

Investment Strategy Update #51

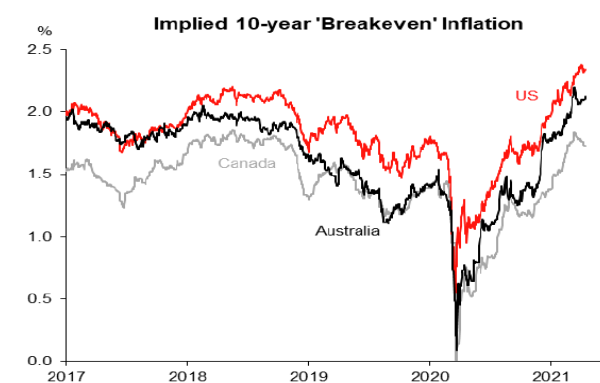
How to Position for Higher Inflation

- We don't know if inflation will prove to be the biggest risk for portfolios in the coming few years. It might, but it is too early to predict or position for.
- Historically, a low but rising inflation environment has been positive for risk asset. But, once inflation begins to rise above the long-term average, it acts as a headwind for financial assets particularly if bond yields are rising and/or policy is tightening.
- Neither bonds nor equities perform well during high inflation periods. Contrary to popular belief, equities are not a good hedge against inflation (although they do outperform inflation over the long run). Consequently, even a 60:40 portfolio is not enough to protect against high inflation periods.
- Investors can minimize the damage from rising inflation, but it is hard to completely avoid any negative impacts.
 - Commodities have been the best hedge while other real assets such as real estate (and collectables) have generally held their value.
 - "Quality" and "Dynamic Strategies" outperform "Value" and "Simple Strategies" during high inflation periods but investors must still consider valuations and the type of dynamic strategy to best employ.
 - No equity sectors provide consistent protection against inflation, but Energy, Materials and Healthcare are strong relative performers. Consumer sectors as well as financials generally underperform.

We are not sure if inflation will be the biggest risk for portfolios over the coming few years. Certainly, the conditions for higher inflation and as a result, a reversal of ultra-easy monetary conditions are falling into place. But, at this stage it is too early to tell.

As a result, we remain vigilant in assessing this risk, but we are not positioning for this outcome given it remains highly uncertain and because we believe the opportunity cost of being overly defensive is too high when the global economy is recovering faster than expected and central banks are resolute in letting the recovery gain traction.

Inflation breakevens have normalised



Source: ABS, Macrobond, Bloomberg, Macquarie, April 2021

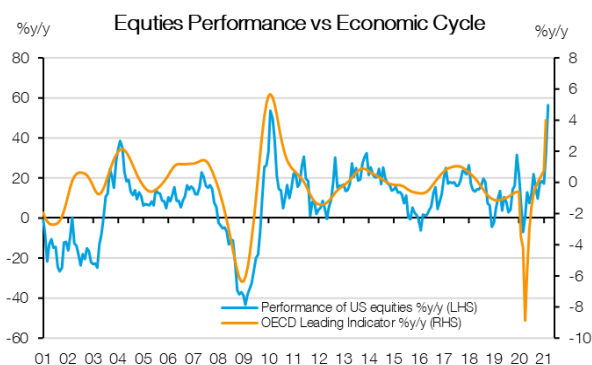
We accept that some investors might have a different view, so in this week's update we outline how to position for rising inflation at either a portfolio level or within specific assets. Before then, we reiterate a number of points that should be considered before any decisions relating to positioning around rising inflation and higher bond yields are made.

1. For the most part, bond yields are rising because real rates are rising and not because inflation expectations have risen above long-term levels –

providing some indication that while the discussion on inflation is ferocious, its largely “expectational”;

2. There is no magic bond yield level that consistently tips the equity market over – so investors should not pin their portfolio allocation decisions to a fixed bond yield. Sustained equity market weakness usually requires a combination of factors including a reversal of central bank policy and deteriorating economic fundamentals;
3. It is “unexpected” inflation that investors should fear most. This is what surprises markets and causes the greatest level of volatility. In addition, it is usually unexpected inflation and/or getting behind the inflation curve that causes central bank policy tightening; and
4. Historically equities have outperformed bonds during cyclical rebounds even in the initial stages where bond yields are rising. In addition, as inflation begins to pick up, positioning in areas that benefit from a normalization in inflation (commodities and energy) and a stronger cyclical pulse (value stocks and financials) more than offset the drags from rising yields.

The cycle still supports equities over bonds

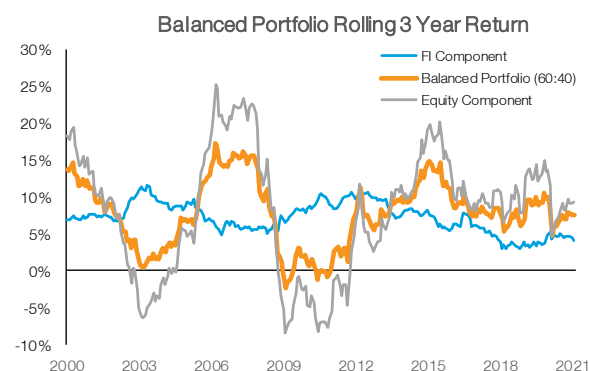


Source: FactSet, Macquarie WM, April 2021

Incorporating these factors would suggest we see no need at this time to be aggressively positioned for rising inflation, but rather than debate whether inflation will or will not sustainably increase, we simply look at how best to position for this outcome either at a portfolio of asset class level. We refer to recent articles – “The Best Strategies for Inflationary Times” Neville, Draaisma, Funnel, Harvey and Van Hemert and “Australian Equity Strategy – Winners & Losers from Rising Real Rates” Matthew Brooks for empirical analysis.

