Investing in an Inflationary Environment

December 2021

PART OF INVESCO'S

Education Series

invesco

Bronagh Traynor, Investment Consultant

Introduction

Over the past few months, with businesses and economies opening up after severe lockdown measures put in place to help curtail the spread of the coronavirus, inflation has surged and has been a hot topic in investment commentary. The US Consumer Price Index (CPI) increased 5.4% in the 12 months to the end of June and July, the highest in 13 years, whilst stripping out the more volatile elements of the metric (food and energy) saw an increase of 4.5%, the largest since 1991.

A lot of discussion has taken place as to whether the recent spike in inflation rates both realised and expected are temporary, or will the rise be more persistent for months or even years. The predicament for investors is that inflation increasing is a risk whether you are funding your retirement or seeking real growth in your investment portfolio.

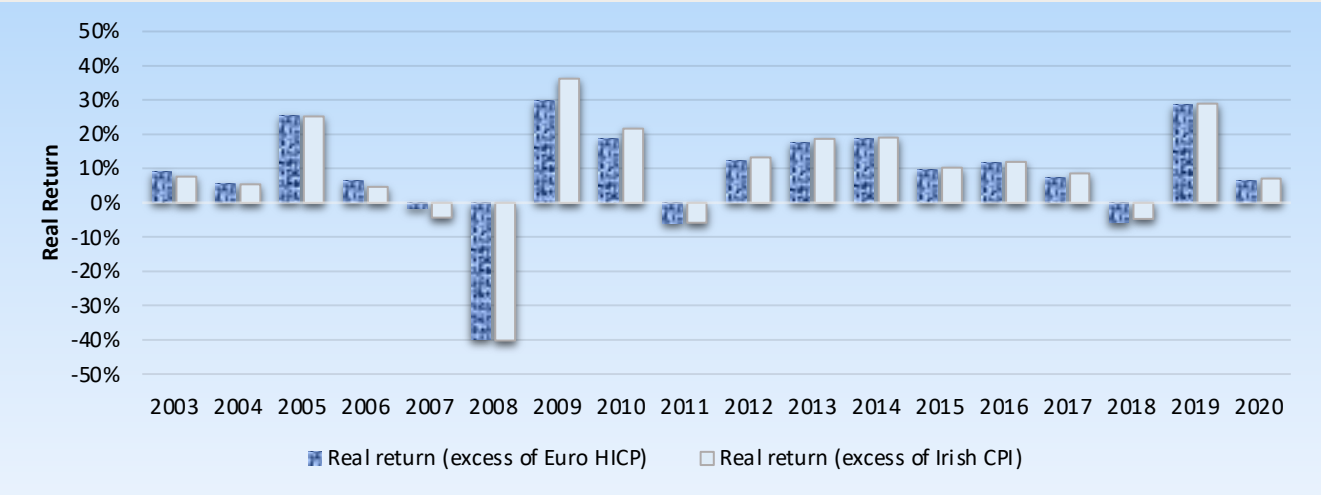
In this paper we analyse the inflation challenge for investors and discuss areas where investors may seek inflation protection from the various asset classes.

Equities

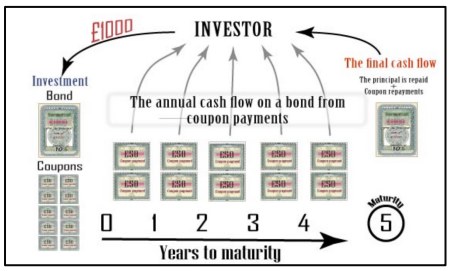
Typically equities are chosen within an investment strategy to provide growth returns i.e. high single digit returns. Although not directly chosen for inflation protection, equities/shares are assumed to have inflation protection. When inflation increases, this raises the input costs of companies in terms of their raw materials. In turn these companies can try and pass these increased costs through to consumers by increasing the price of their products, which then has a knock-on effect of increasing revenues/earnings for the company. It should be noted that not every company will have the ability to pass through all their rising input costs, and there will be a timing consideration of any price hikes due to competitive reasons.

