# Inflation Resurgence: New Risks and Opportunities

## Inflation, after decades of benign influence on the economy and global capital markets, is back with a vengeance.

Only recently considered a cold-war era afterthought in most investment decisions, it has moved to top-of-mind in relatively short order. Arguments about its influence have evolved from temporary to structural in a matter of months as price increases have spread across a growing swath of goods, services, intermediary inputs, and raw commodities—permeating entire supply chains. COVID-19 policies sparked its resurgence. Now, geopolitical events emanating from Ukraine are fanning the flames.

Generating positive real returns and preserving the purchasing power of assets have taken on a new importance for many investors. In this note, we've assembled five investment leaders from across Allspring to share their most recent thoughts on this topic.

BRIAN JACOBSEN, PH.D., CFA, CAIA, CFP®

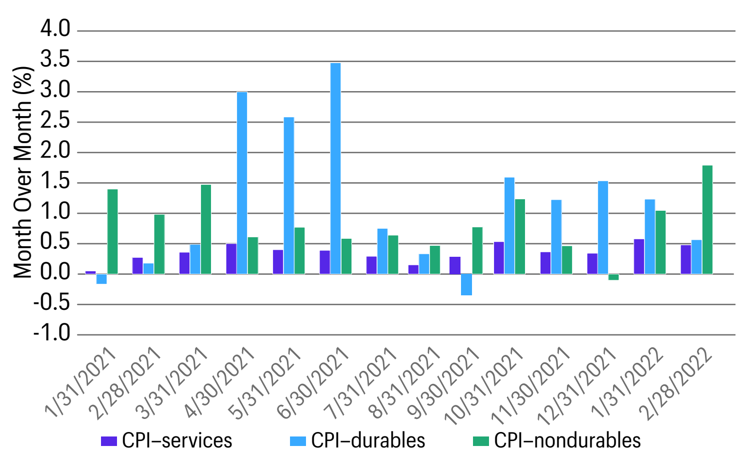
+ Systematic Edge

### INFLATION: UNDER PRESSURE

There are many different flavors of inflation: It can be broad-based or narrow, high or low, accelerating or decelerating, and persistent or fleeting. None of these varieties really leave a good taste in people's mouths, but not all kinds of inflation are horrible for investors either.

Between April and June 2021, inflation was mainly concentrated in durable goods, especially autos. High oil and agriculture prices then led to a pop in inflation in nondurables. It is now spreading to services like rent. The most distasteful flavor of inflation is the kind that is broad, high, and stubborn. While the inflation we have is broad and high, it might not be stubbornly high at these levels.

MONTH-OVER-MONTH INCREASES IN THE CONSUMER PRICE INDEX (CPI)




Source: Bloomberg monthly data from January 2021 through January 2022 for the CPI

Lower inflation does not require lower prices, it just requires prices from rising as quickly as they have. For example, oil prices at around $100 a barrel is painful for consumers. Going from $60 to $100 is more than 66% inflation, but staying at $100 is 0% inflation from that point forward. If supply chains slowly heal, we could see a material reduction in inflationary pressures and the fears that come with inflation.

Perhaps the most important thing for investors is that inflation this last year hasn't been horrible for corporate profit margins. Businesses seemed to be able to increase prices because they knew everyone else was raising prices, too. Inflation rose alongside profit margins. Going forward, those companies that were able to pass through cost increases the most to consumers will likely be in a good position to expand margins if their costs begin to decline. That's why we're still leaning into equities even after spectacular 2021 returns.


