IR+M
INCOME RESEARCH + MANAGEMENT

IR+M UPDATE

Inflation: Mountain or Molehill?

June 23, 2021

As the global economy continues to recover, an accommodative Federal Reserve (Fed) and stimulative fiscal policy have pushed inflation concerns to center stage. By some measures, inflation is at its highest in over a decade, and several factors could sustain these levels. Conversely, other metrics point to a more benign environment, and suggest the recent increase may be "transitory." While we do not predict the future, we believe overall inflation risks are elevated, particularly given current spreads and valuations. In this piece, we focus on key inflation metrics, and identify which asset classes and sectors may be better positioned to handle the rising risks.

On a Scale of 1 to 10, How Much Does This Hurt?

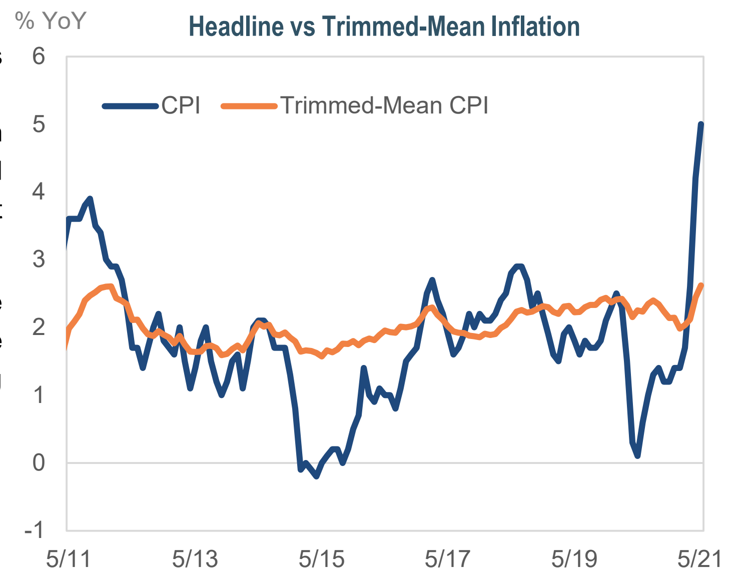
- **Inflation impacts different people differently**. We all have anecdotes of higher prices, whether at the grocery store or gas station. Some will experience inflation considerably more, such as an individual looking to buy a house or a car. Companies also feel squeezed, with homebuilders paying as much as four times the price for lumber compared to a year ago, or retailers giving sign-on bonuses to attract employees. However, some are better hedged or able to pass along these costs to customers.
- **The same is true at an institutional level.** For example, with endowments, real returns may be negatively impacted by higher inflation, but they may also have flexibility to reduce spending. Pension plans, which may not have the flexibility to reduce benefits, might need to make additional contributions.

LDI Can Make Inflation Hurt Less for Corporate Pensions

- Rising rates under an inflationary environment may lead to lower liabilities and fixed income market values. However, the uncertainty around when and if rates rise could result in funded status volatility.
- By utilizing a liability driven investment strategy, assets and liabilities would have commensurate changes regardless of how interest rates evolve.

Measuring Inflation: The Devil Is In The Details

- **Alphabet soup.** There is no one way (or acronym) to measure inflation. While each method helps tell the story, Consumer Price Inflation (CPI) and Trimmed-Mean CPI are two key metrics that illustrate how results can differ based on the methodology.
  - **CPI,** or headline CPI, measures the prices paid by consumers for a basket of goods and services, including food and energy, which are often more volatile. The recent jump in CPI has been fueled in part by supply chain bottlenecks. For example, used cars and trucks account for almost one third of recent increases, which have been affected by the chip shortage.
  - **Trimmed-Mean CPI**[1] adjusts CPI to remove the items with the highest and lowest one-month price changes. By excluding the outliers, this metric can provide a better signal of the underlying trend.
- **Both metrics show an increase in inflation.** However, trimmed-mean CPI has experienced a much smaller rise, which might indicate a more transitory jump than a sustained shift higher.

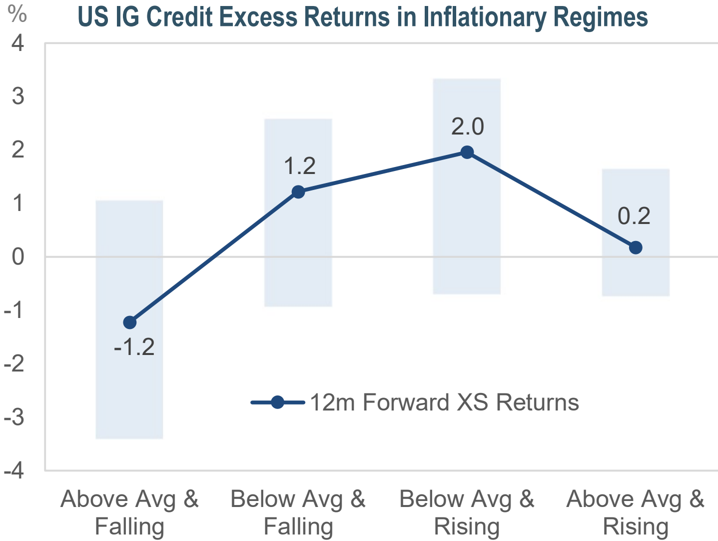


- **Inflation expectations are important.** The Fed watches real-time inflation data, but also factors expectations into their decisions. The Fed closely monitors breakeven inflation rates, which measure the difference in yields between nominal Treasuries and similar-maturity TIPS (Treasury Inflation-Protected Securities). Although breakevens have been on the rise, they recently fell as the Fed continues to emphasize the temporary nature of the current inflation spike.