The following chart shows the calendar year returns of global equities (measured by the FTSE World Index in euro terms) over the last 18 calendar years when inflation has been stripped out of the returns. A bar above the zero line illustrates that the global equity benchmark delivered returns in excess of inflation, whereas a bar below the zero line shows when inflation exceeded the returns on global equities. There were only 4 years in this 18 year analysis in which the returns on equities trailed inflation (2007, 2008, 2011 and 2018). 2008 shows the most significant deviation, when average inflation in the Eurozone and Ireland was above 3% but global equities were down nearly 40%.

Although investing in equities may deliver returns in excess of inflation, investors have to be aware that equities will not always provide the perfect match to inflation.



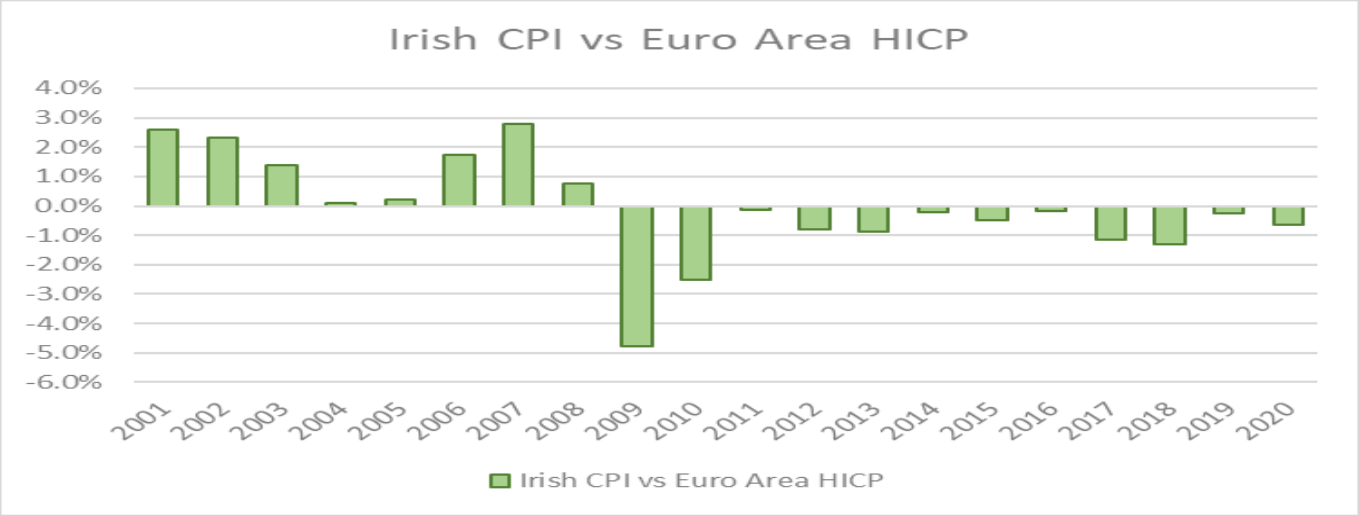
Bonds



Government bonds with coupons and maturity values linked to inflation (inflation-linked bonds) seem like an appropriate choice of instrument to try and mitigate the inflation risk in a portfolio.

While the NTMA has issued Irish inflation linked bonds through two private placements in 2017 and 2019, there is currently no secondary market and therefore it is not considered to be a liquid and transparent market. The second issuance was in March 2019 and the maturity date of the bond was 1 April 2045. The coupon payments and maturity value for this issuance was linked to Irish HICP (ex tobacco), so would offer a broad match to inflation. However this could prove challenging for Irish investors, where more often the inflation-linked increases are linked to Irish CPI to a maximum of 4% with possibly a floor of 0%.

