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CIO Weekly Perspectives

Remember Inflation Risk?

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It may be time to add to inflation-sensitive assets.

I recently was giving a presentation on the various risks stalking global markets, speaking from a list in a PowerPoint deck. Included were the usual suspects: negative growth shocks, China, commodity prices, over-aggressive action by the Fed, the strong dollar, etc. But then someone raised their hand and asked, what about higher inflation? I realized it wasn't even shown.

Pausing for a moment, I thought, did that omission make sense? Should we relegate inflation risk to a footnote and focus our attention on the more obvious challenges that face the global economy and markets? After all, U.S. headline inflation is running at just a 0.8% annual rate, while in Europe it's a mere 0.2%. Inflation is something that central banks are trying to catalyze, not eradicate, and generally with limited success.

On the other hand, that doesn't mean that higher prices won't make a comeback. A few weeks ago, my colleague Brad Tank explored the potential value of an unpredictable Federal Reserve in addressing inflation, and noted Alan Greenspan's recently articulated view that a combination of economic stagnation and price increases could be something to worry about.

In my view, unexpected inflation could emerge from a combination of flashpoints, whether the strong U.S. housing market, firming wages or health care costs, which have been low but are now starting to surge, three years into Obamacare. Other potentially inflationary trends are (aside from a post-Brexit bump) this year's decline in the dollar as well as the rally in commodities. Employment figures are already at the Fed's target levels, implying that wage pressures may be building, while the most recent print for U.S. core inflation (excluding energy and food) was 2.2%, or north of the central bank's long-term target.

Thinking about Inflation Hedges

In the context of a multi-asset portfolio, it is important to consider the potential cost of hedging the risks of extreme economic environments. Right now, it is very expensive to hedge against negative growth shocks—because the traditional vehicles for this purpose, cash and government bonds, pay investors very little, if anything. In contrast, the cost of hedging against inflation is relatively low. Although commodity prices have increased this year, they remain at deflated levels, while the breakeven rate for 10-year Treasury Inflation Protected Securities (TIPS) is about 1.5%, which is lower than the current core inflation rate in the U.S. (implying a return premium if inflation continues at or exceeds current levels).

Based on the pricing of inflation in the markets, it's clear that few investors are really focused on it as a risk. But given the low price of inflation-sensitive assets, our Multi-Asset team believes that it may make sense to add to them in diversified portfolios. At this point, we prefer TIPS over commodities, which given recent gains are likely to be range-bound in the near term. TIPS also have the advantage of providing some duration exposure, which can be helpful if we experience further declines in interest rates. Although U.S. bonds appear pricey in relation to U.S. fundamentals, we acknowledge that their yields may decline further based on the influence of negative rates in Europe and Japan.[1] Nevertheless, on balance, our view is that rates are likely to creep up from here.

In sum, although I don't believe higher inflation is a front-and-center concern, I do think that its importance is growing. It is often said that "the time to buy insurance is when it is cheap," and inflation-hedging exposure is definitely cheaper than many other components of global markets. The potential for rising prices definitely merits an "upgrade" to my list of key risks the next time I give a talk on market prospects and asset allocation.

[1] An interesting study by Lombard Street Research ("What is the fair UST 10yr yield?", August 10, 2016) used regression analysis based on U.S. inflation and growth rates to estimate a 3.5% fair value for the 10-year U.S. Treasury. But under the assumption that global dynamics would influence U.S. yields, they then incorporated German and Japanese government bonds into the regression and came up with a much lower 1% fair value estimate for the Treasury yield, a remarkable divergence from the expected yield driven solely by U.S. fundamentals and highlighting the challenges facing bond investors in today's market.