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Inflation: Preparing your portfolio for the surge

Author
Seema Shah
Chief Global Strategist,
Principal Global Investors

After falling to almost zero during the height of the COVID-19 pandemic, the rate of U.S. inflation is on the rise. To navigate the current market environment, today's investor must understand *how quickly* the United States economic recovery will generate inflation, *how long* that inflation will be sustained, and what investment implications follow.

After nearly a decade in which inflation has been of little concern, several inflation drivers seem to be aligning. By February 2021, the U.S. Consumer Price Index (CPI) had increased to 1.7% year-over-year. By March, it rose to 2.6%, the highest in more than two years. Investors are rightly concerned about an even higher spike by the end of 2021.

If this surge proves long-lasting, it could prompt policymakers to withdraw their stimulus before a full economic recovery can play out, plus further implications for interest rates, asset prices, and portfolio construction.

In this piece, we'll cover how inflation changed from an afterthought to a top concern, and what investors can do to get ahead of a surge.

At a glance

After falling to near-zero during the pandemic, inflation is now investors' Number One concern.

The big comeback: Inflation concerns resurface as breakeven rates rise. A surge would bring implications for interest rates, asset prices, and portfolios.

Mitigating factors: COVID-19 conditions contribute to inflation's rise. But unusual base conditions aren't the only factors in a spike; other market conditions indicate inflationary effects such as sustained pricing pressures may linger, at least in the near-term.

Investment implications: Considering the long absence, many investors aren't prepared for inflation's portfolio effects. Investors may want to add assets that are likely to outperform to get ahead of a spike.

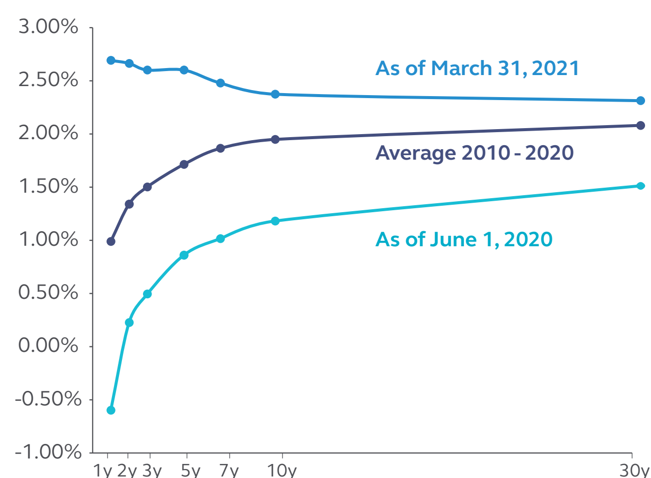
The inflation comeback: Factors to watch

In early 2021, inflation quickly replaced COVID-19 as investors' Number One concern. The big turnaround began last year, when U.S. breakeven rates—a measure of future inflation expectations—dropped meaningfully in reaction to the COVID disinflationary shock, before steadily recovering. Breakeven rates are now at their highest level since late 2018. (Market-based inflation expectations are measured by TIPS breakeven rates, the difference in the nominal yield on Treasury bonds and the yield on comparable TIPS, or Treasury Inflation Protection Securities.)

In recent months, the breakeven curve inverted, signaling that markets expect an immediate—but transitory—inflation surge in the months ahead.

Higher short-term inflation expectations

U.S. inflation breakeven curve



Source: Bloomberg, Principal Global Asset Allocation. Data as of March 31, 2021.

Climbing prices

The transitory aspect of the expected inflation increase is due in part to the unusual nature of 2020. Year-over-year comparisons will almost inevitably jump because of last year's big drop. Equally, inflation could fall once last year's pandemic-driven decline drops out of the annual comparison.

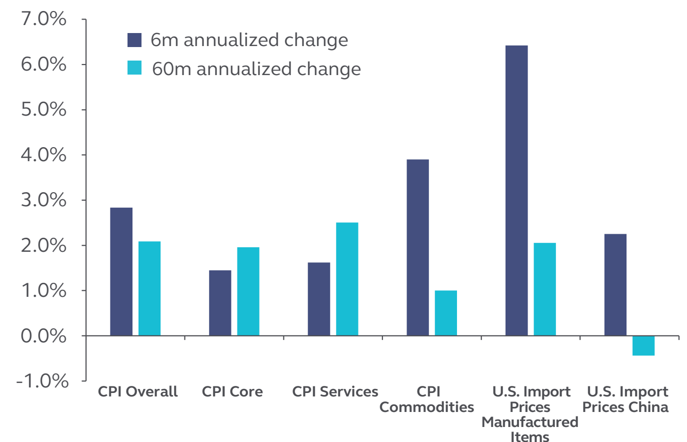
While "base effects" are indeed at work, other factors, like the unusual nature of the pandemic where the initial demand shock was followed by an outsized fiscal boost, lockdowns, and the vaccine-led recovery, have shifted the inflation dynamics, with some segments getting an early boost.