BRYANT VANCRONKHITE, CFA

+ Special Global Equity

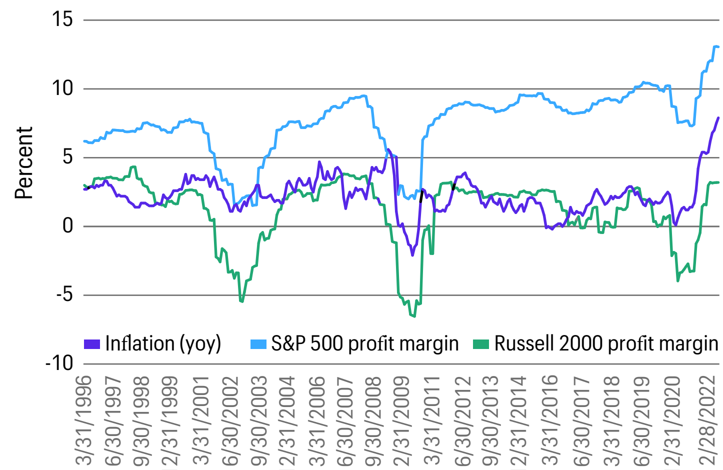

## A BOTTOM-UP PERSPECTIVE

Inflation does not occur in a vacuum and its impact can differ across industries. Each cycle has unique characteristics, but inflation is often accompanied by strong economic growth and higher future interest rates. In this cycle, many companies have benefited from stronger economic growth as the economy has recovered from the initial COVID-19 shutdown, but pandemic-related supply chain bottlenecks and ongoing labor tightness has affected companies differently. For our process, we think the effects of inflation can best be evaluated at the individual stock level. We look to assess the effect on each company's cost of goods sold and its ability to pass price increases along to customers to truly measure the inflationary impact.

In all environments, our investment process demands that portfolio companies possess strong competitive advantages. A great way to assess the strength of a competitive advantage is by determining if a company can raise prices when it needs to. These "special" companies have durable competitive positions within their product or service categories that have few viable substitutes—this gives them unique pricing power. The ability to pass on higher costs to customers can often lead to higher revenues and cash flows in the future.

Price increases will often lag input cost increases, which can temporarily squeeze reported margins. This often allows active managers a window to exploit market misperceptions of a company's true economic value. Many cyclical companies did not see strong pricing power for the majority of the last cycle, but they stand to benefit in today's environment. Higher inflation is leading to higher interest rates, which is something that companies had also not seen for the better part of the last cycle. In addition to examining each company's operational cost structure, we closely examine each company's capital structure and their cost of capital to better understand their overall sensitivity to interest rate fluctuations—it stands to reason that companies with superior financial flexibility can benefit. We believe this unique analytical lens can provide additional selection opportunities for us to exploit in the current environment.

PROFIT MARGINS HAVE RECENTLY BEGUN TO EXPAND




Source: Bloomberg quarterly data from fourth quarter 1995 through fourth quarter 2021


CHRISTOPHER MILLER, CFA

+ Select Equity


## REAL ESTATE INVESTMENT TRUSTS (REITS) MAY OFFER DIVERSIFICATION AS INFLATION RISKS EMERGE

In real estate, inflationary periods are frequently accompanied by rising rental rates. This can benefit REIT cash flow streams and underlying property values. REITs with shorter-duration leases, such as multifamily, self-storage, and hotels, can adjust pricing almost immediately, but even longer-term leases can enact rate increases as contracts renew or if they include CPI-linked rent escalators.

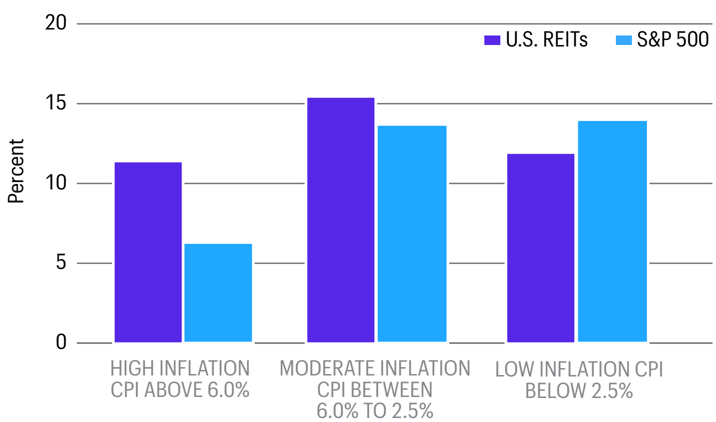
In addition to the prospect of rental rate increases, REITs are also often better insulated from expense pressures that adversely affect traditional businesses during inflationary periods. Many expense increases are borne more directly by tenants. Public REITs often have a scaled purchasing and procurement advantage over smaller nonpublic competitors. These unique cost structures can help REITs avoid significant margin pressure from inflation and help sustain cash flows.

Inflation can also create a favorable outlook for real estate supply. Higher building material and labor costs can make the returns on new property development less attractive, which effectively curtails competition from new properties. Rising construction costs also translate to higher replacement costs for existing assets, which increase the overall value of a REIT's existing property portfolio.