Other inflation linked bonds that could be utilised are those linked to Euro HICP (ex-tobacco) inflation, but the basis risk also arises here that Euro HICP varies significantly from Irish CPI. Therefore, these investments might not deliver real returns for Irish investors. As shown in the graph below, having an instrument that was linked to Euro HICP would have delivered greater returns than Irish CPI in the period from 2009.



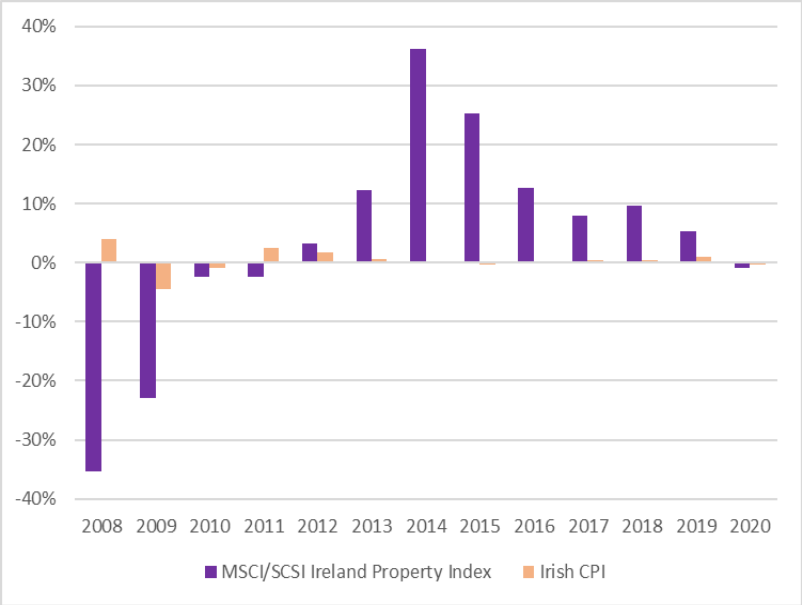
In terms of the market for euro HICP (ex-tobacco) bonds, there are very few governments in the eurozone who issue such bonds. Of the countries Germany, France, Italy and Spain are the largest issuers of inflation-linked bonds in the eurozone. Investors should understand the credit worthiness of these governments when considering an allocation to these inflation-linked bonds.

Property

For individuals conscious that they don't want to lose out on the purchasing power of their investments, they will explore other ways to hedge inflation. Traditionally bricks and mortar property has been considered a hedge against inflation as rent and property values tend to increase with inflation.

If you hold physical property you will have some control in terms of rent reviews and whether you increase the rental income to be linked with inflation. However, there is likely to be a lag between inflation rising versus when the rental increase actually happens, and due to rent controls there may be restrictions when you can next increase the rent. It would be hard to imagine that many tenants would be happy to sign into a rental agreement where the monthly rent fluctuates according to inflation as it just becomes an unnecessary administration burden between the renter and the landlord, as well as the uncertainty of the level of payments for the tenant.

The chart on the right illustrates the total returns of directly held Irish property from one valuation to the next over the last 13 years. The MSCI/SCSI Ireland Property Index tracks the performance of 490 property investments, with a total capital value of €10.4 billion as at December 2020. More often than not the returns from Irish Property more than exceeded Irish CPI, so investors could invest in Irish property to generate returns in excess of inflation over the longer term. However, investors need to be conscious of the illiquidity of direct property investment.



