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Inflation's Impact on Assets

ACA Sessional Meeting

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Contents

What are we going to look at today?

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Is inflation temporary?

There are some reasons why inflation may not be temporary

1

Working age population

The global workforce will not see the same increases we have seen over the last 20 years.

2

Dependency Spending

As populations age there will need to be further spending on healthcare and other services.

3

Anti-Austerity

Globally we appear to be more in a world of spending rather than austerity.

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H1 2022

The performance of bonds and equities moved together for the first time in a long time

Historically we have seen bonds provide protection in falling equity markets.

	Equity Return	Bond Return	Period
H1 2022	-16.0%	-8.4%	Dec 21 – Jun 22
Covid	-15.4%	2.0%	Feb 20 – Apr 20
Q4 2018	-11.1%	4.6%	Sep 18 – Dec 18
GFC	-47.1%	11.5%	Dec 07 – Mar 09
Dot Com	-20%	21%	Apr 00 – Dec 01

This upended many portfolios that have been designed around this construct

Source: Shiller dataset (http://www.econ.yale.edu/~shiller/data.htm) adjusted by author. All periods shown are month end to month end. Past performance is not a guide to future performance and may not be repeated.

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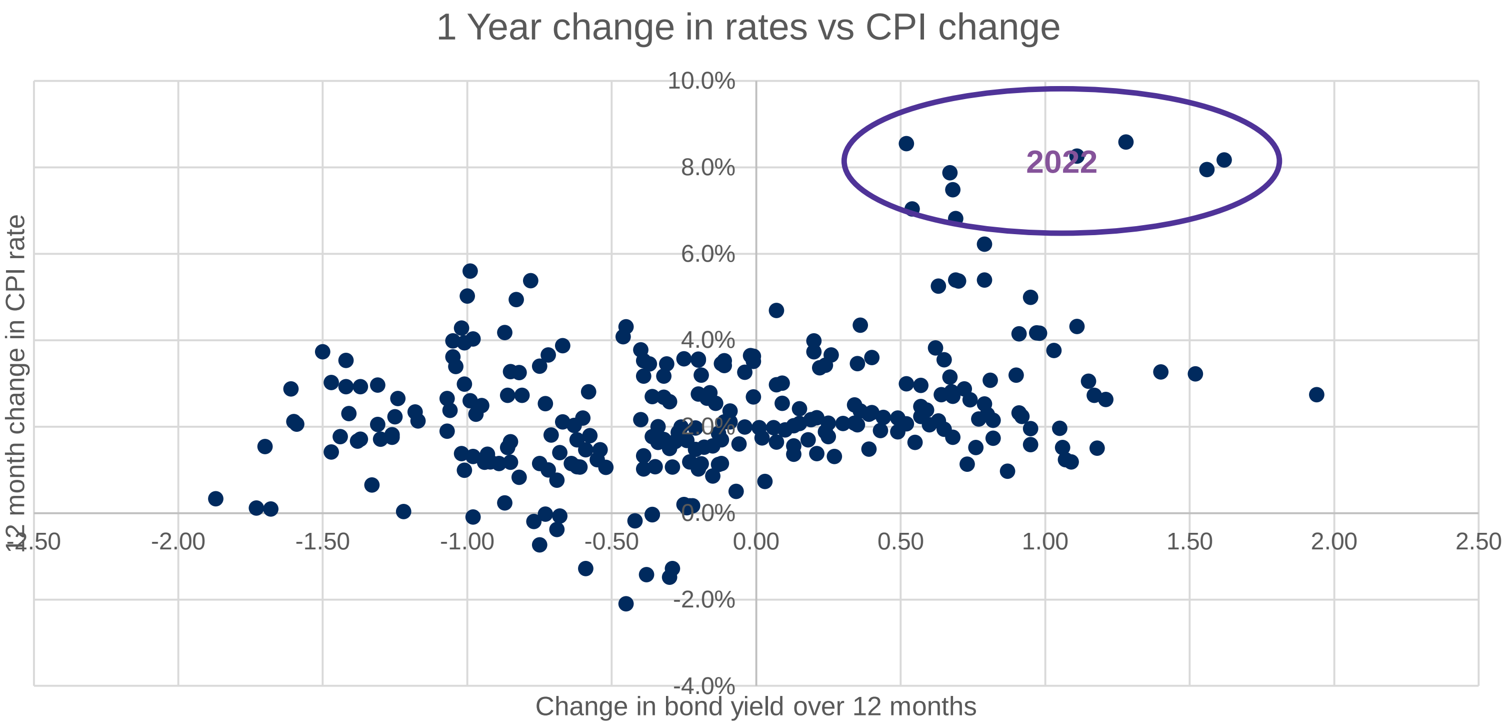
Inflation was the key