An inflationary environment can accelerate secular trends, including faster adoption of technology or labor shortages that drive increased use of automation. This can accelerate use changes in existing real estate. Moreover, these trends can create winners and losers across different REIT sectors. For example, data centers, cell towers, and logistical facilities are poised to benefit from demand tailwinds, while traditional office and retail properties may be oversupplied. Such dispersions present selection opportunities for active managers focused on the nuances of sector and company fundamentals.

Historically, REITs have generated attractive total returns through capital appreciation and current income, and this can be accentuated through inflationary periods. The chart below illustrates REITs have performed well in periods of low, moderate, and high inflation going back to 1972. In fact, REITs have outperformed the S&P 500 Index in moderate- and high-inflation periods over this 50-year period.

REIT TOTAL RETURNS DURING DIFFERENT INFLATION PERIODS (1972–2021)




Note: Data from FactSet 1972 to 2021; annual returns and change in CPI at rolling quarterly intervals: U.S. REITs represented by FTSE Nareit All Equity REITs Index; high inflation periods defined as CPI > 6.0%; moderate inflation periods defined as CPI between 2.5% to 6.0%; low inflation periods defined as CPI lower than 2.5%

MIKE SCHUELLER, CFA
+ Global Fixed Income

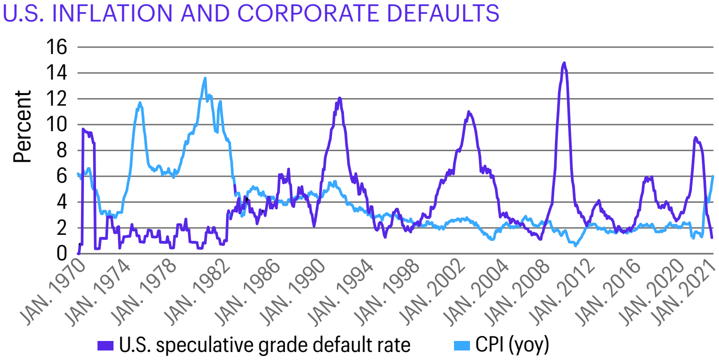
## THE DOUBLE-EDGED SWORD OF INFLATION

When it comes to corporate bonds, inflation is a double-edged sword. On the positive side, inflation tends to help the credit quality of many corporate issuers as the real cost of debt declines with increases in nominal earnings. On the negative side, however, investments in bonds typically generate a fixed stream of interest and principal payments that lose purchasing power over time as inflation rises. As a result, we think it's useful to consider how inflation affects both the financial health of bond issuers and the valuations of bonds they issue. Due to the secular downdraft in inflation over the past 40 years, it's important to consider that the recent upsurge in inflation is a relatively new—but not unprecedented—phenomenon that leaves many investors and companies in unfamiliar waters.

Since most companies finance their operations, inflationary pressures cause two diametrically opposed forces that can affect issuer creditworthiness. On one side, the company's "real" borrowing costs should decline as interest and principal payments are mostly set at a fixed rate. If the company can reprice its revenues with inflation, the creditworthiness of the company should improve and the risk of default should decline. As of late, this has been true for energy companies, commodity producers, and some chemical companies.

However, on the other side, if a company's pricing power for its goods or services lags the rising costs of inputs necessary to produce them, profit margins will be squeezed. Rapid margin contraction can lead to quicker deterioration in the fundamentals of highly levered companies. Indeed, we are especially concerned about companies with low margins, a tight labor supply (implying higher wage costs), and/or providers to low-income consumers who are especially feeling the bite of higher gas and food costs (implying weak pricing power). Select retailers, discretionary goods producers, and leisure companies generally face greater exposure to these dynamics.

U.S. INFLATION AND CORPORATE DEFAULTS




Sources: Bloomberg and Moody's; data presented from January 1970 through December 2021

Looking back to the inflationary period of the 1970s, many companies were able to keep pace with inflation and maintain creditworthiness as speculative-grade corporate defaults remained quite low throughout most of the decade. To be fair, the corporate bond market was much different and much smaller than it is today, but the evidence suggests that the initial phases of inflation tended to benefit the creditworthiness of corporations. In today's environment, some companies can sustain pricing power due to a favorable industry structure or a durable competitive advantage. Thus far, strong demand has allowed many corporate bond issuers to pass cost increases on to their customers, which supports margins. But, as the late 1970s and early 1980s have shown, this shouldn't last forever. If inflation continues to rise and/or remain at elevated levels, policy intervention—either monetary or fiscal—could bring negative growth implications and could result in increased corporate defaults.

