Inflation and Strategic Asset Allocation

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A brief history of inflation

Beyond the fluctuations in economic growth that guide tactical asset allocation, the most fundamental question for strategic allocation is the inflation regime that the developed world stands to experience in the coming years. For a variety of reasons, we may currently be at a major crossroads and at a time of radical change.

For almost 25 years, from 1960 to 1983, the world lived through the consequences of the monetary disorder that led to the end of the Bretton Woods Agreement in 1973, which established just after the Second World War a fixed exchange rate system with the dollar-based "gold-exchange" standard. This system could only function due to a permanent influx of dollars into the international economy, which led to very accommodating monetary policies –an essential condition to ignite inflation. The oil crises of 1974 and 1979 acted as the triggers for the period of Great Inflation, which raised consumer prices in the developed world from around 4 to 10%, with automatic wage indexation to prices further fuelling the fire.

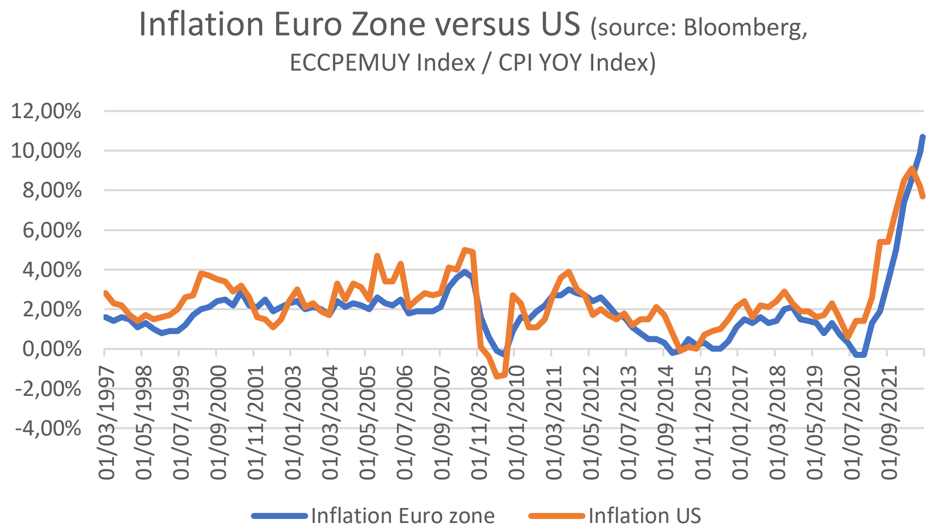
Then, for 40 years, from 1983 to the present, the developed countries changed their inflation regime to the Great Moderation, i.e., inflation between 0 and 3%. The man responsible was Federal Reserve System (FED) Chairman Paul Volcker, who raised the Fed's key interest rate to 20% in 1981 and adopted a strict policy of controlling the growth of the money supply, causing a severe recession. The lack of monetary fuel and the end of price-indexation schemes for wages have permanently broken inflationary expectations. Then came globalisation with the fall of the Berlin Wall in 1989 and China's entry into the World Trade Organisation (WTO) in 2001. The persistent deflationary pressures caused by the constant introduction of comparative advantages in the free-trade world have moderated wage demands while increasing household purchasing power.

But globalisation has experienced serious headwinds over the past 15 years: the Global Financial Crisis of 2008, the clash between the United States and China from 2018, the pandemic in 2020 and the war in Ukraine in 2022. The world economy remains globalised, but fragmentation and segmentation are its new watchwords, with fewer competitive advantages and less of a network effect.

On the central bank side, it all started with the ultra-accommodating monetary policies put in place in 2009 in the United States and in 2015 in the eurozone to counter the effects of the global financial crisis, with the corollary of money supply growth of more than 20% at an annual rate over a long period. The fuel was in place. The onset of Covid then ignited inflation with a constraint impact on supply linked to containment and an overstimulation impact on demand linked to public support measures.

Then, comes the pressure for climate transition. The price of the carbon externality, which until now has not been taken into account, but which is the only truly effective instrument for passing through climate transition safely, will weigh heavily on energy prices. After all, economic activity is nothing other than the transformation of energy. The price of carbon will rise inexorably, as it reflects the present value of climate damage that is largely expected to occur after 2050, a date that is looming large ahead of us but closing in fast.

All this points to a rising trend in inflation. Other structural developments such as an ageing population could interfere with this trend in one direction or the other.