Over the last 20 years there has been little relationship between rates and inflation

Below we have shown the 12 month change in US CPI and the 10 year bond yield



It is only 2022 where inflation has been high enough to have a material impact

Source: Shiller data (http://www.econ.yale.edu/~shiller/data.htm), time period is from January 2000 to June 2022.

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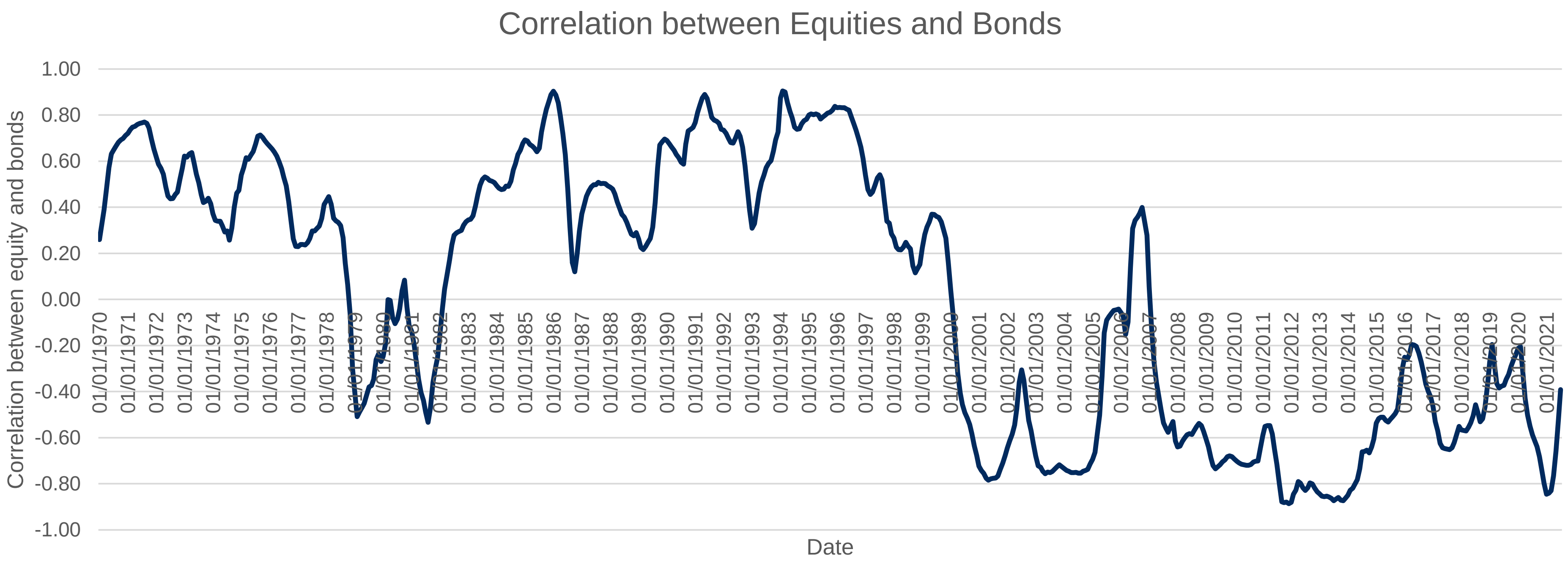
Equity/Bond correlation

For the last 20 years the equity/bond correlation has been negative

The below shows the rolling 3 year correlations between equity and bonds



Many risk models have depended on this relationship

Source: Shiller data set (http://www.econ.yale.edu/~shiller/data.htm). Past performance is not a guide to future performance and may not be repeated. Correlation is calculated using 12 month performance of equities and bonds over a 3 year time horizon up to each month end on a monthly basis.