Near-term changes in inflation are notoriously difficult to forecast. However, once an inflation trend is established it tends to remain intact until acted upon by fiscal policy decisions, monetary policy decisions, or exogenous macroeconomic shocks. Today, markets are contending with all three. COVID-19 brought unprecedented monetary and fiscal stimulus and revealed fragility of global supply chains. Adding Russia's invasion of Ukraine to the mix, we now have macro forces that may compound inflationary pressures for several years to come.


ALISON SHIMADA

+ Total Emerging Markets

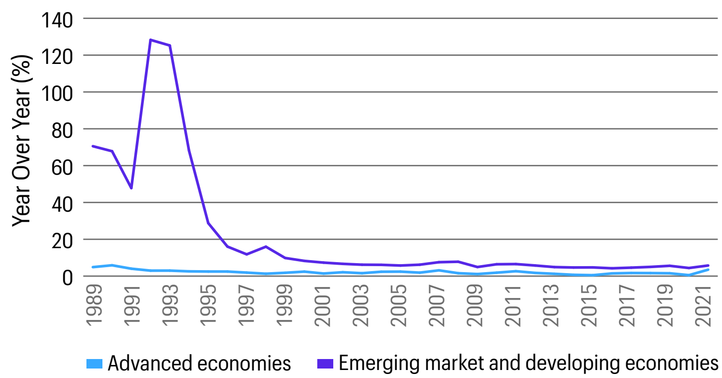

## INFLATION TAKES DIVERGENT PATHS IN DEVELOPING MARKETS

Over the past 20 years, emerging and developing economies have experienced a rate of inflation roughly four times that of developed markets. However, the rate of inflation in emerging markets has come down from 8.3% in 2000 (from double digits from 1989 to 1998) to a range of 4% to 6% following the global financial crisis. With the euro area and the U.S. recently seeing 5% and 7% consumer price inflation, respectively, inflation in emerging markets is now poised to fall below that of developed markets in 2022, according to Bloomberg forecasts.

Headline prints from some emerging market countries have tended to obfuscate this overall trend. For example, Turkey saw inflation spike to 36.1% year over year while Argentina reached a pandemic low of 35.8% in November 2020. Yet their impact has been muted as Turkey represents only 0.23% of the MSCI Emerging Markets Index and Argentina was actually dropped from the index at the end of 2021 due to its imposition of capital controls and deterioration in market accessibility. In contrast, China, which represented 28.8% of the index at year-end, saw consumer prices rise only 1.5% in 2021, largely due to a combination of stricter COVID-19 policies and efforts to deleverage the economy. More broadly, emerging market central banks, except for Turkey, have been proactively raising policy rates ahead of many developed market countries in order to tame inflation. For example, Brazil took up its policy rate by 875 basis points (bps) over the past 13 months and Korea raised rates by 75 bps in 2021, while China maintained its policy rate through the pandemic, making its interest rate cycle inverse to most other economies.

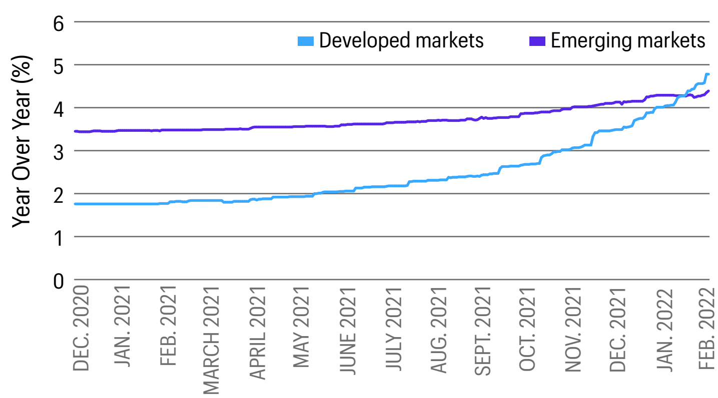
We expect Russia's invasion of Ukraine to add to inflation globally as Russia is a major producer of oil and gas, aluminum, and PGMS (platinum/palladium) while Ukraine is a major exporter of grains. Supply disruption is expected to further drive cost-push inflation, which may hurt demand and overall global economic growth. Stagflation can no longer be dismissed as a tail risk. As a result, we are focusing on companies with a track record of being able to provide food security, material security, energy security, and national and cyber security over the near to medium term.

### INFLATION




Source: IMF World Economic Outlook, October 2021

### 2022 INFLATION FORECAST




Source: Bloomberg

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