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Navigating Inflation: Three Views

Decades have passed since the threat of high inflation has preoccupied investors' minds. Some of the price increases we see splashed across headlines today are due in no small part to policy decisions to shut down large sectors of the economy and stimulate consumption to fight the pandemic. This has both limited the near-term availability of goods and services and, simultaneously, increased demand for them.

The results of these actions are manifest in supply chain bottlenecks, worker shortages, heightened geopolitical tensions, and the price increases of everyday staples. Yet, longer term, there are secular deflationary forces at work that may ultimately temper inflation. Globalization of trade, aging populations, and the ongoing digitization of the economy are powerful trends that may offset some of the more temporary pandemic-related factors. Understanding how these opposing forces may play out is central to how asset allocators approach their markets.

To be clear, inflationary episodes have historically presented headwinds for most risk assets, but we believe active investors have opportunities to defend their portfolios against uncertainties and capitalize on a number of selection opportunities during this rotation. Of course, tactics vary by market. Below, we've asked senior investment leaders to comment on how they're thinking about inflation in their respective markets today. We hope this discussion can help you position your portfolio to stay on course toward your long-term, strategic goals in 2022.

VIEWS FROM ANN MILETTI
+ Head of Active Equity

The past year has seen the onset of an inflationary cycle that is affecting different sectors of the economy in different ways. Companies of all stripes are being forced to defend their margins in this environment. Their success or failure will depend on their ability to raise prices, control input costs, and realize productivity gains. While each company faces its own unique circumstances, companies operating in some sectors may be in a better position than others during this environment. I can outline a few of them here:

- **Energy.** Despite a desire by many asset owners, allocators, and managers to focus on transitioning to climate-friendly investments, it's hard to ignore the return opportunities in the energy sector as we look deeper in 2022. Energy companies have historically had pricing power in inflationary periods. And, with limitations on the ability to drill more, the threat of overinvestment is low and pricing power should remain very strong.
- **Real estate.** This is traditionally seen as an inflation hedge. Real estate investment trusts (REITs) own and operate income-producing real estate. Property prices and rents usually rise during inflationary periods. These companies are required to distribute at least 90% of their net earnings to shareholders annually to maintain their tax treatment, and this should benefit REIT investors.

- **Health care.** This sector tends to enjoy inelastic demand (that is, customers tend to be insensitive to price increases). We've seen this strong pricing power in action as price increases have stayed well above the Consumer Price Index this past decade. Having underperformed the broader market in 2021, I expect renewed strength from this sector in 2022.
- **Information technology.** This sector has always been a key driver of innovation and productivity across the broader economy, and tech companies tend to be the recipient of capital expenditures from nearly every sector. The ongoing digitization of the economy should support continued pricing power in this sector.

These are a few broad brushstrokes, but I want to caution investors not to make significant sector or style bets in this environment. Broad price inflation is something that no company has experienced in recent memory, and I expect there will be a wide variance in the degree of success experienced by different companies operating within even the same industry. The key takeaway is that stock selection is going to matter more than ever in this environment. I encourage investors to be opportunistic but also to remain disciplined to their overall strategic allocations as we move forward in 2022.

VIEWS FROM GEORGE BORY, CFA

+ Fixed Income Strategy/Portfolio Specialist

The current dichotomy in fixed income is the upsurge in inflation over the past year, while bond yields have remained stubbornly low. As a result, much of the world's bond market—at least in the developed world—currently offers deeply negative real yields when compared with current inflation rates and modestly negative yields when compared with medium-term inflation expectations.

To be fair, since the start of the year, bond investors have started to reprice the entire term structure of the yield curve to reflect the very real possibility that monetary policy will need to get much tighter more quickly if central banks want to or need to get inflation under control. Indeed, the bond market is now pricing in three to four rate hikes in the U.S. in 2022 and a high probability that the Federal Reserve (Fed) will wind down its current quantitative easing program very quickly and may even start quantitative tightening in the second half of the year.

The best-case scenario for central banks and the market is that inflation organically decelerates in an orderly fashion, which would temper the need for central banks to react aggressively. But inflation is only one side of the coin—the other is the labor market. Recent reports show the U.S. economy is quickly reaching "full" employment. With U.S. headline inflation currently running around 7% and unemployment under 4%, a federal funds target rate at 0.125% and a 10-year U.S. Treasury yield at 1.75% seem out of line. This conundrum presents a meaningful challenge to bond investors trying to preserve purchasing power in the face of persistent inflation pressures and rapidly changing central bank expectations.

So what are we doing in our fixed-income strategies to manage through this period of volatility? To borrow a sports analogy, the best offense is a good defense.

01 Our first line of defense has been duration management. Most of our strategies came into the year modestly short duration. The recent backup in yields provided an opportunity to cover some of these shorts, but our bias remains cautious with respect to duration and we would likely reset shorts if bond prices were to rally again.

02 Our second line of defense is using diversified sources of income in portfolios where possible. When fixed-income volatility increases, it's critically important to diversify sources of income so cash flows can be reinvested on a steady and regular basis. As most fixed-income investors know, the power of compounding interest is the primary driver of portfolio returns.

