Time, Tide, and Rising Inflation

"Bond vigilantes may be back" claimed a recent New York Times article on inflation. Inflation is making headlines and moving markets. As of March, inflation concerns have displaced COVID-19 as the top portfolio risk, according to a recent survey of 200 investment managers. A record 93% of them expect global inflation over the next year.

As COVID concerns fade, investors confront an economic recovery (pushing inflation higher), fueled by pent up demand and stoked by higher savings (pushing inflation higher), and the Fed's toleration of rising inflation rates (obviously, pushing inflation higher). Higher inflation could bring equity market declines—big tech investors already got a taste of that in Q1—and fixed income investors are shifting to short duration, accepting lower yields to preserve capital.

How are institutional investors handling the possibility of simultaneous declines in stock and bonds? After we review market activity for Q1, we discuss how inflation could impact the financial markets and what investors can do about it.

2021 Q1 Economic Summary and Market Performance

Q1 2021 continued Q4 2020's trends: Stocks climbed, central banks provided liquidity, employment rose, GDP grew, and credit market issuance remained robust.

Economic Performance: Strong and Rising

Accelerated vaccine deployment, additional government stimulus, and expanded reopenings have the economy primed to surge in 2021. Consumers are eager to spend money, take vacations, and return to normal. In March, the Fed bumped its FY 2021 GDP growth estimate to 6.5%, up from 4.2% in December.

The US job market appears to be recovering. Restaurant jobs, which had been devastated by the quarantine, boomed in Q1. The unemployment rate dropped to 6.2% in February, a steep decline from the 15% rate at the peak of the pandemic. However, there are still 9.5 million fewer jobs than one year ago.

Monetary Policy Overview: "I wouldn't say I've been missing it." – The Fed Re: Inflation

In Q1, the Fed doubled down on its commitment to let inflation run hot (i.e., over two percent) and maintain a loose monetary stance indefinitely. The bond market is not as sanguine. In Q1, the yield on 10-year treasuries rose to 1.74% on inflation concerns, its highest level in over a year. The Fed estimates that inflation will hit 2.4% this year.

The Federal Reserve continues to add liquidity, supporting asset prices, but further delinking those prices from underlying fundamentals. The Fed's balance sheet increased another $400 billion in Q1 and is now over $7.7 trillion. By contrast, immediately following the 2008 crises, the Fed's balance sheet was a comparatively paltry $2 trillion. It then doubled to hit $4 trillion in 2014. And now has nearly doubled again and continues to grow. The Fed has no immediate plans to stop riding the low interest-rate tiger.

US and Global Equity Market Summary: Still Climbing in the US and Abroad

The US equity market continued climbing through Q1. Rising not only on good vaccination news, but also from new fiscal stimulus and continued monetary support. The S&P 500 hit the 4,000 level on April 1, an all-time high at the time. The index is up nearly 80% from its March 2020 lows. The DJIA also hit a new high in Q1. Equity valuations are quite frothy by historical norms, with tech firms having an outsized impact on the indices. Tech is now 27% of the S&P 500, more than twice the size of the next biggest industry. Bloomberg noted, "If the FAANG stocks declined by 10%, the bottom 100 S&P 500 stocks would need to rise by a collective 90% in order for the S&P 500 to be unchanged."

Global equity markets generally surged in Q1. Leading the pack was Canada (+ 10.4%) and Italy (+ 7.0%).

Credit Markets: IG Smoked, HY and LL Still Performing Well

Investment Grade[1] bonds got walloped in Q1, declining 4.65%. Record low yields have left fixed income instruments particularly vulnerable to rate changes. Coming off a strong Q4, High Yield[2] returned .85% in Q1. The Leveraged Loan[3] market returned 1.78%. Low yields haven't stifled market activity, as deal volume remains high.

Although shutdown-related defaults have increased, the expected wave of credit defaults has not yet occurred. Distressed debt dry powder—record amounts were raised in 2020—remains difficult to deploy. But perhaps not for long.

What can we expect from markets in 2021? With Covid in the rearview, we will be closely watching the strength of economic recovery. A strong and growing economy is needed to support current valuations. With monetary and fiscal flood gates open, inflation is a concern. Today's higher inflation will likely have a large impact on asset prices. This will be new territory as inflation has averaged around 2% over the last 20 years.

Rates haven't always been this low. Nearly 40 years ago, Volcker vanquished double-digit inflation rates with double-digit interest rates. Today, inflation has been so low for so long that investors basically stopped caring about it.

Price Stability and the Fed

Investors are paying attention now. The inflation rate has a real economic and policy impact. Predictable, steady inflation is an economic policy goal. Price stability, i.e., controlling inflation, is a mandate of the Federal Reserve. Inflation comes when and whether the Fed likes it or not. The Fed's only choice is how to respond.

