International Forum of Sovereign Wealth Funds

Winners and losers in an inflationary environment

April 2022

Introduction

In April 2022, the International Forum of Sovereign Wealth Funds (IFSWF) partnered with LCP, the UK's largest independent investment consultancy, to bring together a small group of sovereign wealth funds and discuss which asset classes will perform best in times of high inflation and high interest rates.

Hish Ravindra and Tom Farrell, investment partners at LCP, led the discussion by sharing historical research on the financial and economic impact of previous periods of inflation.

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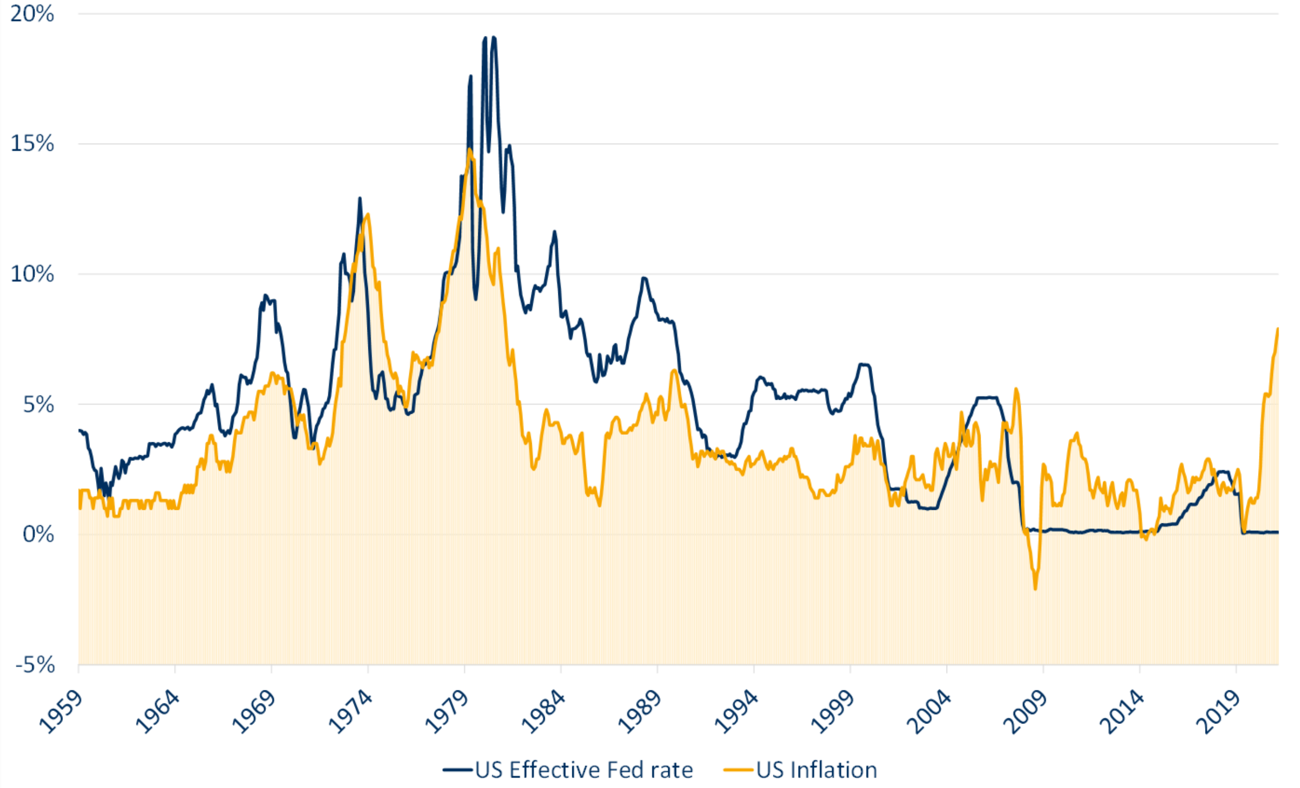
Background

All investors are currently facing similar issues: how to allocate capital in the presence of a period of sustained high inflation and rising rates while continuing to meet their mandated returns. According to LCP's historical analysis of US inflation and interest rate data, only twice in recent history, have there been periods of higher inflation than today: in 1973, during the Yom Kippur Crisis and in 1979, in the aftermath of the Iranian revolution. In both these cases, rapidly spiralling oil prices were the main driver of inflation.

However, today there are unique factors driving inflation: the impact of the global lockdowns during the COVID-19 pandemic and the ensuing supply chain issues were creating inflationary pressures well before the Russia-Ukraine conflict exacerbated already rising energy prices. 2022 is also unique

Only twice in recent history has US inflation been higher than it is today



Source: Bloomberg and LCP research

in that the gap between inflation and the interest rate set by the Federal Reserve (Fed) is the largest it has been in recent history, reflecting fears that rising rates may trigger a recession. Indeed, there have only been three times in modern financial history when a period of rising rates has not been followed by a recession.