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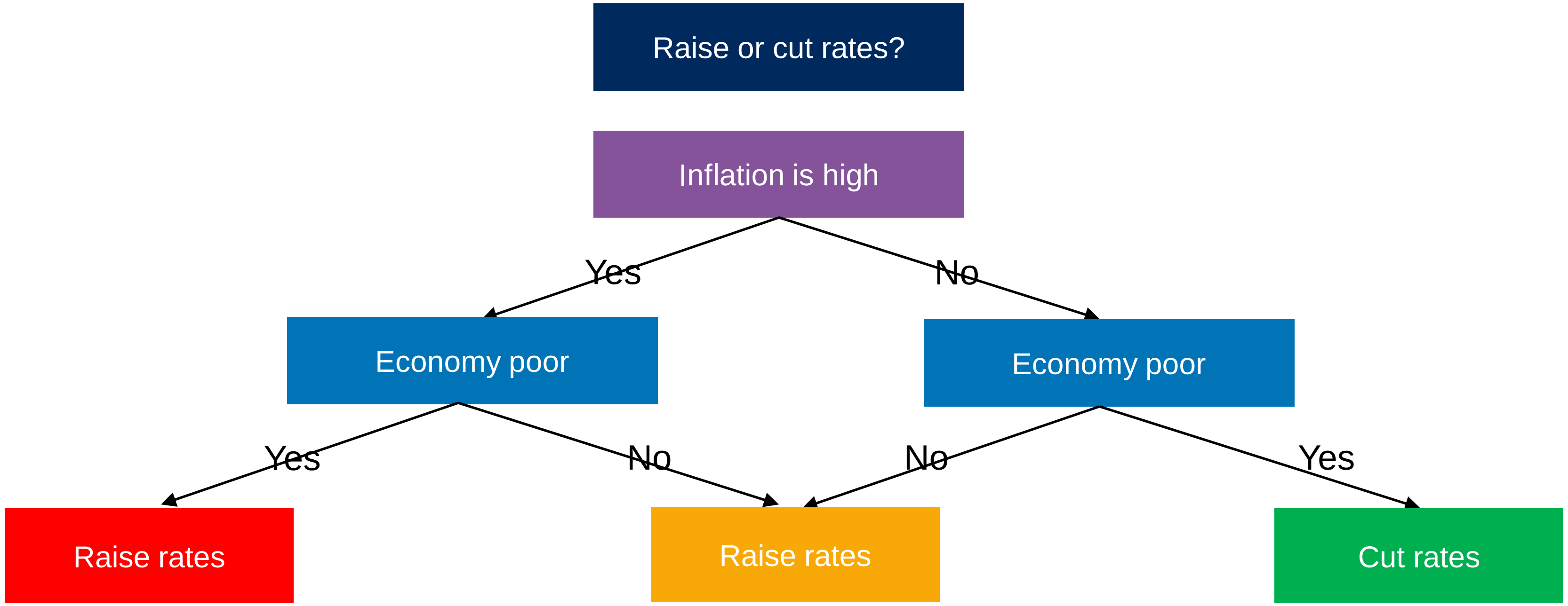
Fed Reaction Function

This was heavily driven by the Fed’s reaction function

If we look at their decision tree we can see how it emerges



Bottom right is where we have been in the last 20 years

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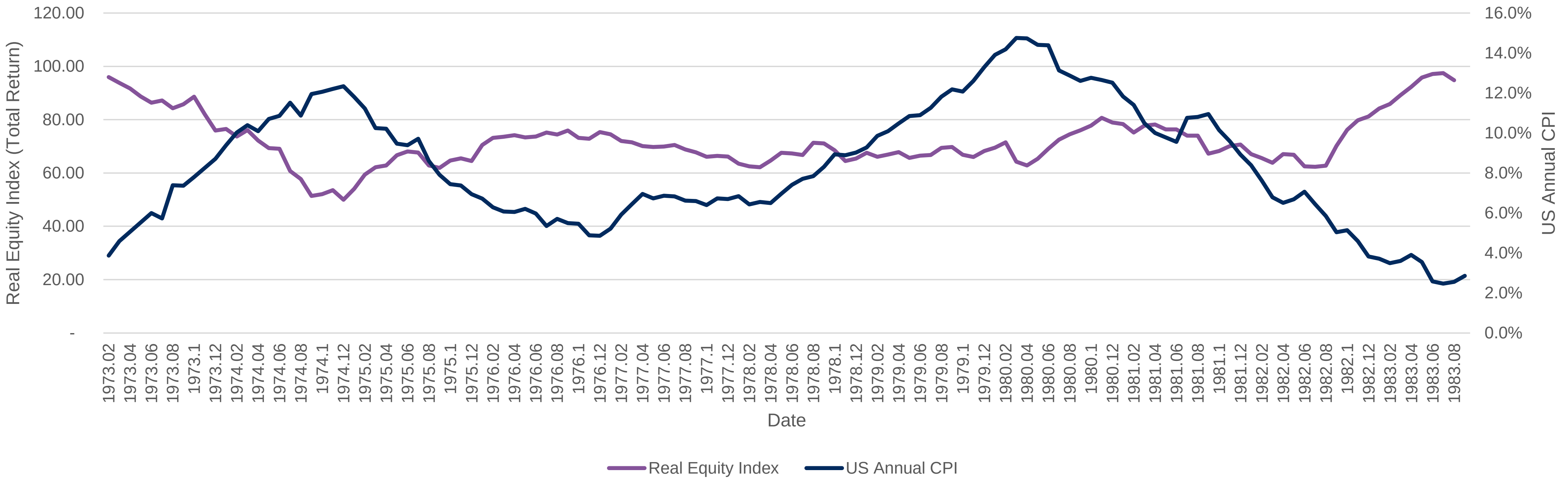
Equity – inflation protection?

