It's a supply shock stupid!

OK. Maybe it is a bit unfair to mock the Fed's response to the coronavirus as panicked and perhaps of limited utility given that the issue is best viewed as a supply shock. After all the Fed (and our RBA) pulled the only lever they could in the circumstances.

Perhaps something that has escaped notice during the pages of anxiety-ridden ink devoted to the coronavirus is that being a supply shock it has a potential inflation dimension.

This makes for a tricky environment for both policymakers and investors. Policymakers because options are limited for quick and highly effective responses. For investors because it may portend a potential regime shift in the relationship between the prices of financial assets. It is true that government bond and equity returns continue to be negatively correlated. In an appropriately diversified portfolio of government bonds and equities therefore, falling bond yields (rising bond prices) cushion the negative impact of declining equity markets.

That will be of some comfort to investors in "balanced" portfolios and indeed in an environment of stubbornly dormant inflation it is difficult to see that relationship changing.

However, global markets find themselves in uncharted waters. The potential growth impact of the coronavirus is difficult to estimate but there is an emerging consensus that it may tip the global economy into a recession. And while central banks embark on an aggressive easing campaign there is some emerging doubts over the efficacy of a monetary response both in terms of its potency in combatting a pandemic as well as a pre-existing view that the monetary policy well has pretty much dried up.

With bond yields already at record lows there is some question as to how much further they can fall thereby potentially calling into question the degree of negative correlation in bond and equity returns. But with stubbornly dormant inflation it seems unlikely that bond yields could rise in dramatic fashion.

There are, however, arguments that inflation is an underappreciated risk.

Inflation could emerge from a number of sources even in an environment of continuing headwinds to growth.

Even prior to the emergence of the coronavirus, there were elements of the policy landscape that implied some greater inflation risk. Governments are increasingly suspicious of a deregulatory agenda. There is a process of "deglobalisation" and re-regulation that has accompanied the rise of left / right populism in the developed world. Inflation can much more easily take root in such a world.

That process might be given further impetus should policy authorities move to embrace more unorthodox approaches to protecting against downside risks to growth such as (partial) money financing of budget deficits (as opposed to bond issuance), that was reasonably commonplace in a number of developed countries right up until the early 1980s.

A pandemic would represent a significant supply shock arising from the disruption to global supply chains that also has the potential to give inflation a little kick.

In such an environment the diversifying properties of bonds in a "balanced "portfolio may diminish.

Not that any of this might unfold quickly, but perhaps investors need to be now contemplating a greater array of uncorrelated sources of return in a portfolio, such as gold or absolute return type exposures given rising uncertainties (not just the coronavirus) about global economic prospects.

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