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INCOME INVESTING AND INFLATION RISK

As the global economy emerges from the depths of the pandemic recession, inflation expectations have risen significantly. Many investors are now justifiably concerned about how inflation could impact their portfolios. This uncertainty is confounded by the fact that developed markets have not had to contend with elevated levels of inflation for decades. There have indeed been a number of important developments since the beginning of the pandemic that could clearly contribute to a step change in the inflation outlook

Capacity reductions: the closure of large portions of the economy, whether a result of changing consumer behaviour or government-imposed shutdowns, may lead to short- and long-term reductions in the potential capacity of the economy to meet rising demand. Rising prices may be necessary to bring this idled capacity back online, or to replace capacity that was permanently liquidated.

Labour market frictions: it is generally more difficult to find and train workers than it is to get rid of them. We are seeing broad-based evidence of labour shortages, which are potentially exacerbated by incentives related to unemployment insurance as well as other challenges (like school closures and other complications related to childcare). Wages may need to increase further to attract talent.

Government stimulus: here in the US trillions of dollars of direct payments have left consumers flush with cash and many of them have built up savings or paid down debt due to reduced spending during the 2020-2021 lockdowns. More stimulus appears to be on the way in the US with the pending infrastructure bill. These "borrow and distribute" policies may increase potential future demand, just as supply may be constrained.

Regulation: with the US Democratic party controlling both the US Presidency and Congress in 2021, businesses active in this geography may face increased regulatory burdens. To the extent that higher operating costs follow, these are likely to filter through the economy in the form of higher prices. The fossil fuel sector may be particularly challenged to attract capital. While policies will likely spur increased renewable energy in the medium term, there is near term risk of significant energy price inflation.

Taxation: the potential for rising corporate income taxes, as well as capital gains and other investment-related taxes, could, at the margin, inhibit investment and therefore supply growth.

China de-coupling: political frictions with China since the pandemic, in the context of a broader trend toward insourcing, runs counter to the disinflationary trends of globalisation which characterised much of the past two decades.

Housing market strength: just as depressed home prices left many households "underwater" following the Great Financial Crisis and represented a headwind to recovery, the suburban home price appreciation we have seen in the wake of the Covid crisis has left many households in a stronger financial position with a greater capacity to spend. The positive momentum in the housing sector itself represents a potentially important wave of demand for labour and materials (coincident with a renewed political commitment to infrastructure investment).

Deferred consumption and investment: as the developed world is vaccinated and the pandemic recedes, consumers and even businesses may be emboldened to make up for lost time.

Fed policy: the Federal Reserve remains extremely accommodative and has clearly signalled a high level of tolerance for "transient" inflation as the economy recovers from the pandemic. The Fed Funds target rate remains at 25 bps (versus a 2019 high of 250 bps). Long-term interest rates have increased somewhat over the past year but remain at their lowest levels in decades, excluding the depths of 2020. Consensus thinking holds that accommodative monetary policy is inflationary (in fact, inflation is precisely what central banks are accommodating). Ongoing asset purchases are also viewed as inflationary.

To summarise, in the aftermath of the pandemic, the supply side of the economy appears to be somewhat damaged and constrained, while demand is recovering both naturally and through government support. Inflation expectations, as inferred from inflation-protected securities (TIPs) pricing, have risen from March 2020 lows that were below 1.5% to close to 2.5%. Inflation expectations are towards the high end of the range (2.0% to 2.5%) they have occupied since 2014, although still below the range (2.5% to 3.0%) they occupied for many years prior. From a historical perspective, it is not difficult to imagine inflation expectations continuing to trend upward.

Ten year Treasury yields since 1999

Source: Bloomberg.

Five-year Forward Inflation Expectations over the past 15 years

Source: Bloomberg.

Why inflation is problematic for income-oriented investors

Inflation is dangerous for income investors in two major respects. First, inflation by definition erodes the purchasing power of future cash flows. Whatever cash you expect an investment to generate, it is diminished in real terms the greater inflation is.

Second, inflation normally puts upward pressure on interest rates, as investors demand higher nominal future returns to offset declining purchasing power and/or central banks typically implement tighter monetary policy. As interest rates go up, the net present value of future cash flows tend to decline, which typically reduces the current market value of a given investment. The more "fixed" an investment's future cash flows are, the more vulnerable to inflation it is.

Ten inflation protection strategies for income investors

While traditional fixed income approaches may be most susceptible to inflation-related risks, there are ways for income-seeking investors to minimise the potential damage or even benefit from inflationary trends. Here are some ideas:

1. **Own dividend-paying stocks that having pricing power:** unlike fixed income, the equity universe provides opportunities to benefit from rising earnings and rising dividends through exposure to companies that may actually prosper in an inflationary environment. Banks, for example, stand to benefit from net interest margin expansion as interest rates rise.
2. **Shorten fixed income duration:** in an inflationary environment, as noted above, the longer and more fixed cash flows are, the more impactfully they will be discounted as a result of rising rates. Maintain a preference for shorter duration fixed income instruments.
3. **Focus on credit spreads:** while opportunities to generate income and total return remain in fixed income, focus on securities where the bulk of that potential return derives from attractively priced credit spreads and opportunities to benefit from spread contraction. It is the "risk-free" component of bond yields that are ironically riskiest from an inflation perspective.
4. **Own gold as a hedge – even within income portfolios:** gold tends to benefit in inflationary environments, especially when real interest rates decline (as inflation expectations outstrip nominal interest rates). Gold, as a global commodity, also tends to benefit from relative declines in the value of one's local currency. Gold exposure can be obtained through a variety of approaches, including direct bullion ownership, securities like ETFs that own gold bullion, and gold mining and royalty stocks. The latter tend to offer levered exposure to the gold price, while potentially even offering some dividend yield.

5. **Own stocks with real assets:** in inflationary environments, companies whose intrinsic value is underpinned by exposure to assets that are likely to appreciate in nominal terms (land, infrastructure, natural resources, etc.) may rise in value. Such "real asset" plays typically offer investors meaningful income streams as well.

6. **Seek exposure to commodities and other assets in short supply:** in inflationary environments, the upward pressure on prices is not evenly distributed but often located around certain supply chain "choke points". Certain physical commodities or even service businesses may disproportionately benefit as inflationary pressures persist.

7. **Look for structural growth opportunities that will transcend inflationary concerns:** companies that operate in industries with long-term structural tailwinds may continue to grow earnings and dividends with little interference from inflation pressures.

8. **Take advantage of volatility created by inflation fears:** investor anxiety around inflation may create exaggerated market moves. This could create interesting investment opportunities in businesses that are "oversold" due to what may be short-lived or exaggerated concerns around negative inflation impacts. In March 2021, for example, defensive sectors like consumer staples and utilities, which often trade like "bond proxies" and perform poorly as interest rates rise, performed well even as ten-year treasury yields continued to rise (having fallen quite sharply in January and February).

9. **Be cautious with respect to highly valued unprofitable growth stocks:** to the extent rising inflation expectations push up long-term interest rates, businesses predicated on distant cash flows are mathematically more exposed to rising discount rates (similar to long-term government bonds).

10. **Seek global currency exposure:** emerging market currencies in particular may thrive in a global inflationary environment, especially those whose economies are largely predicated on commodities and natural resources.

The **JOHCM Global Income Builder** strategy seeks to deliver resilience and meaningful income across all market environments, including inflationary ones. We look across asset classes and geographies to assemble a diversified portfolio of generally income-producing investments with attractive quality, growth and valuation characteristics. The strategy offers a flexible, diversified approach to income generation to protect and grow income streams across ever-shifting macroeconomic environments.