Equities have not been great inflation protection in the past

The below shows the period from 1973 to 1983



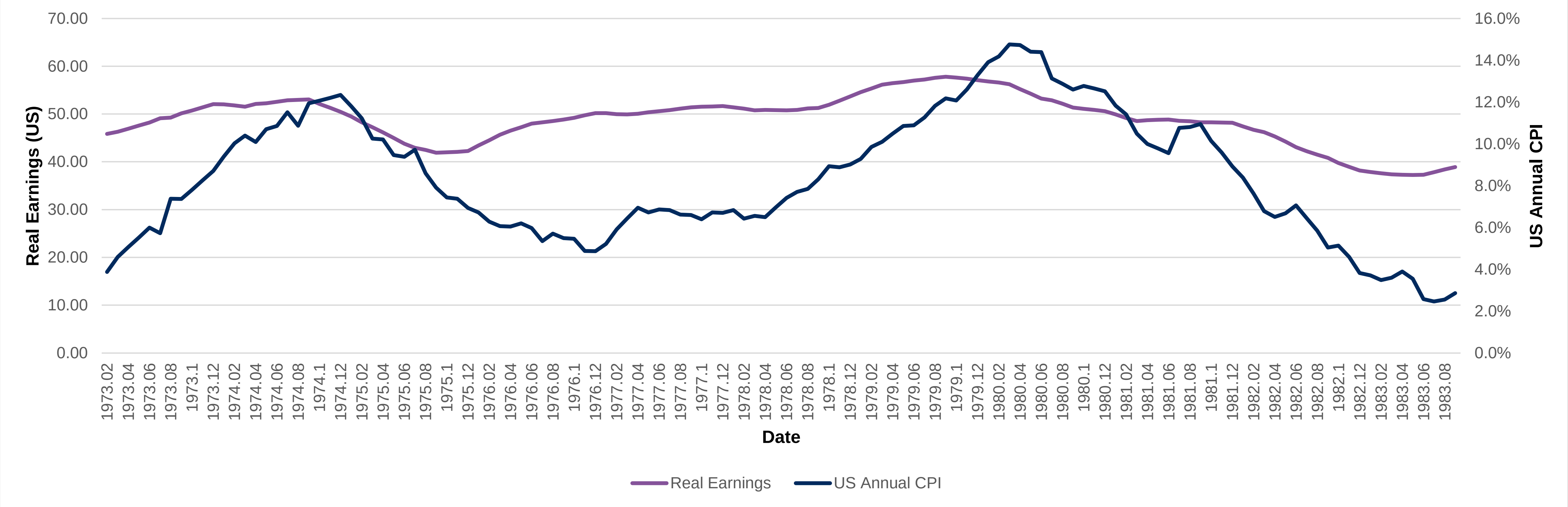
Over that period equity made less than 0% return in real terms

Source: Shiller data set (http://www.econ.yale.edu/~shiller/data.htm). Past performance is not a guide to future performance and may not be repeated.

Earnings

Over that time period earnings did not grow in real terms

This was likely driven by uncertainty and high financing rates



If earnings are not growing in real terms you need valuations to get richer

Source: Shiller data set (http://www.econ.yale.edu/~shiller/data.htm). Real EPS is based on S&P500 earnings per share (USD) deflated by US CPI.