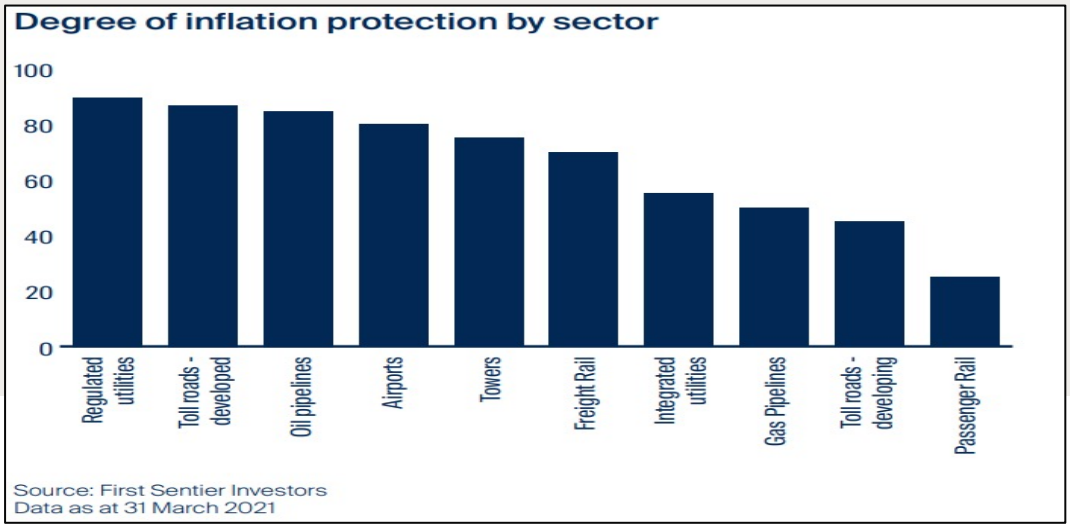
Infrastructure

An investment in infrastructure as part of a portfolio can act as a diversifier, as its income stream is frequently linked to inflation.

Investors should note that any global infrastructure project may well be linked to inflation, but will typically be linked to local inflation rather than Eurozone inflation or Irish CPI. Therefore, investors should be conscious what specific inflation is being used to uplift the cash flow payments under an infrastructure asset, as they may not be similar to inflation in Ireland.

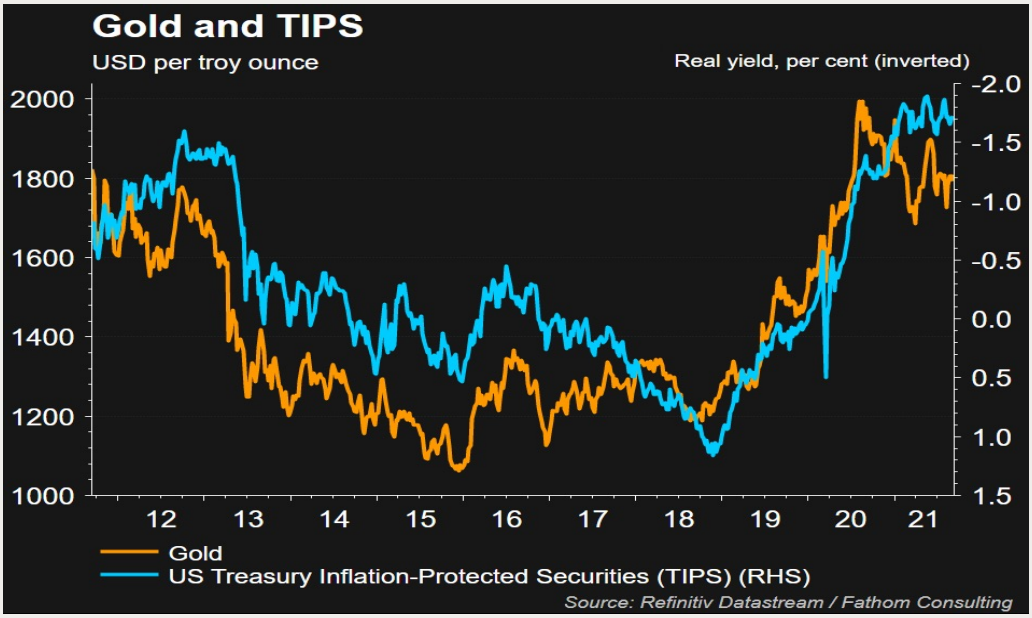
Where infrastructure shares are used as an inflation hedge it is assumed that infrastructure companies can pass on inflation increases easily to their customers and therefore their revenues will be linked to inflation, similar to the process discussed earlier with equities. Investing in infrastructure equities can be a partial hedge to inflation risk, but this also comes with the volatility of an equity investment and not all sectors can pass through inflation in their contracts. The main sectors of infrastructure react differently to inflation. Regulated infrastructure assets where agreements have been put in place that explicitly state how rising costs can be passed onto consumers e.g. utilities will typically be more sensitive to inflation than other sectors.