Against this backdrop, headline consumer price inflation in the US and Europe now stands at nearly 8% and 10% respectively year-on-year and shows few signs of abating anytime soon. Inflationary pressures are likely to ease from 2023, but at what pace and at what level will they eventually settle down?

Central banks were caught off guard and changed their tune from the end of 2021 with a gradual and then increasingly pronounced tightening of monetary policies by acting on both liquidity and interest rates. They are still aiming for the long-term inflation rate expected by the markets to be around 2%. But according to 10-year inflation swap market quotations, we are already at this level. So why do they continue to drain liquidity and raise key interest rates? Certainly, because they do not feel that these expectations are sufficiently anchored with regard to the situation on the labour market. The nearly full employment in all countries, the bargaining power of individual employees in connection with the emergence of societal phenomena as part of the "Great Resignation" and the new employment status in the knowledge economy are powerful forces driving wages upwards. Wage growth is vindicating central banks: 4% in the eurozone as core inflation (inflation excluding food and energy) and 6% in the US as core inflation, with core inflation in both regions being particularly resilient.

Responsible financial management can no longer put off thinking about what the principles of strategic asset allocation might be under a regime of higher inflation than has been experienced by the vast majority of managers currently in charge.

Asset allocation under different inflation regimes

There is a broad consensus in academic research that a level of inflation between 0 and 3% is considered normal, above 3% and up to 10% as a high level of inflation and above 10% as hyperinflation regime, implying that inflation is getting out of control. There is also agreement that financial and real estate markets behave differently in periods of normal inflation than in periods of high inflation. In fact, beyond economic growth cycles, inflation profoundly governs asset performance, their volatilities and co-movements – essentially the entire basis of strategic allocation.

In terms of performance, real estate is the asset class whose performance is most directly polarized to inflation. The Great Inflation episode of the 1970s demonstrates this to the extreme. During this period, nominal interest rates on 10-year government bonds gradually rose, incorporating an increasingly large inflation risk premium. The real overall performance of government bonds has always been negative because the rising coupon rate has never been enough to compensate for the capital loss. At first, stocks experienced essentially no real performance before recording a real gain when rising cost prices could be passed on to selling prices. Residential and commercial property initially reacted with an increase in rental yields due to the rise in interest rates. But the increase was not 1:1, but rather 0.5:1. And this rise quickly stopped when the rental yield reached

6% just because real estate is a real asset, the land constraint prevents prices from falling too much and the constraint of tenant solvency prevents rents from rising too much. At the same time, the effect of the indexation of rents to prices, which continues to this day, has pushed up the capital return. When the rental yield stopped rising, the indexation effect came into full play and the real performance of real estate remained positive over the entire period.

As far as volatilities are concerned, high inflation usually results in large fluctuations in economic growth, both because the unexpected component of inflation increases, but also because the prices of goods and services react differently to inflation. Some economic sectors are able to quickly transfer their inflated expenses to their sales revenue because they are in a position of market dominance or because the demand for their products or services is strong, while other sectors are unable to do such. Fluctuating economic fundamentals spill over into the performance of assets, which see their volatility increase and their risk-adjusted return decrease, with riskier assets being relatively penalised and less risky ones favoured.

As far as co-movements are concerned, the diversification gain between equities and bonds fades in times of high inflation, while the diversification gain between real estate and bonds remains significant.

In theory, the correlation between stocks and bonds is negative or positive depending on the direction of the causal relationship. Causality can run from equities to bonds: for example, a fall in equity prices, which is a sign of weakening activity, can lead to an easing of monetary policy and a fall in interest rates, in which case the correlation is negative. It can also go from bonds to equities: a rise in interest rates for example tends to increase the cost of capital of equities, in which case the correlation is positive.

In times of normal inflation, the main factor influencing the markets is economic growth. The equity market becomes a driver, as growth is its main indexing factor. The correlation between equities and bonds is therefore fairly negative. This has been observed throughout the rise of globalisation, with growth essentially dependent on demand without supply constraints.

In times of high inflation, the main factor influencing the markets is inflation. The bond market becomes a driver, as interest rates respond primarily to inflationary expectations. The correlation between equities and bonds is therefore fairly positive. This is what we are likely to see as globalisation recedes and growth becomes essentially dependent on the availability of supply.