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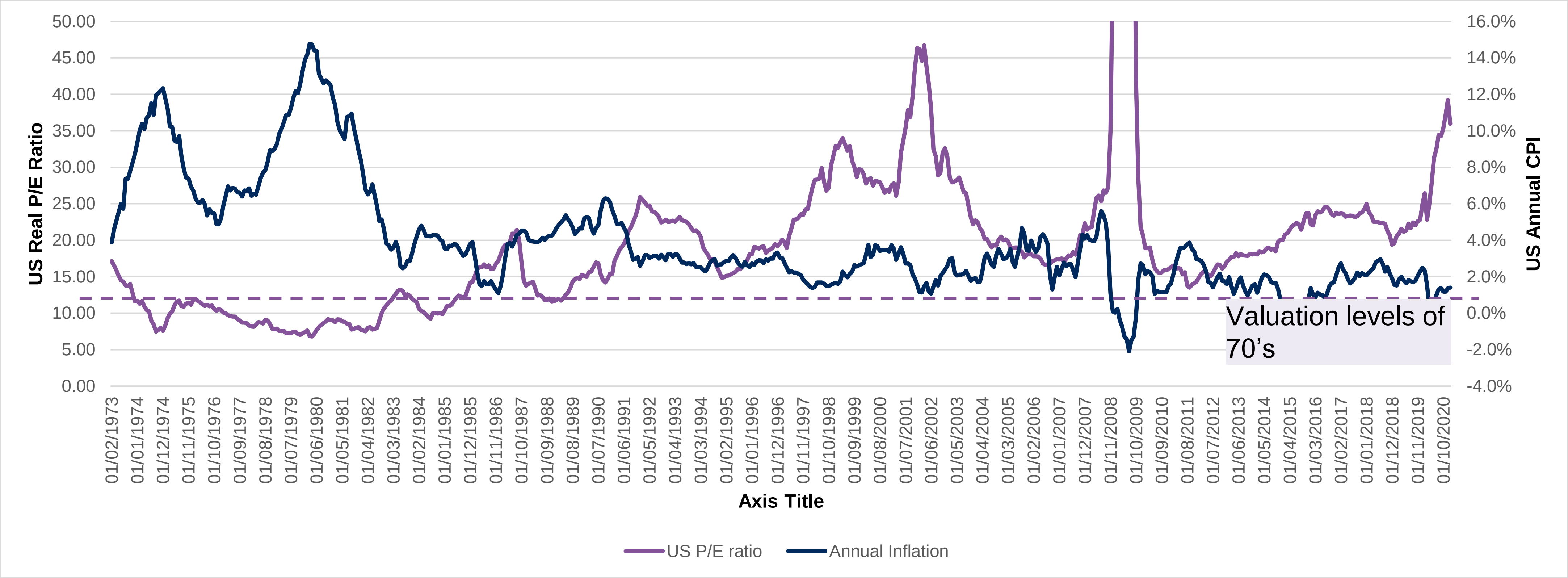
Valuations

At the same time valuations were very depressed

It was low valuations that then set up the bull market of the 1980's and 90's.



We do not have the helpful low valuations today

Source: Shiller data set (http://www.econ.yale.edu/~shiller/data.htm).

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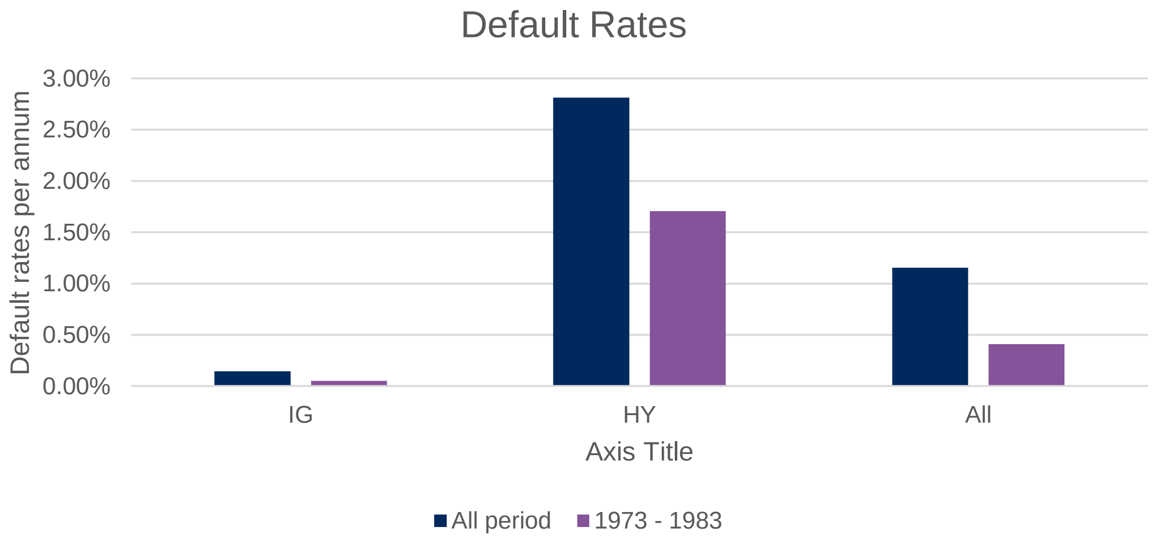
Credit – not so bad?