Bloomberg, Bloomberg Barclays and IR+M Analytics as of 5/31/2021. [1]Trimmed-Mean CPI refers to the Federal Reserve Bank of Cleveland 16% Trimmed-Mean CPI. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable. This report is for informational purposes only and is not intended to provide specific advice, recommendations for, or projected returns of any particular IR+M product. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission from Income Research & Management.

Impact of Inflation Regimes on Different Asset Classes

- Based on history, trend inflation, defined as the 5-year rolling average of CPI, is at relatively low absolute levels. Asset classes respond differently when inflation is rising or falling relative to trend.
- **Where are we now? I**nflation was below trend going into 2020. However, since hitting a pandemic-low of 0.1% in May 2020, inflation has broadly moved higher. While base effects and supply chain bottlenecks have factored into recent CPI reports, the last two readings have been sharply above trend, which could have implications for asset returns.



- **Treasuries** tend to perform worst in rising inflation environments, as higher inflation both reduces the value of cashflows and typically leads to higher interest rates.
- **TIPS** can offer protection against rising inflation. However, TIPS returns are more correlated to interest rates than changes in inflation. Additionally, TIPS look most attractive when deflation fears have pushed breakevens near zero, like last year. As inflation recovers, we see more relative value in spread product. See our blog post for additional information.
- **Credit** typically does best when inflation is below average and rising, which is generally an indicator of economic growth. However, too much inflation might be the result of an overheating economy, which can lead to diminished returns.

Opportunities and Watchouts In A Rising Inflationary Environment

- Within credit, we believe certain sectors, such as Transportation and Energy, are better positioned to moderate the impact of inflation. We think other sectors, like Consumer, are less so.

	Inflation Risks	Rationale
Transportation	Low	• Companies can pass along price increases or offset with higher volumes. • Railroads generally have strong pricing power and will also benefit from the economic recovery through volume gains. • Transportation services should be beneficiaries of freight inflation. Labor is a concern, but most of these companies already pay above minimum wage.
Energy	Low	• Higher oil prices are usually a positive for this sector, as they reflect healthier demand, which leads to better cash flows. • Refiners should benefit from higher selling prices, while Producers are not as concerned about raw materials costs as capex budgets are low.
Consumer	Medium	• Sector is more exposed, particularly Food and Beverage and Consumer Products. • Freight, packaging, and labor make up a significant portion of costs and all are seeing price pressure. While many companies have hedged some of these costs, margins could be more challenged next year.

- **Don't throw the baby out with the bathwater.** Although some sectors are more inflation-sensitive, there are attractive opportunities at the security level. Given current valuations and higher overall risk levels, we think it is prudent to focus only on the highest conviction ideas.
- **Uncovering value in Securitized.** Securitized assets can offer attractive relative value in this environment. These bonds have more frequent cashflows than a corporate bond, providing the ability to reinvest if rates rise due to inflation.

Bloomberg, Bloomberg Barclays, and IR+M as of 5/31/2021. Top chart sourced from Morgan Stanley as of 5/31/2021 and shows 12 month forward US IG Credit excess returns in inflationary environment based on CPI from 1970 to 5/31/2021. Blue bars show the interquartile range of excess returns and dark blue line is the median. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable. This report is for informational purposes only and is not intended to provide specific advice, recommendations for, or projected returns of any particular IR+M product. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission from Income Research & Management.

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The Only Thing I Cannot Predict Is The Future

- **Accurate forecasting is difficult.** The number of scenarios that could lead to greater inflation have increased, and several factors may lead to a sustained higher level. This bout of inflation could also be temporary, as there are many structural elements that could keep levels low.

Upside Risks

- **Accommodative monetary and fiscal policy.** The Fed's balance sheet has expanded more than during QE1, 2, and 3 combined. Fiscal response increased the budget deficit in 2020 to almost 15% of GDP, compared to the 50-year average of 3%.
- **Fed policy.** In a historic shift, the Fed last year stated that it would target an average, instead of fixed, 2% inflation level. Fed officials have commented that they are comfortable letting inflation "run hot" for some period to achieve this goal.
- **Labor market pressure.** Job openings are at a record high, but so is the percentage of firms not able to fill positions. Certain sectors, like hospitality and leisure, are seeing significant growth in wages.

Downside Risks

- **Demographics.** Forecasts call for a declining birth rate and general graying of the population. An older and slower-growing population may be deflationary if it leads to lower overall demand.
- **Technology.** Besides creating a better iPhone, technological revolutions lead to supply-side shocks. These shocks can be deflationary, enabling companies to produce more for the same cost or less. Many automation trends that existed before COVID accelerated during the pandemic, which could constrain labor pressure.
- **Labor market pressure.** The US is still over 7 million jobs short of pre-pandemic levels, and there remains little sign of broad wage pressures. Additional unemployment benefits are set to expire in September, which could lure more workers back to the workforce.

- **Don't go chasing waterfalls.** Inflation is an important factor to consider when making decisions related to portfolio positioning. While we do have views on the potential direction of inflation, we remain duration-neutral and instead express these views through bottom-up security selection. We prefer to remain diversified and "take what the market gives us," rather than position for a specific forecast.

At IR+M, we believe the risk of higher inflation, particularly in an environment of tighter spreads and high relative valuations, cannot be overlooked. However, we maintain that inflation is difficult to predict accurately and consistently, and as such, do not position for a specific target. We endeavor to create well-diversified portfolios and rely on our bottom-up security selection expertise to identify bonds that may be less susceptible to rising inflation. If inflation does lead to increased interest rates, fixed income investors stand to benefit due to the ability to reinvest at higher rates.

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