How to position a portfolio for rising inflation: Maintaining diversification across growth, defensive and alternative assets classes help to smooth portfolio returns and limit drawdowns. Investors should not get too focused on negative returns in single asset classes and instead focus on the overall portfolio returns.

Diversification dampens return volatility



Source: Morningstar, MWM Research, March 2021

At the start of an inflation cycle, the reflationary backdrop should see gains from growth assets outweigh negative returns on fixed income (sovereign bond) exposures. However, if inflation rises to a level that begins to drive rising economic uncertainty, then both bond and equity values will decline. There are three strategies that will help boost returns as inflation begins to rise and/or mitigate portfolio downside if inflation begins to undermine asset values more broadly:

- **Reduce passive interest rate risk exposure** favouring active management (with capacity to invest in inflation-linked bonds) and/or increase credit spread exposure to mitigate the impact of rising yields in defensive allocations.
- **Increase allocation to real assets** (real estate, commodities and GDP sensitive infrastructure) that benefits from a pro-cyclical backdrop which is likely to offset the impact of rising yields. Infrastructure assets in particular often benefit from cash flows directly tied to inflation.
- **Increase exposure to alternative strategies** that have limited exposure to the direction of interest rates and/or equity markets. Dynamic strategies (i.e., long/short or trend following) have historically provided positive returns during rising inflationary

periods although this is highly dependent on the type of strategy (there is a strong size bias against small caps).

Unfortunately, even a 60:40 portfolio has not been enough to protect against falling asset prices during historically high inflation periods given both equities and bonds tend to decline. However, we think a 60:40 portfolio would be the minimum level of diversification required for those worried about inflation. Within a portfolio context, we would recommend investors are overweight real assets (commodities, real estate) and alternative assets (dynamic strategies), underweight sovereign bonds and duration and within equities they are overweight large cap / quality stocks over small caps.

Hedging against Inflation (relative)



Source: Macquarie WM, April 2021

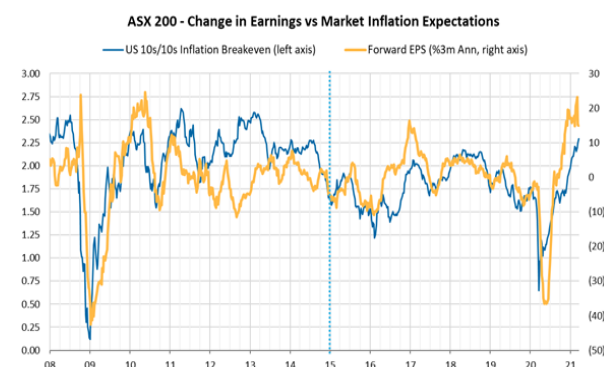
Increasingly cryptocurrencies (i.e., Bitcoin) are finding their way into diversified portfolios and being put forward as inflation hedges. Cryptocurrencies are highly volatile and have not been tested in high inflationary environments, so their reliability is uncertain. In addition, while it is argued that they are independent of economic events (zero market beta), recent performance suggests otherwise with Bitcoin falling by more than other risk assets during the COVID-19 sell-off.

It is possible that they perform like other risk assets during high inflation periods that drive weaker equity returns. Nevertheless, the fundamental reasons for adding as inflation protection remain strong (see Investment Strategy Update #38: Does Bitcoin have a place in your portfolio).

Finally, there is a long-standing view that “value” is a hedge against inflation - this is incorrect. Value has a spotty track record during high inflation periods,

providing positive returns only 50% of the time. For those focused on style, if they are better to remain in “quality” over “value”.

Macro fundamentals are supportive of earnings gains



Source: FactSet, Macquarie Research, April 2021

How to position within equities for rising / high inflation

Our starting assumption is that equities are not a good hedge for high inflation – contrary to popular belief – but that there are ways to minimize losses from the asset class during inflation periods.

- **Stick with quality over value and tilt towards large over small caps.** This is because value tends to be more exposed to consumer cyclicals and financials which are both impacted by rising economic uncertainty. However, the caveat is to avoid high multiple stocks where valuations will come under pressure from rising yields. In Australia, consumer staples, consumer discretionary and technology have the highest correlation with real rates.
- **Overweight resources and energy.** Resource stocks (mining and energy) have a positive correlation with real yields and are generally strong performing sectors into rising (but not high) inflation. However, historical correlations suggest rising real yields are simply less of a headwind vis-à-vis other more highly correlated sectors.
- **Avoid financials (particularly if the yield curve is flattening).** Banks and diversified financials perform strongly in a recovery phase of the economic cycle and when inflation is normalizing. However, they don't perform well when short rates rise (in response to inflation) or when the default cycle begins to pick up.

Macquarie WM Investment Strategy Team

The report was finalised on 18 April 2021.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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