If we look back at the 1970's defaults weren't that bad

We have shown below the defaults



This was in a period when Real GDP was 2.6% p.a. vs the long term average of 3.2% p.a.

Inflation can be helpful to inflate away debt…

Source: Moody's default study. All period is from 1920 to 2017.

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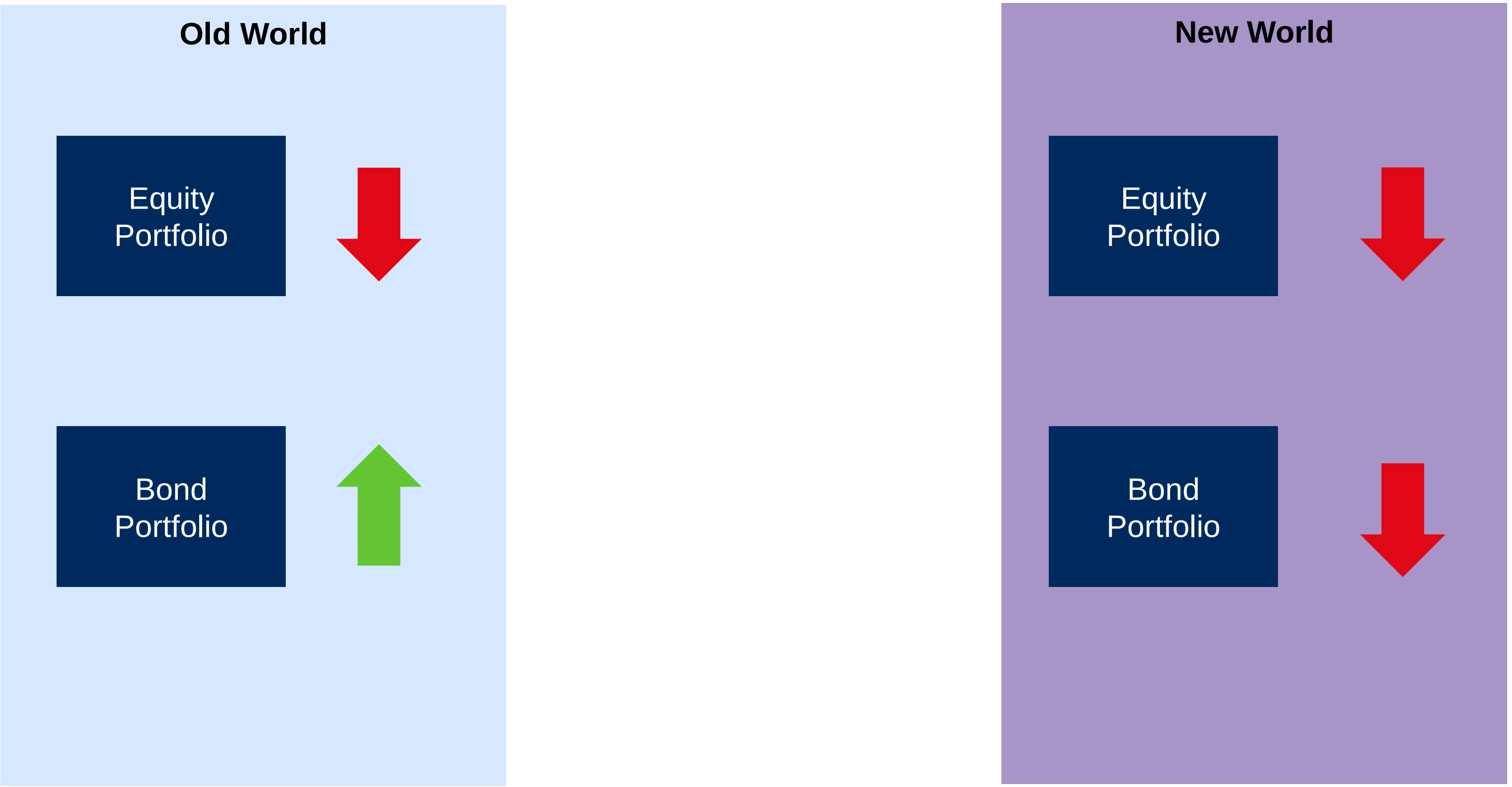
Strategic Consideration 1 – Growth portfolios

