory: talking about the deficit not being a problem. Is MMT just too good to be true? A lot of people seem to hope it's true.

Well first off, it's not modern, there's nothing monetary about it, and there's no substantive theory behind it. That said, you can see the allure. As you just said, many people hope it's true. Why wouldn't they like that to be true?

ANALYSIS AND INSIGHTS

Deficits don't matter, we can just print and spend unlimited amounts of money, and there don't appear to be any consequences. It sounds ridiculous on the surface. But we have had quantitative easing for a long time now and all the naysayers were saying, "You're going to see inflation," and it didn't happen.

So you see how people could become emboldened and say, "Maybe it really doesn't matter. Let's give it a try." And because of the pandemic combined with the U.S. election, we are seeing the idea that deficits don't matter in practice. I'm not talking about the typical 2% or 3% deficits that you might run during a cyclical downturn, but gigantic deficits in the 20% to 30% range - World War II kind of deficits. We at Reams are going to take the other side of that bet and say no, they have to matter. Common sense tells you, at least, that they might matter. So the idea of just saying they don't matter and proceeding along those lines seems completely ridiculous. But we've also been around long enough to know that people have been calling for inflation that hasn't yet materialized, so we'll be cautious and avoid being too dogmatic on this topic. If nothing else though, common sense tells you this: Be prepared, be worried, be concerned, be afraid, be very afraid.

But we also look at this MMT experiment as a potential opportunity. This may give central banks and fiscal authorities - or at least our central bank and federal government - the cover to do whatever it is that they want to do in terms of spending with no adverse consequences. We shall see. But as I said before, what we're practicing right now seems insane. We can pretend to know exactly how all of this is going to be resolved. We don't. But what we do know is that with yield and spread levels where they are right now, the costs of forgoing opportunities that require you to be aggressive and take a lot of risks are small. Things are in motion right now that tell you to be cautious, but also to be prepared, to be opportunistic, and to be ready.

How exactly should people be prepared?

I think you want to realize that, at least in the fixed income space, you've already banked of a lot of the potential returns that were available over the past 30 or 40 years, the gift of pretty much steadily declining interest rates. Now look at the dismal interest rate environment of today, whether it's negative rates in Europe or close to negative in the U.S. The price of allowing yourself to be flexible - the price of liquidity, we would argue - is very low by historical standards. So make the portfolio flexible, put an emphasis on liquidity, and understand that if you're giving up a half a percent or so in current income, so what? If you believe, as we do, that we are in a treacherously transitional environment, you most definitely want to do that right now

and the opportunity cost for maintaining liquidity and flexibility is a small price to pay. And that's what our experience tells us to do.

As we saw last year during the pandemic, when opportunities present themselves it's not going to be a straight line. We can never predict the precise timing or cause of any particular dislocation, or what the opportunity set will even look like in advance, but we do believe that we can be prepared and also gauge when risk is being adequately compensated and when it is not. The previous cycle in global interest rates started in the early '60s and went to the early '80s. That lasted 20 years. The current cycle, which may have run its course, has been 40 years. The transition to what comes next is likely to take a long time, this isn't a quarter or two we're talking about here, but it's very likely that the next 10 years are not going to look like the last 10 years or the last 40 years, for that matter. So you need to be flexible and you need to understand the reasons that the regime is changing.

As an asset manager one of the things that we find comfort in are objectives: What are your objectives as an investor? What do you hope to achieve? What are the guidelines? What are the parameters you're giving us? We try and make sense of those things so that in the environment going forward, uncertain though it may be, we can have the best chance to actually make you happy as a client and achieve those goals. But also understand that those goals you achieved before - we have clients who want a real rate of return of 6%, for example - that's simply not going to happen right now. So set your expectations appropriately and don't reach for things that aren't there.

About Reams Asset Management

Reams Asset Management is a fixed income investment management firm whose mission is to provide high-quality investment expertise and unmatched client service. We apply our consistent investment process across a range of strategies, seeking to take advantage of volatility and react opportunistically to price and valuation dislocation in the bond market. Reams offers clients customized solutions that seek to maximize risk-adjusted total returns over a full market cycle and across a range of fixed income strategies.

About Carillon Tower Advisers

Carillon Tower Advisers is a global asset management company that combines the exceptional insight and agility of individual investment teams with the strength and stability of a full-service firm. Together with our partner affiliates — ClariVest Asset Management, Cougar Global Investments, Eagle Asset Management, Reams Asset Management (a division of Scout Investments) and Scout Investments — we offer a range of investment strategies and asset classes, each with a focus on risk-adjusted return and alpha generation. Carillon Tower believes providing a lineup of institutional-class portfolio managers, spanning a wide range of disciplines and investing vehicles, is the best way to help investors seek their long-term financial goals.

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Many investors consider bonds to be “risk-free” investment vehicles. Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors which may affect the risk and return profile of a fixed income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. The risk of a change in the market value of the investment due to changes in interest rates is known as interest-rate risk. Interest-rate risk is subject to many variables but may be analyzed based on various data (e.g., effective duration). The risk that the issuer may default on interest and/or principal payments is often referred to as credit risk. Credit risk is typically measured by ratings issued by ratings agencies such as Moody’s and Standard & Poor’s. Bonds issued by the U.S. Government have significantly less risk of default than those issued by corporations and municipalities (see below for a discussion of the risk associated with convertible securities). However, the overall return on Government bonds tends to be less than these other types of fixed income securities. Finally, reinvestment risk is the possibility that the proceeds of a maturing investment must be invested in a lower yielding security, all other things held constant, due to changes in the interest-rate environment. Investors should pay careful attention to the types of fixed income securities which comprise their portfolio and remember that, as with all investments, there is the risk of the loss of capital.

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The firm was previously defined as UMB Institutional Asset Management, a subsidiary of UMB Bank, which managed both institutional and high net worth, trust, and estate assets. On July 1, 2009 the firm transitioned from UMB Bank and became a subsidiary of UMB Financial Corporation in order to focus on institutional investment management. On November 30, 2010, the firm acquired the advisory business of Reams Asset Management Company, LLC. On December 28, 2010, the firm changed its name from Scout Investment Advisors to Scout Investments. On November 17, 2017, Scout Investments was acquired by Carillon Tower Advisers.

Scout Investments claims compliance with the Global Investment Performance Standards (GIPS®).

The Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services. The U.S. Bureau of Labor Statistics bases the index on prices of food, clothing, shelter, fuels, transportation, doctors’ and dentists’ services, drugs, and other goods and services that people buy for day-to-day living. Prices are collected each month in 75 urban areas across the country from about 6,000 households and 22,000 retailers.

Modern Monetary Theory (MMT) is a heterodox macroeconomic theory that, for countries with complete control over their own fiat currency, government spending cannot be thought of like a household budget. Instead of thinking of taxes as income and government spending as expenses in a checkbook, MMT proponents say that fiscal policy is merely a representation of how much money the government is putting into the economy or taking out

Learn more about Reams’ approach to fixed income investing.
Call 1.800.521.1195 or visit carillontower.com.



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