The Fed uses interest rates as an indirect control of inflation. Lowering interest rates is the monetary equivalent of pressing on a gas pedal. Conversely, if the economy starts running hot, then the Fed raises rates to tap the brakes. Therefore, the Fed closely watches inflation in order to adjust interest rates. And investors closely watch—and try to front run—the Fed.

Investors Expect to Be Compensated for Lost Purchasing Power

The Fed has committed to keeping rates low and letting inflation rise. This is a problem for investors. Investors expect to be compensated for lost purchasing power. The combination of an economic expansion, excessive liquidity, and increased spending all suggest higher inflation rates and higher interest rates are coming.

Inflation and Higher Rates Could Impact Equity Markets

Equity investors have benefitted from low rates. Record low rates helped bring one of the greatest bull markets in history. Equity valuations are at stratospheric levels by nearly every historical measure. Higher rates may dampen further equity upside, as investments such as credit or cash will begin to look comparatively more attractive.

Inflation, and accompanying higher rates, act on equities in two primary (and opposing) ways. The first is that higher discount rates, i.e., interest rates used in DCF analysis, lower valuations. Second, is that higher inflation results in higher prices. The two forces somewhat offset. But in a low interest rate environment even small increases in interest rates decimate present values. With sky-high equity market valuations fueled by low rates, the full impact of higher rates, though likely negative, is hard to predict.

Higher Rates and Big Tech

Low rates are why big tech firms with low profitability but massive anticipated future cash flows act like high duration bonds. Such firms are long term bets. Present values are most sensitive to higher discount rates when cash flows are expected far in the future. Speculative bets made in a zero-rate environment become untenable when rates rise.

Inflation is Double-Toxic to Bond Investors

Fixed income investors hate inflation. First, it causes existing interest payments to be worth less. Second, rising rates demolish bond prices. Which is a problem given current yields.

Ray Dalio, the billionaire hedge fund manager, recently asked why anyone would own bonds. In many cases, even positive yields are so low that they are actually negative yields in real terms (that is, after accounting for inflation).

How bad is it? Dalio says:

> *If I give $100 today how many years do I have to wait to get my $100 back and then start collecting the reward on top of what I gave? In US, European, Japanese, and Chinese bonds an investor has to wait roughly 42 years, 450 years, 150 years, and 25 years respectively to get one's money back and then one gets low or nil nominal returns.*

Traditional Fixed Income Investors Prepare for the Boom

And it's not just government debt. Corporate bonds too suffer low fixed yields. BBB yields are at 2.55%, far below their long-term average of 5.35%. Even High Yield investors are struggling. According the research by Bank of America Merrill Lynch, rates for High Yield are about 4.70%, far below the long-term average of 8.65%.

Because price and yield move inversely, rising yields will damage fixed income prices. The WSJ notes[4] that the current duration on investment-grade bonds implies an 8.5% change in bond prices for each 1% move in interest rates. This is a higher duration than at the height of the Global Financial Crisis. It is true that an investor who holds until maturity should eventually get back full principal. In the meantime, however, they are stuck holding a low yielding, poorly priced asset. And that ignores the risk of default.

Institutional Investors Flee High Duration

For this reason, institutional investors are shedding duration to preserve capital, adding floating rate instruments to reduce interest risk, and flocking to alternative investments to lessen exposure to broader market volatility.

Private markets are gaining attention from this shift. Sovereign Funds doubled their private market allocations in 2020. Credit and real estate funds focused single-family homes are receiving increased institutional interest. Private markets thrived last year, especially in credit. Private debt had sub 2% default rates, higher yields, and less volatility vs the broader leveraged loan market.[5]

What Investors Can Do About In lation

FA good aphorism condenses a complicated idea into a memorable soundbite. Buffet's famous one - "When the tide goes out you learn who is not wearing a bathing suit" may be more relevant than ever. 2021 may be the year portfolios are tested against higher inflation and its consequences. If rates rise, the fixed income market and stock market could suffer.

Time, tide, and rising inflation wait for no one. Investors are reallocating quickly. Smart money is shifting to platforms with active management, interest rate risk mitigation, and low correlation with equity market investments. When the stakes are high, investors are willing to pay for assets that perform regardless of the sea level.

[1] As represented by the Barclays Capital US Investment Grade Bond Index.
[2] As represented by the Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged USD
[3] As represented by S&P/LSTA Leveraged Loan Total Return Index
[4] Bond Rout Hits Safest Company Debt, WSJ, 3/22/2021
[5] Sacher, Bill. Private Credit 2021 Outlook: A Steady Ship in Choppy Waters. Adams Street Partners, 10 Feb. 2021.