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April 22

Note: The objective of this article is to discuss managing inflation and its associated risks and not about generating alpha

**Article: Investing in a Sustained Inflationary Environment**

## 1. Introduction

The U.S. Consumer Price Index (CPI) inflation is at a 40-year high and numerous economists from large financial institutions have called the Federal Reserve "totally wrong" about inflation being transitionary. With the recent Federal Open Market Committee meeting in March 2022, Federal Reserve Chair, Jerome Powell, admitted that inflation was not transitionary but instead "inflation is much too high", committing that the central bank "will take the necessary steps to ensure a return to price stability." This led to the Fed funds futures to price in expectation of multiple rate hikes, or even the possibility that the rate hike would be more than the usual 25 basis points. With such a backdrop, how can one remain invested in a sustained inflationary environment that is often accompanied by higher volatility and recession risk?

## 2. Equities

With high inflation, equities may seem to be the worst place to be in due to the negative correlation equities have with inflation (future cashflows are discounted at a higher interest rate). However, certain sectors outperform the rest and depending on the investor risk profile, equity investment may still be suitable if the asset allocation is kept to the right exposure. The next few paragraphs will discuss which sectors to invest in.

Firstly, high growth technology companies should be avoided as higher borrowing costs would cause net income to worsen further given the fact that most are already unprofitable. Instead, invest in high-quality companies with real products or services that have meaningful dividends and buybacks.

Secondly, sectors that enjoy pricing power, and can pass on higher input costs (e.g. wages and materials) to the customers should be considered. This includes sectors such as transportation, materials and market-dominant companies (e.g. McDonald's and Microsoft).

Thirdly, the energy sector, which includes oil and gas companies, has beaten inflation consistently. This is intuitive as the revenues of energy stocks are naturally tied to energy prices, which is a key contribution to inflation.

Next, Real-Estate Investment Trusts (REITs) may mitigate the impact of rising inflation. REITs own real-estate assets and may provide an inflation hedge via price increases in rent and property prices.

Lastly, gold is often touted as a hedge against currency debasement fears. However, it is worth pointing out that investing in companies in the gold industry is not the same as owning gold outright as it is not perfectly correlated and exposed to idiosyncratic risk.

## 3. Fixed Income

The yield of a bond is largely composed of two parts, the interest rate and credit spread. While credit spread reflects idiosyncratic risks associated with individual issuers, the interest rate can be considered the base rate for compensation to investors for their baseline economic risks. Hence, in a high inflationary environment, interest rates and bond yields will rise, resulting in falling bond prices.

In such a scenario, it would be wise to consider different types of inflation resistant fixed income securities such as Treasury Inflation-Protected Securities and reduce those that are sensitive to inflation such as treasury bonds.

To invest in investment-grade bonds, it is optimal to keep the duration low to reduce the impact or risk of rising interest rates. In addition, it allows for the reinvestment of short-term bonds at higher interest rates as the bonds mature. Alternatively, one can long a payer swaption to specifically hedge rising rates but still enjoy the benefits of a possible decrease in interest rates.

As for high yield bonds, the increase in interest rates may lead to higher credit risk for such issuers due to an increase in the probability of default. These issuers may have difficulties managing the higher borrowing costs from their business operations and hence unable to repay bondholders. A long credit default swap (buy protection) may be optimal to hedge such a scenario if the premium is reasonable.

## 4. Alternatives

Direct real estate is an alternative to REITs. Tangible assets tend to hold value during prevalent inflation as there will always be a demand for homes, regardless of the economic climate. However, since it is a tangible asset, it faces more unique risks such as illiquidity, leverage and regulation.

Instead of investing in energy or gold companies, investing directly in raw materials such as oil and gold products is also possible. However, commodities can be extremely risky as the prices largely depend on supply and demand, which can be highly unpredictable. This makes them a risky investment, on top of the fact that leverage is necessary. Some notable examples include WTI Crude Oil trading at a negative price in 2020, and most recently the LME Nickle price doubling in a day. These caused market confusion and panic which will be detrimental to an investor if the risks were not managed properly.

Bitcoin, a “digital gold”, is often argued to be the best inflation hedge instrument due to its limited supply. However, that statement is debatable due to its short trading history, resulting in limited data available for analysis. Other risks associated with cryptocurrencies are that they are currently unregulated by any authorities and are subjected to hacking risk.

## 5. Diversification

Diversifying internationally is a good strategy to hedge against inflation. Several major economies do not rise and fall in tandem with the U.S. market indices. Some examples include Italy, Australia, and South Korea. Adding stocks from such countries can help to hedge against domestic economic cycles. Bonds from foreign issuers can provide investors with exposure to fixed income that may not drop in price if inflation appears on the domestic front. However, by diversifying internationally, the portfolio is exposed to forex risk which is affected by the pair interest and expected inflation rate which brings more complexity to portfolio optimization.

## 6. Conclusion

In conclusion, it is possible to stay invested during high inflationary times. The key is to build an efficient portfolio that can not only manage the inflation risk but also the increased volatility and recession risk. By picking stocks more carefully, having a shorter duration in the bond holdings, managing credit exposure, and diversifying into alternatives and international holdings, one will be able to ride the period out unharmed.