WINDROSE ADVISORS

2021 INFLATION AND REAL ASSETS

SUMMARY

As the world slowly emerges from a global pandemic, a new worry has taken center stage in investors' minds: inflation. Propelled by powerful monetary and fiscal stimulus, the U.S. economy is in the process of recovering and posted GDP growth of 6.4% in the first quarter of 2021[1]. However, this growth was accompanied by an inflation reading of 4.2%[2], a level not seen since 2008 and much above the Federal Reserve's stated target of 2%.

Seemingly overnight, everything screams inflation, from rising commodity and food prices to a red hot housing market to a global shortage of computer chips and transportation bottlenecks. Inflation risk, mostly dismissed by investors over the past four decades, has become front and center given the potentially momentous impact on capital markets.

In this note, we explore what has led to this situation, potential market outcomes and how to position portfolios to hedge this rising risk.

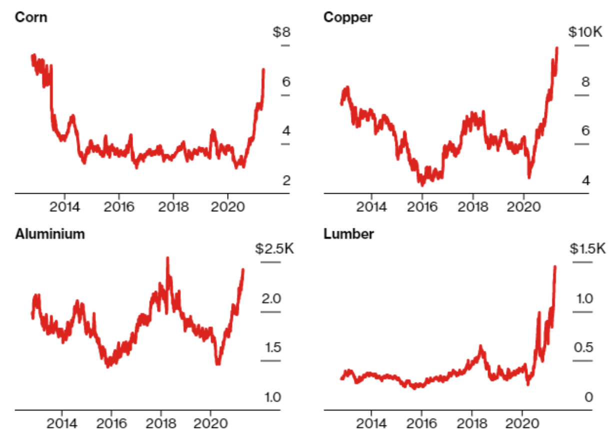
INFLATION EVERYWHERE

Commodities have become the poster child of inflation fears, as they recorded strong increases since the lows of March 2020.

As shown in figure 1, the rebound in commodity prices was spread across subsectors. The Bloomberg industrial metals index gained 67%, agriculture index 57%, energy index 47% and precious metals index 19% through April 2021. Supply chain disruptions tied to the pandemic clearly affected supply over that time, and demand strengthened in anticipation of an economic recovery, all of which should prove transitory.

[1] U.S. GDP quarter over quarter growth, seasonally adjusted annualized rate (Bureau of Economic Analysis).
[2] U.S. CPI Urban Consumers year over year, non-seasonally adjusted (Bureau of Labor Statistics).

(Figure 1)

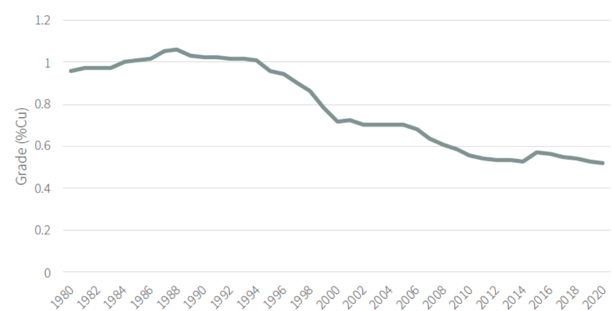


Source: Bloomberg

However, market tightness has appeared in multiple markets, following years of underinvestment amid poor capital returns. Resource depletion is also becoming an issue as producers relied on their best reserves during years of low prices to sustain margins, and new reserves are costly to develop and require long lead times, limiting near term supply.

Nowhere is resource depletion more apparent than in copper mining. As shown in figure 2, the proportion of copper found in mined ore is consistently declining as new high grade deposits are increasingly difficult to find.

(Figure 2)

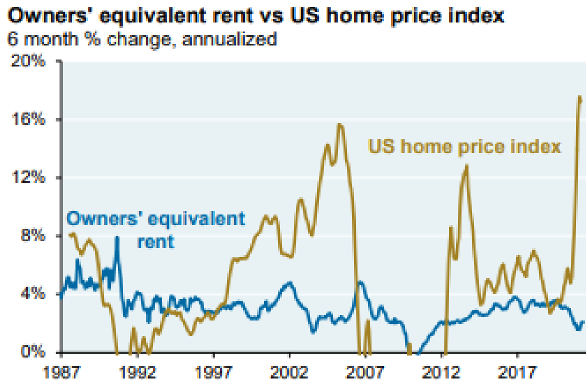


Source: Wood Mackenzie, Bernstein, Goehring & Rozencwajg

And as the world embarks on ambitious plans to develop renewable energy, a secular trend of rising demand for metals is emerging, beyond the cyclical recovery, with long lasting implications.