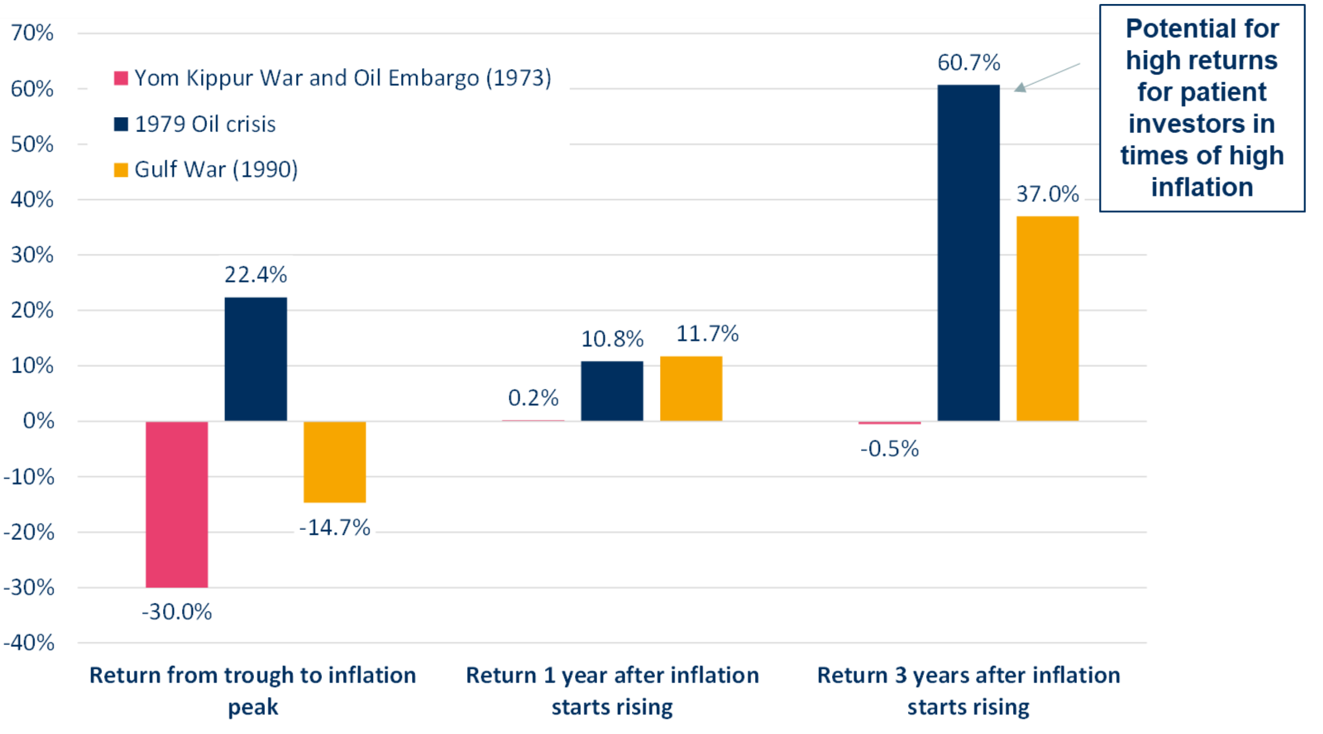
Inflation started rising in the US about a year ago, but it was only in late 2021 when central banks started talking seriously about persistent inflationary pressures rather than transitory ones. According to LCP's analysis of US equity market returns in periods of high inflation, performance has been mixed around inflationary peaks. That said, for patient investors, there has previously been the potential for high returns as long as they hold investments for three years after an inflation spike. The exception was after the Yom Kippur crisis because this was followed by a stagflationary environment. In the current economic situation in Europe, the United Kingdom and the United States, where inflation is rising and economic growth is relatively weak, LCP puts the probability of the economy entering stagflation at around 20%.

Most participants agreed that their organisations initially thought inflation would be transitory due to COVID-19 supply disruptions and demand bouncing back post-restrictions, but they are all now predicting a two-to-three-year period of high inflation. Some of them are also considering stagflation as a possible scenario. The main issue, and an open question, is if central banks, and the Fed, in particular, will be able to rein in inflation with multiple drivers: energy prices, supply chain disruptions, and a persistently tight labour market (particularly in the US). While oil price shocks tend to be transitory – as eventually, they become disinflationary when oil prices fall (or stop rising) – a mismatch in demand and supply in the labour market, can result in more persistent inflation.

Equity returns in times of high inflation

During previous high interest rate and inflationary environments equity returns have been mixed.

Returns measured from point that inflation starts rising



Source: Bloomberg, based on performance of S&P 500 (price index to 6 September 1984 and total return index thereafter due to availability of data)

Is this the end of tech?

We can understand the type of risks we are facing by analysing US equity markets in previous inflationary periods. The Yom Kippur Crisis caused the worst drawdown – the decline in an investment's value from its peak to its nadir – happened later when the oil embargo hit, just after inflation had already started rising. And while large drawdowns at times of economic shocks are expected to a degree, perhaps what is more interesting from the historical analysis of periods of high inflation, is that the frequency of drawdowns is higher than we have been accustomed to over recent years in the recent era of low interest rates. This trend suggests that investors holding equities are taking on higher levels of risk.