03 Our third line of defense is using Treasury Inflation-Protected Securities (TIPS) and floating-rate structures, where possible. To be fair, U.S. TIPS do not appear to offer great value at the moment, but they may provide some protection as a hedge against higher-than-expected inflation. In addition, floating-rate bonds and loans should perform nicely if the Fed truly does embark on a rate-tightening cycle.

04 Our fourth line of defense is "spread product," which are bonds that trade at a yield higher than U.S. Treasuries (that is, at a spread to U.S. Treasuries). This includes corporate bonds, mortgage-backed securities, structured products, and loans. Economic fundamentals should be quite favorable to the creditworthiness of non-government-related borrowers. In addition, bond supply should decline as borrowers reduce the amount they borrow as the cost of the debt rises. Furthermore, the "real" cost of debt remains extremely low, and often negative, for many borrowers. However, tighter monetary policy will eventually erode creditworthiness as the cost of debt rises and availability of debt is constrained. To be clear, we do not believe we are at that point in the cycle, and we still favor holding various forms of spread product in most of our portfolios, but we

have been steadily reducing those allocations over the past six months and moving up in quality in anticipation of less favorable borrowing conditions. Our deep fundamental research is laser focused on evaluating cash flow certainty and possible pressure points for each borrower over the coming months and years.

05 Finally, our fifth line of defense is pursuit of positive real yields. Given the current rate of inflation and level of interest rates available in the market, this is hard to come by. But, we continue to look for bonds and issuers that offer positive real yields to help offset the erosion of purchasing power in other parts of the portfolio. Short-duration high-yield bonds and leveraged loans are two segments of the fixed-income market that currently offer positive real yields (versus medium-term inflation expectations) and are in the cyclical sweet spot economically.

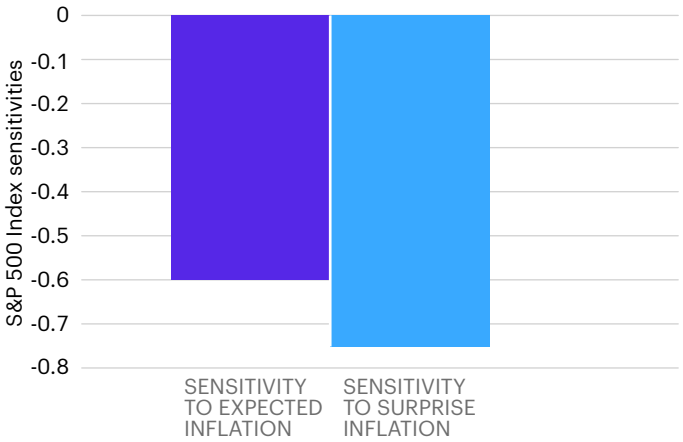
At some point, hopefully in 2022, we would like to pivot from defense to offense in our fixed-income strategies, but we recognize that the favorable economic tailwinds of late 2020 and 2021 are likely to fade in 2022 and turn into headwinds. Our objective is to position portfolios to be nimble enough to capitalize on market dislocations when they occur and recoup any mark-to-market losses incurred due to higher rates. When coupled with a steady stream of diversified income, we believe our portfolios are well positioned to weather volatility in 2022.

VIEWS FROM MATTHIAS SCHEIBER

+ Portfolio Manager

A lot of attention has been paid to the high levels of inflation experienced in the U.S. in 2021. The headline U.S. Consumer Price Index approached 7% recently on a year-over-year basis. This is the highest reading since the early 1980s. Investors are right to be concerned about the potential impact on their asset portfolios. However, our research shows that it's really upside surprises in inflation that present the most risk to asset portfolios. The chart below compares the sensitivity of the S&P 500 Index to expected inflation and to surprise inflation. Because higher levels of inflation are already being priced in by markets, we are beginning to see a waning impact from upside surprises. Downside surprises could present an equal opportunity. It helps that growth continues to look robust on a go-forward basis.

EXPECTED SENSITIVITY OF EQUITY TO INFLATION



Source: Bloomberg. The analysis period is from January 2000 through November 2020.

In this environment of high price uncertainty and high asset price volatility, wealth preservation takes on a heightened focus. Investors would be well served by maintaining proper exposure to growth opportunities so they can pursue their long-term wealth accumulation goals. In this environment, there are ways to structure a portfolio to benefit from inflation. We can think of these hedges as building blocks in an overall strategic asset allocation:

- A strategic asset allocation should provide exposure to inflation-sensitive assets. For example, allocations to commodities or inflation-linked bonds can provide positive exposure to inflation.
- A second building block is factor exposure, or exposure to risk factors that have historically performed well when inflation has been elevated. These include value, carry, and trend-following strategies.
- A third building block is security-specific alpha, which comes from the active managers we select to build out a strategic asset allocation. My colleagues outlined some of the opportunities in the equity and fixed-income markets above. Selection alpha—a source of excess return beyond what is expected from taking factor risks—tends to be uncorrelated to other sources of return, providing the added benefit of diversification.

As multi-asset investors, we wrap each of these building blocks into a strategic asset allocation as a starting point. We account for current market conditions by making tactical adjustments, which account for developing views on prospective growth and on the inflation environment. We also employ risk management techniques to fit the risk tolerance of unique investors. From the above discussion, it is clear that inflation can present risks, but it can also present opportunities if managed holistically against an investor's unique portfolio goals.

To learn more

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us:

Contact details

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