Import prices are a good example. Last year, pandemic-related closures created global supply-chain bottlenecks. As demand accelerated due to fiscal transfers and in response to improving COVID conditions in many economies, supply remained constrained, and prices surged. Constraint-led price rises will likely extend through the next few quarters if supply can't keep pace with expected swell in demand.

Of more concern is the possibility of sustained price pressures. Think surging commodity prices or

Higher import prices from supply bottlenecks

U.S. CPI components

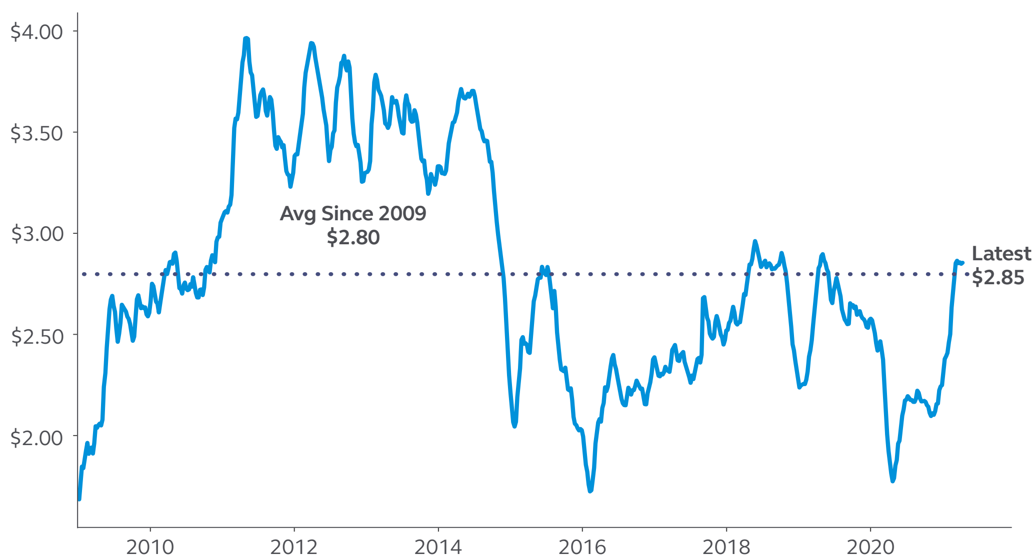


Source: U.S. Bureau of Labor Statistics, Principal Global Investors. Data as of March 31, 2021.

a prolonged spike in gasoline prices. These impact everyday consumers and can be detrimental to long-term economic growth. In the wake of the extraordinary fiscal and monetary policies implemented in response to the pandemic, we've already witnessed the average price of unleaded gasoline rise from under $1.80 to nearly $2.90 in just one year.

Sustained gas price pressures would severely impact consumers

Average U.S. gasoline prices nationwide, all formulations



Source: U.S. EIA, Clearnomics, Principal Global Investors. Data as of April 21, 2021.