For example, First Sentier Investors estimate that more than 70% of the companies they invest in through their First Sentier Global Listed Infrastructure Fund have the ability to pass inflation through to the end customer, insulating investors from its impact.



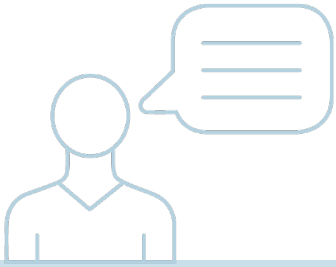
Commodities

Most asset classes will make some implicit assumption of expected inflation in the pricing of those assets, but unexpected inflation is what will hurt investors most by eroding the value of goods that their money can buy. As the demand for goods and services increases, the price of goods and services rises as does the price of the commodities used to produce those goods and services, and therefore commodities are seen as a hedge for inflation typically reacting sooner to inflation increases. For private investors it may be difficult to hold onto direct commodities due to storage costs, so investors may be keen to get exposure to the asset class via funds and Exchanged Traded Funds.



The above chart illustrates that the gold price has a strong correlation to the inverse of the 10-year Treasury Inflation-Protected Securities (TIPS) or US inflation linked bond yield. As yields have an inverse relationship to price then the change in the TIPS yield can give a good indication of where the price of gold may head. If real yields move lower, we would expect to see the price of gold appreciate. However, there will be circumstances when the relationship doesn't always hold. Irish investors should note however, their liabilities will be linked to Irish inflation so a gold investment or an investment in commodities more commonly linked to the US dollar may not be a perfect hedge to domestic inflation.

Summary



Whether or not inflation materialises to be in line with the levels of the target of the European Central Bank, a symmetric 2% over the medium term, any positive level of inflation poses a challenge for investors as it erodes the purchasing power of their investment over time.

We examined a number of asset classes that investors could consider if they want to hedge against inflation. However, Irish investors need to be aware of the basis risk which arises from investments linked to inflation in other regions or countries, and a timing risk that may arise if there is a lag between when inflation is paid on the asset versus when inflation arises in Ireland. These particular challenges may lead to an inadequate hedge to Irish CPI.

For more information on aligning your investments to protect against inflation please reach out to your Invesco consultant.

IF YOU HAVE ANY QUESTIONS ABOUT THE INFORMATION IN THIS DOCUMENT, PLEASE CONTACT YOUR INVESCO CONSULTANT

contact us

INVESCO DUBLIN

2 Sandyford Business Centre,
Burtonhall Road, Sandyford, Dublin 18.

PHONE:
+353 1 294 7600

EMAIL:
info@invesco.ie

INVESCO CORK

Invesco Cork,
No. 6 Lapp's Quay, Cork.

PHONE:
+353 21 480 8041

EMAIL:
info@invesco.ie

www.invesco.ie

Invesco is regulated by the Central Bank of Ireland as an Investment Intermediary under Section 10 of the Investment Intermediaries Act 1995 (as amended) and is registered as an Insurance Intermediary under the European Communities (Insurance Mediation) Regulations, 2005 (as amended). An analysis of Invesco's activities between those that are regulated by the Central Bank of Ireland and those that are not are set out on the company's website **www.invesco.ie.**