Tightness is also evident in the housing market as low inventories, low interest rates and pandemic-induced demand for suburban single family homes conspired to boost prices (figure 3). Demographic trends are worsening the situation as the millennial generation has entered a period of new household formation, which is likely to sustain demand for entry-level homes.

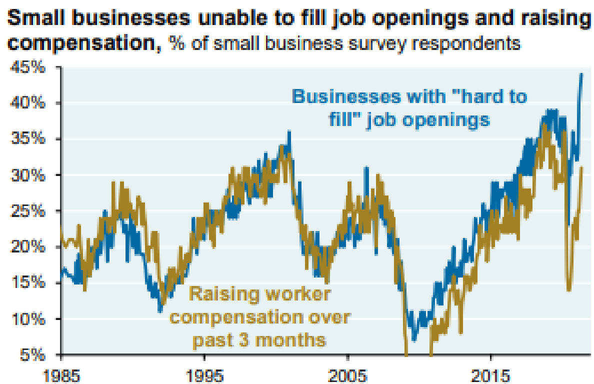
(Figure 3)



Source: Bloomberg, JP Morgan

Finally, labor market shortages have appeared as the workforce participation rate dropped during the pandemic and government subsidies slow a return to work, boosting wage growth in the near term (figure 4). Longer term, however, a push to reduce inequalities via higher minimum wages, and demographic trends in the form of an aging population and restrictions on immigration, particularly in the wake of the pandemic, may sustain wage inflation going forward.

(Figure 4)



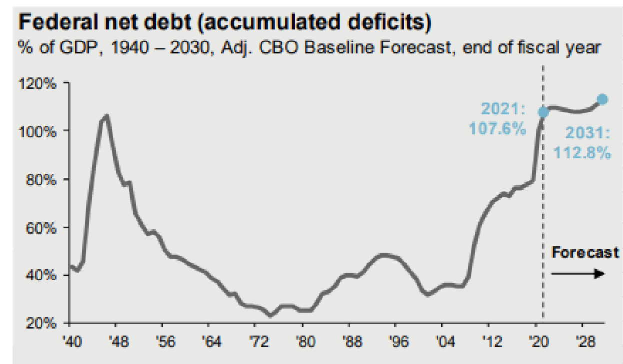
Source: Bloomberg, NFIB, JP Morgan

THIS TIME IS DIFFERENT

The title above is often considered the most dangerous sentence in finance. However, attitudes toward inflation have shifted significantly in recent years.

For starters, both major political parties in the U.S. have embraced higher deficit spending. Republicans financed corporate tax cuts before the pandemic, and Democrats are preparing to spend more on infrastructure and social programs. The net result is a U.S. debt to GDP ratio that is now above 100%, on a par with levels last reached during World War II.

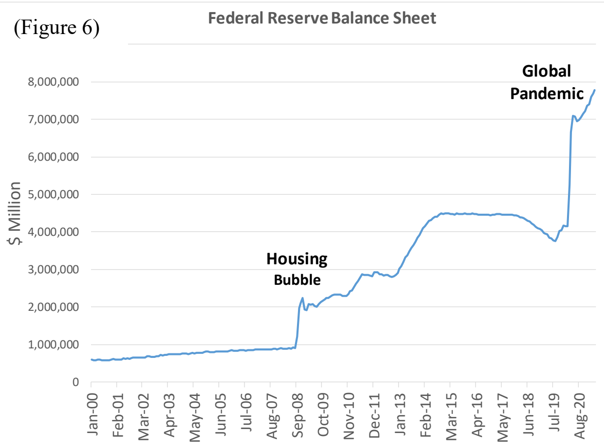
(Figure 5)



Source: JP Morgan

Along with fiscal stimulus, monetary stimulus is now firmly entrenched. Last Summer, the Federal Reserve altered its policy by adopting a softer target of *average* inflation of 2.0%, meaning that it may allow inflation to overshoot its 2.0% threshold temporarily. Meanwhile, the Fed is using its balance sheet to purchase newly issued government debt, helping finance the deficits (figure 6).

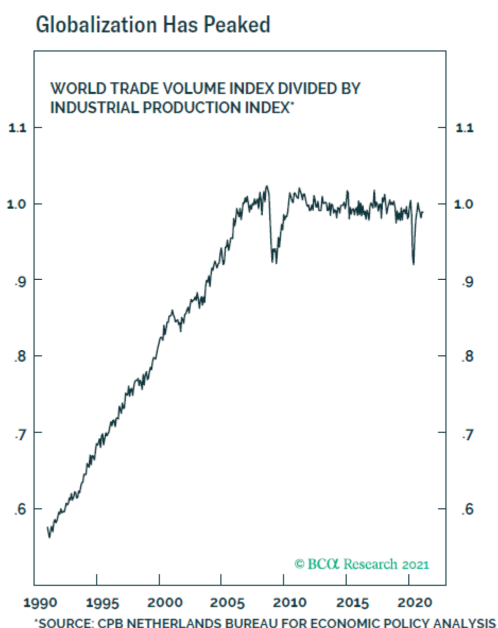
(Figure 6)