Can we depend on historic correlations?

If bonds and equities move together the conventional portfolio is more risky

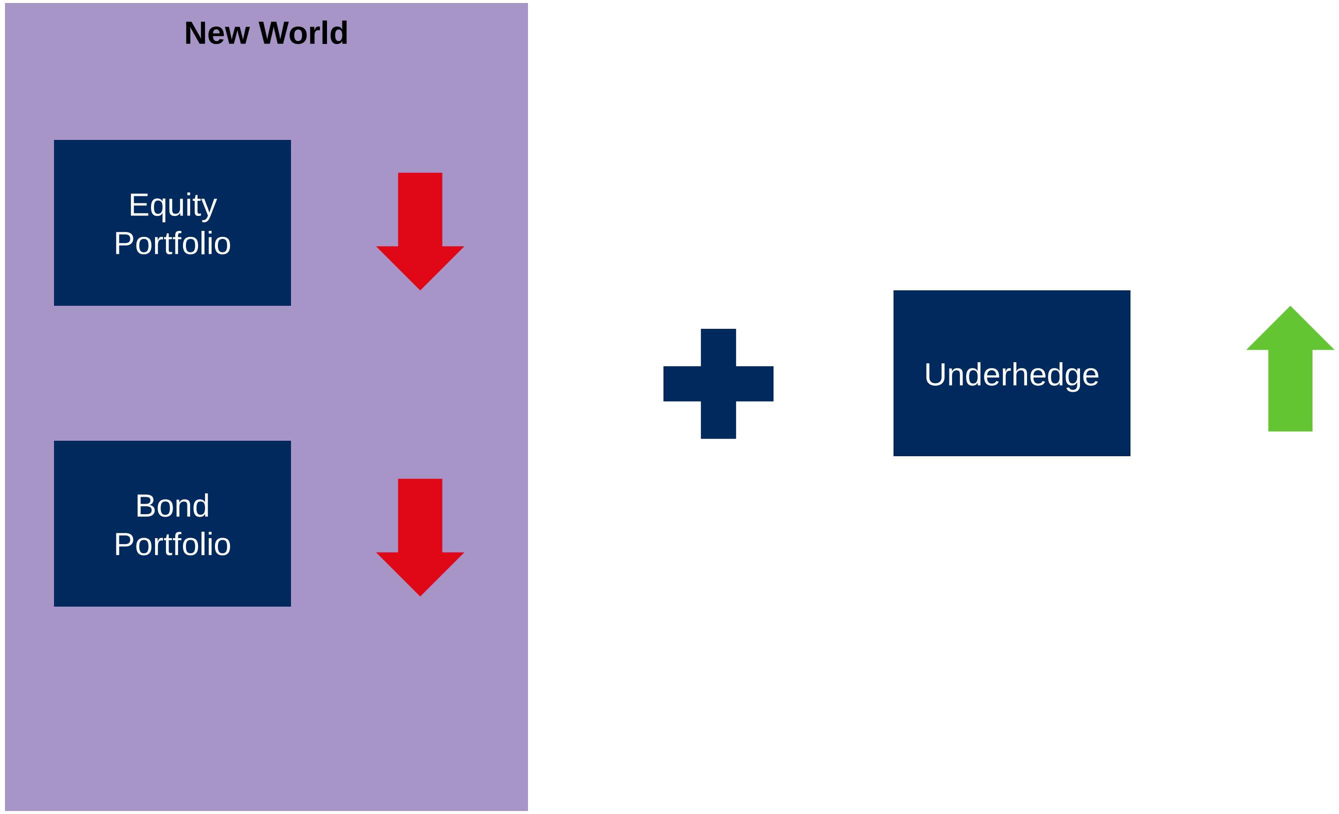


This may imply less duration in a portfolio

Strategic Consideration 2 – Liability Hedging

Does full hedging make sense?