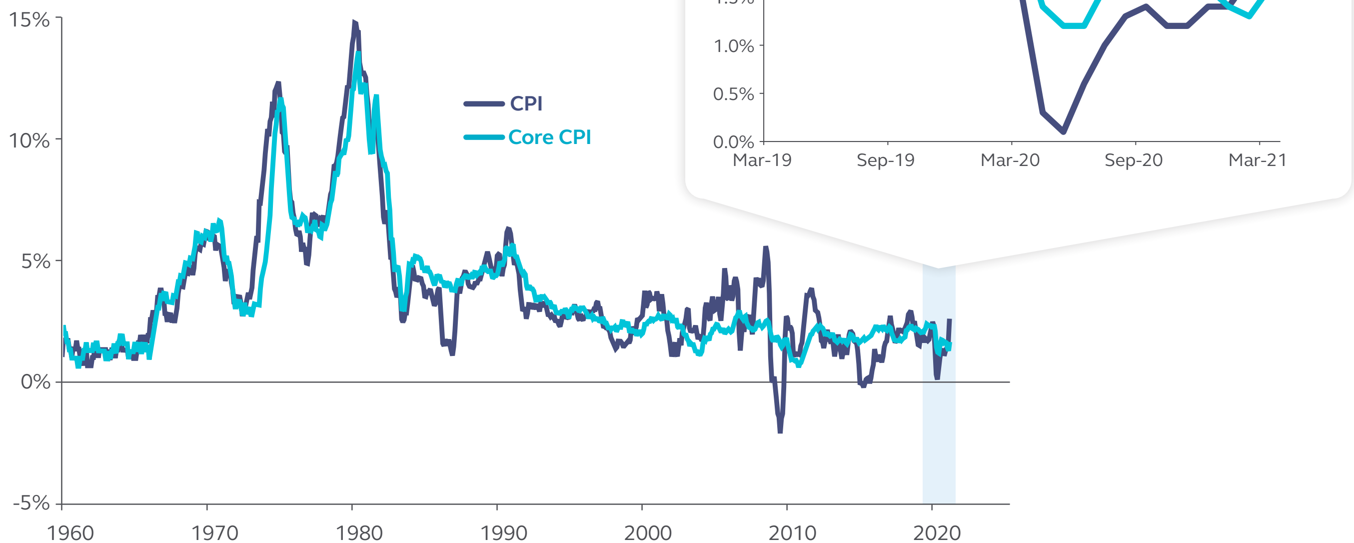
Unusual historical conditions

Inflation has been low since the early 1990s. This period, known as the "Great Moderation," is due largely to the deflationary forces of technological innovation, demographics, and China's entry into the World Trade Organization, which lowered production costs worldwide and revolutionized global supply chains.

Even the extraordinary monetary policy response to the Global Financial Crisis (GFC) failed to overcome these disinflationary forces, primarily because U.S. lawmakers turned to austerity measures before the recovery was complete. Therefore, low money velocity and slow economic growth following the GFC kept pricing pressures from emerging.

Low inflation: the long-time norm

CPI, and CPI excluding food and energy, year-over-year percent change



Source: U.S. Bureau of Labor Statistics, Clearnomics, Principal Global Investors. Data as of April 21, 2021.

Higher prices versus inflation

Rising prices and "inflation," as defined by economists, aren't synonymous. For instance, gasoline prices might increase due to a supply disruption without affecting other prices in an economy. In contrast, if conditions are right, fiscal and monetary stimulus can generate inflation—higher prices throughout the whole economy.

Even narrow price increases can affect tactical asset allocations and sector preferences, however. True inflation can also broadly impact portfolios and favor asset classes and sectors that are stores of value, including real estate, commodities, and natural resources.

Does this post-GFC experience mean inflation will again fall short of expectations? Three factors (in addition to base effects) point to higher inflation in the near term:

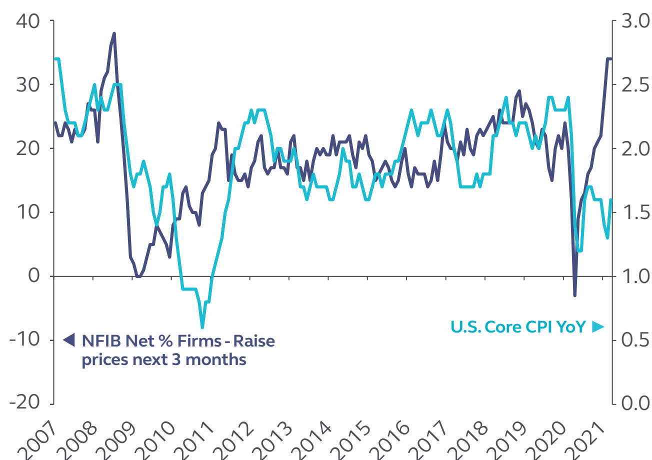
1 Supply-side forces

Supply shortages: Pandemic-related supply chain disruptions have restricted supply, pushing prices higher across many sectors, including energy, food, semiconductors, and building materials. As the U.S. economy reopens, the capacity to meet pent-up demand will be insufficient, intensifying supply constraints. It typically takes time to rebuild inventories, but as supply constraints ease, price pressures should once again abate.

Pricing power: Unlike after the GFC, consumers today have significant pent-up demand, greater savings and are better able to absorb higher prices. If the service sector attempts to capitalize on this by raising prices, the rise in inflation may be more persistent.

Some firms are already planning to hike prices

% of small businesses planning to raise prices in the next 3 months



Source: Bloomberg, Principal Global Investors. Data as of March 31, 2021.

2 Demand-side forces

Large fiscal stimulus: Whereas the fiscal response to the GFC was meager and austerity measures prevented a complete recovery, this time lawmakers have provided extraordinary fiscal support. The three COVID-19 stimulus plans passed by Congress totaled $5 trillion, and there are still the $2 trillion infrastructure bill and $1.8 trillion American Families Plan expected later this year. In all, the stimulus should enable the U.S. economy to return to its pre-pandemic path in 2022.

Small output gap: Furlough schemes and fiscal help for businesses in the past year mean that slack in the labor market is far smaller than after the GFC. So, as economic activity accelerates, the output gap should close sooner—potentially leading to (modest) economy-wide wage increases.