Real estate rarely drives the markets, and when it does, it is during a major financial crisis. This asset is mainly sensitive to real interest rates. A rise in interest rates above inflation is conducive to a fall in real estate, in which case the correlation between real estate and bonds is positive. If, on the other hand, the rise in interest rates is lower than inflation, real estate holds its own and the correlation is negative. This is what generally happens, because interest rates react with a delay and in a reduced manner in the face of inflation.

In summary, what distinguishes asset allocation in times of high inflation from allocation in times of normal inflation is not only the focus on real rather than nominal performance, but also the construction of a portfolio that favours a balance between securities and real estate rather than between equities and bonds.

What Type of Asset Allocation for a Medium/Long Term Investment Horizon?

Beyond the negative real growth impact that our economies are currently experiencing – a phenomenon that is expected to continue in the coming quarters – how can we apply this paradigm shift to our asset allocations for professional investors with an investment horizon of more than 5 years?

The context of climate transition, coupled with the gradual decline in fossil fuel reserves, is set to lead to a trend towards higher energy prices in the coming years. In terms of asset allocation, this should translate into greater exposure than before to commodities and to sectors whose profits are positively correlated to these assets. This applies to both equities and bond assets. Conversely, business models that depend on stable, low-cost energy supplies may have more difficulty.

As illustrated above, we are potentially heading for a very uncertain period in which inflation and disinflation, growth and recession could follow on from each other. These periods are conducive to strong differentiation between the various segments of the economy, and this will no doubt be true this time around. Long-term trends such as the growth of cities, decarbonisation and digital innovation will lead to the emergence of the major players of tomorrow, as has been the case over the last 20 years with the development of the internet. In our view, these trends should form the basis of long-term asset allocation today, and again, regardless of the assets under consideration.

The massive investments needed to meet the challenges ahead will also require very strong support from States, which will see their need for financing increase. The current restrictive financial conditions will probably need to be relaxed in the medium term to allow for such financing. This should be accompanied by lower real interest rates (but not as low as in the last 10 years) and higher break-even inflation rates than at present. On this last point, it is striking to note that today the financial markets are expecting inflation to return to the central banks' targets around 2% very quickly, which has not been the case historically.

Government bonds are structurally underweighted. Beyond the trend in inflation, which should have a lasting negative impact on this asset class, it is likely that government actions will hit the bond market. The example of the UK illustrates this point and shows that it will be difficult for central banks to maintain restrictive monetary policies for prolonged periods of time.

To put it more bluntly, a period of high nominal growth should help corporate earnings to remain resilient even if large sectoral disparities arise. However, this positive factor will be offset by likely increases in business taxation. The overall path could therefore ultimately be rather chaotic but not necessarily negative, at least in nominal terms.

There are likely to be many disparities within corporate bonds as well. Some companies that owe their existence exclusively to extremely low financing rates will find it difficult to survive. A rise in default rates is therefore likely in the medium term, hence our preference for good quality bonds, rated BB or better, bearing in mind that these assets are quite sensitive to interest rate risk.

Real estate, on the other hand, offers an interesting protection in times of inflation as its income is indexed to inflation. This inflation cover may have been provided for in leases. This is particularly the case in France where leases are indexed to indices directly linked to inflation. This is also the case in Spain and the Netherlands. This is less commonly seen in Germany and rarely the case in the UK, with the exception of supermarkets.

However, inflation protection may be limited if there is a cap on the indexation indices. These caps are intended to preserve the purchasing power of the occupants of real estate assets. They are generally found in residential assets and some commercial assets. Similarly, several significant increases in indexation indices could erode the solvency of tenants. Preference should be given to users with significant pricing power, i.e., who are able to pass on the inflated expenses to their sales prices.

In times of inflation, it is therefore essential to have a cross-analysis by asset type and by sector of activity to identify the assets offering the best protection against inflation. We favour offices leased to growth sectors (luxury, energy, transport, etc.), healthcare assets or managed residential properties with little impact from economic cycles and retail brands in growth sectors.

Rising inflation may result in higher capitalisation rates and higher financing rates. In order to limit the negative impacts of this increase, it is advisable to favour scarce assets, i.e., those in markets characterised by low vacancy. The low vacancy rate comes as a result of land scarcity in urban areas and regulations that limit the production of new supply to meet the objectives of a strong reduction in new land use. We favour dense urban areas where the building can be converted to another use if necessary. Vineyard products whose land value is based on being part of a limited terroir and whose prices are expected to follow inflation may also present an interesting solution.