Protection may no longer be afforded by long bond positions



Could underhedging improve your risk profile?

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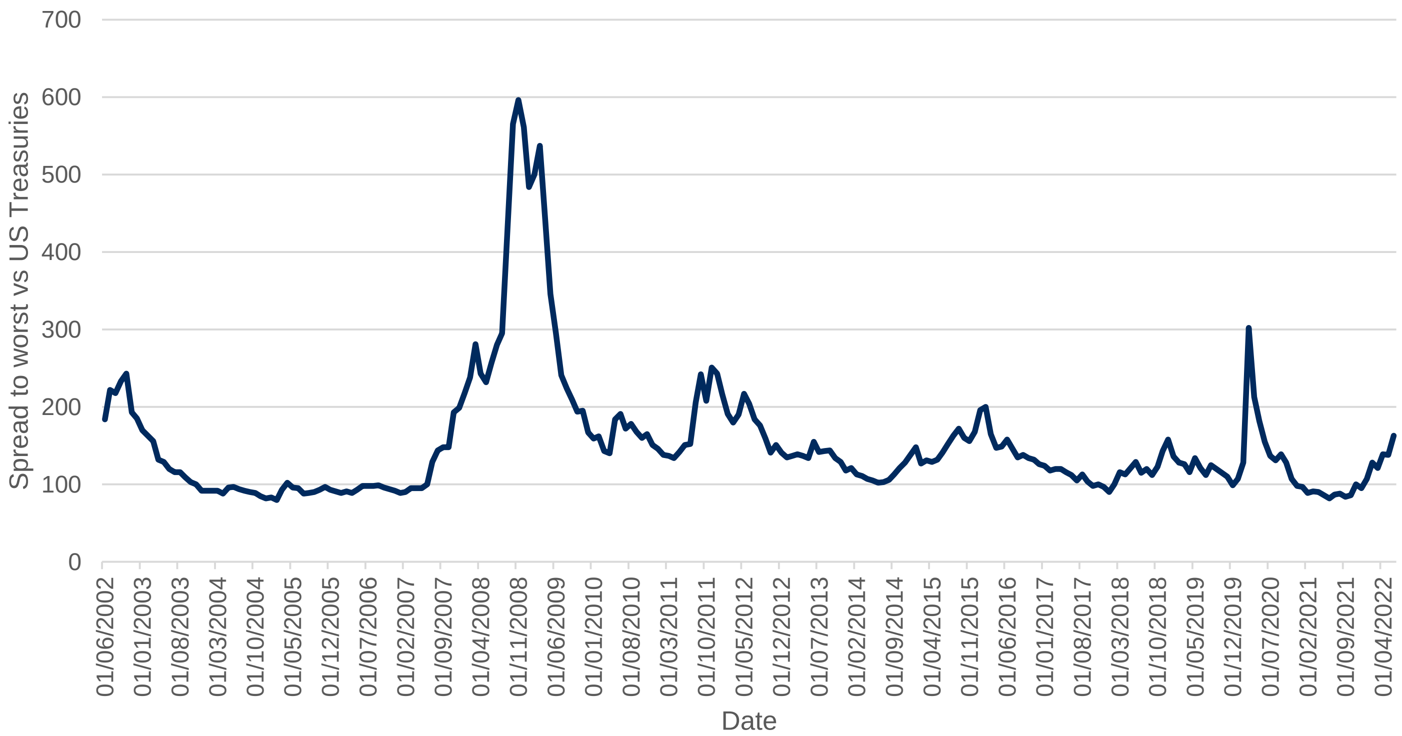
Strategic Consideration 3 – Credit

For a cash plus target is fixed rate ok?

Spreads today look quite wide



Time Period	Current Spread Percentile
20 Years	73.7%
10 Year	90.0%
5 Year	95.0%

The value of spreads may depend on cash plus or CPI objectives

Source: Bloomberg, BoFA Global Corporates index using excess spread to worst for time period from June 2002 to June 2022

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Summary

Investing is different

1. **Old relationships are broken**
2. **Consider your risk analysis**
3. **What positions could work in the future**

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