Healthy consumer balance sheets: Going into the GFC, private sector balance sheets were very extended, so after the crisis consumers focused on paying down accumulated debt. Today, healthier consumer finances mean that the fiscal stimulus and high, pandemic-induced savings rates could cause spending to soar.

3 Federal Reserve policy

A new inflation regime: The Fed's new Average Inflation Targeting Framework allows inflation to overshoot the 2% target for a period before implementing tightening moves. This will likely allow some "economic overheating," thereby making inflationary pressures more probable.

Extraordinary monetary stimulus: The quantity of money in the U.S. economy, measured by M2, increased by $4 trillion (a 26% increase) in the last year, and is likely adding to inflationary pressures. Not only is this the largest annual increase since the 1940s, it is also meaningfully higher than the 5.8% average annual growth of M2 registered in the last decade.

Investment implications: Preparing for the new inflation regime

Considering these factors, we believe pricing pressures will rise in the short term. This may mean that after years of minimal inflation expectations, investor portfolios may be unprepared. In this new inflation regime, investors may want to consider adding assets that are likely to outperform.

Equities

The effect of inflation on stocks varies, depending on its level, duration, and driver. Inflation shocks, in which prices shoot up quickly, tend to be disruptive. Long-term interest rates rise, which ultimately bring down growth expectations, hurting intrinsic asset values and causing prices to decline.

Equities tend to perform best when inflation is low and rising gradually. When inflation is moderate, companies with pricing power can pass on their higher costs, though others may see their profit margins narrow.

Equities also perform well despite higher bond yields, when inflation expectations rise due to stronger economic growth expectations. In contrast, when bond yields rise due to uncertainty in central bank policy or increased risk premiums, it can disrupt stocks.

Today, inflation is rising from very low levels, and its pace will likely be gradual once the current surge slows. Moreover, while bond yields have risen, financial conditions are extremely easy and against this backdrop, equities should continue to perform well.

How to Prepare:

- Higher inflation expectations and bond yields are leading to a shift in equity sector leadership. Growth has outperformed value since the GFC, but investors have begun rotating into cyclical and value stocks. With continued economic recovery, this shift will have further to run.
- The steepening yield curve presents a supportive environment, particularly for financials stocks.
- Lower quality stocks have also benefited from policy stimulus and should prosper in a global environment of solid growth, central bank support, and inflation recovery.

Fixed Income

Rising inflation can be particularly costly to bonds, and today this is exacerbated by historically low yields. Typically, higher growth expectations support corporate bonds but, with little room for further spread compression, rising inflation can swiftly erode principal, offsetting a historically reliable income stream.

If inflation proves transitory, the current threat to fixed income assets may be exaggerated with the Federal Reserve indicating that transitory inflation effects will not knock them off their lower-for-longer policy rate path. They want a full economic recovery, complete with higher labor market participation and reduced income inequality. Therefore, with interest rates pinned at near-zero for the next couple of years, significantly higher bond yields appear unlikely.

What's more, even during periods of rising inflation, the diversification value of fixed income securities is undeniable. Higher equity allocations leave portfolios vulnerable to growth disappointments, so fixed income securities can help mitigate the downside.

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How to Prepare:

- Not all fixed income asset classes are harmed by inflation. Historically, high yield, bank loans, and Treasury Inflation Protection Securities (TIPS) have offered some purchasing power protection.
- High yield bonds often perform like equities, outperforming during strong growth environments.
- Floating rate structures, like many bank loans or preferred securities, have interest rates that reset periodically and can provide opportunities for investors.
- TIPS have also helped portfolios in periods of high and rising inflation, so portfolio tilts in this direction are likely to help reduce the risk of principal erosion.

Alternatives

Real assets typically have a positive correlation with inflation and interest rates, and therefore are considered a good inflation hedge. At the same time, given low correlations to the more traditional assets, they can offer diversification as well as potential for enhanced returns.

Indeed, during the 1970s inflation years, real assets such as real estate and commodities outperformed large cap stocks and government bonds. Similarly, during eras where both bonds and stocks have struggled, real assets have tended to provide more favorable risk adjusted returns.

Certainly, for real estate, the rise in material costs typically results in home price increases, providing a valuable offset during an inflationary environment like the one we're entering. As interest rates rise, demand for renting typically increases, resulting in higher rents.

How to Prepare:

- Alternatives exposure falls into three distinct categories: return enhancers (asset classes such as private equity and private debt); risk reducers (including cash and hedge fund-of-funds); and real assets (such as commodities and real estate).
- Real return-focused strategies gain attractiveness when nominal growth slows. REITS, private real estate equity, are early participants in a cyclical expansion.
- Although real assets can be volatile on a stand-alone basis, a multi-asset approach can enable investors to take advantage of the potential for diversification and total return, while mitigating the impact of inflation on portfolios.

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