One participant provocatively asked whether we are seeing "the end of the tech sector?" drawing parallels to the 2008-9 financial crisis when financial stocks stopped being the major contributors to the S&P 500 index. Even though this is a contrarian point of view, participants agreed that most of the large tech companies like Alphabet, Apple and Microsoft – if their stock prices drop further – could be considered value plays, as they are profitable and have predictable revenue streams.

According to LCP's forward-looking analysis based on Robert Schillers Cape Yield method – earnings-yield measure using 10 years of average earnings divided by share price – equities are predicted to return 2.5% over inflation. This shows that while equities are not yet overpriced, they aren't cheap either. Growth stocks are "long duration", as their earnings are projected further out in the future. Higher interest rates, therefore, effect growth stocks more due to the "discounting effect" of their future earnings.

Bonds: no longer a shelter in periods of volatility

Fixed income has seen substantial outflows in recent years, particularly over the last twelve months as interest rates are rising, and bond prices plummeting. Investors have traditionally used bonds to shelter from periods when stock markets decline, because of the negative correlation between bond and equity returns. However, according to LCP, this has historically been true when inflation is below 3% on average, when inflation has been higher (as was the case before 2000), there has historically been more of a positive correlation. Indeed, this is supported by US Treasuries' returns when S&P 500 lost more than 2%. In periods of low inflation, Treasuries have previously been a good hedge in periods of volatile equity markets as they rise in value. However, this has not tended to be the case in periods of high inflation, i.e., Treasuries have tended to fall in value on days that the S&P 500 fell by 2% or more.

Longer-duration bonds could be affected more by rising interest rates than short-duration securities due to the "duration effect" (i.e., when interest rates rise, longer duration bonds suffer a higher fall in value than low duration bonds). Participants agreed that perhaps it is best (for those asset owners that have large bond holdings) to restructure bond portfolios to have shorter tenures so unexpected rate hikes will have less mark-to-market impact on the portfolio.

Corporate bonds offer tough choices for investors. While the nominal yield on corporate bonds has not changed much over the past three years, if the real yield is the reference point, there is a significant difference. Currently, there are negative real yields on short-term bonds. Longer duration corporate bonds offer positive real yields, however, are more exposed to the "duration effect," a fall in value caused by rising interest rates. High-yield bonds are offering higher spreads, but historically it has been quite risky to invest in non-investment-grade bonds during times of rising interest rates as companies' balance sheets can be under stress and more likely to default.

The participants at this session confirmed the findings of IFSWF's recent research on green bonds, which suggested that they are not yet an attractive proposition, as their market is illiquid, and yields are too low compared to other bonds. This environment is conducive to holding private credit, and most of the participants do, but they also highlight how important it is to invest in companies and sectors that are well-known to the sovereign wealth funds.

Gold or Real Assets?

Gold has always been used by investors as a shelter against inflation, as the metal has traditionally held its value in periods of high inflation. While gold had delivered good returns over the year to date, there are underlying forces that will influence its price on a forward-looking basis. A stronger US dollar (if it materialises) is a key risk. However, strong demand (particularly from central banks) may drive up its price. According to a survey from the World Gold Council, more than half of the 56 central banks surveyed were looking to increase their gold holdings. Provided that a gold allocation is sized appropriately it may help hedge against inflation and stagflation by acting as a store of value.

Finally, participants debated whether real assets could be a good hedge against inflation. Most academic studies confirm that real estate is not actually good protection against inflation, contrary to conventional wisdom. Real estate is normally more sensitive to interest rates, not only because most of the financing is interest-linked, but most valuation models discount future asset values according to interest rates, and when these are rising, they have a negative effect on valuations. It is, therefore, important to also factor in the amount of debt that is already servicing some properties. One participant offered a contrary view, that real estate was a good hedge for inflation once the effect of interest rates had been allowed for. Its organisation currently views real estate positively as an asset class, noting there is also an opportunity to review rental agreements to keep in line with inflation.

According to LCP, regulated infrastructure yields are generally more directly linked to inflation as they can pass on rising costs to consumers, by increasing income streams, such as tolls or utility charges in line with inflation. However, infrastructure has only really come into its own as a separate asset class over the last 20 years or so, therefore, it is trickier to analyse how it has performed in periods of high inflation (such as the 1970s). There is also a political and regulatory risk as governments and regulators can modify fees and therefore revenue flows or the competitive environment.

There is no free lunch

Overall participants agreed a well-diversified portfolio is still the best defence against inflation. Although equities will remain volatile, they should still be a key part of investors' portfolios. Government and corporate bonds will remain more challenging in the short term, as negative real yields coupled with rising interest rates could result in negative returns. Real assets provide diversification and attractive returns. Investors may wish to favour infrastructure over property due to better inflation protection, notwithstanding the regulatory and policy risk that infrastructure can present. Overall, diversification can protect investors from some volatility in the equity and bond markets in the short term while providing them with the opportunity to pick up some of the upside when markets recover.

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