Source: Bloomberg

Finally, free trade agreements and the opening of the Chinese economy were powerful forces contributing to declining inflation over the past few decades. However, this trend seems to have run its course (figure 7) as the emergence of China as a geopolitical competitor to the U.S. is creating impediments to trade. In addition, a decline in the working age population is stoking wage inflation in China, reducing the benefit of offshoring production capacity, while the pandemic has exposed the shortcomings of extended supply chains.

(Figure 7)



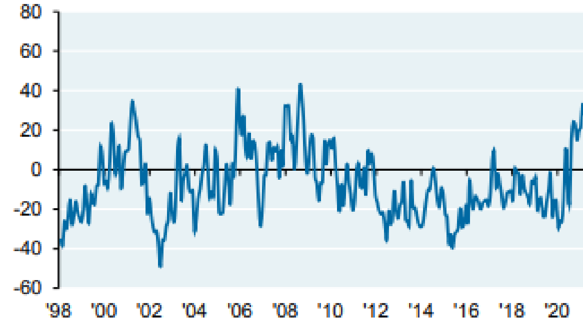
Source: BCA Research

WHAT TO EXPECT WHEN YOU ARE EXPECTING INFLATION?

There is no question that recent inflation readings have come as a surprise (see figure 8). After 40 years of disinflation, a whole generation of investors had been taught to dismiss inflation risk.

As a result, this risk was quickly re-priced in financial markets, leading to a sharp rise in longer interest rates. The yield on the 10-year treasury rose from a low of 0.51% in August 2020 to a peak of 1.73% by the end of March 2021. Current levels between nominal treasuries and treasury inflation protected securities (TIPS) imply a break-even inflation rate of 2.45% over 10 years. In other word, TIPS would outperform nominal treasuries if realized inflation over 10 years averaged more than 2.45%. This is essentially in line with Fed expectations, considering that the Fed actually targets core inflation (i.e. excluding volatile food and energy prices) of 2.0% and the consensus view is priced in.

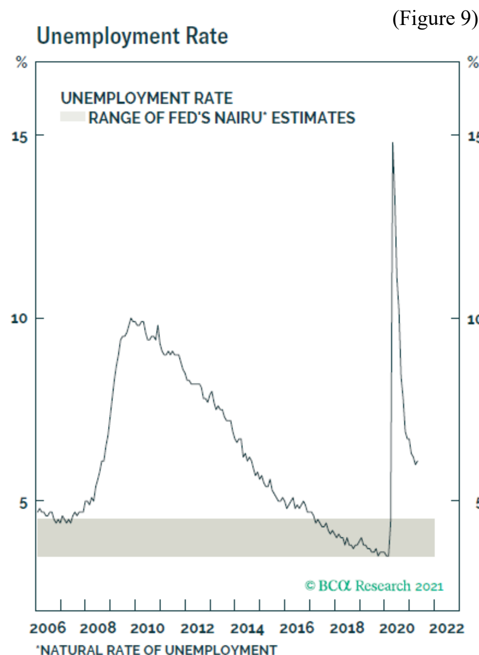
(Figure 8)



Source: Citibank, Bloomberg, JP Morgan

Further moves from here will be dependent on Fed actions. The Fed has communicated that it will start tapering asset purchases when "significant progress" has been made toward its maximum employment target (defined as a 3.5% to 4.5% unemployment rate). This goal could be reached by late 2021 (figure 9), opening the door to rate hikes by late 2022.

(Figure 9)

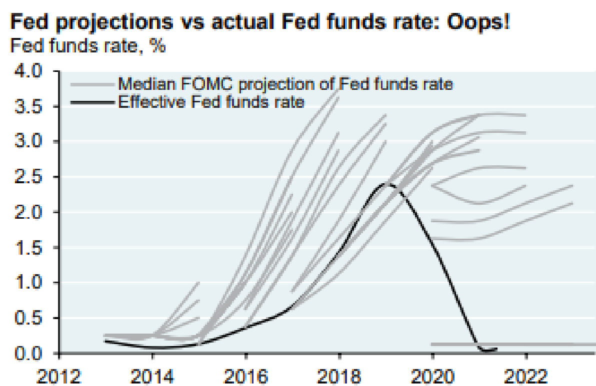


Source: BCA Research

This scenario assumes that most inflationary effects are transitory in nature and that the Fed will be able to progressively withdraw stimulus without stoking inflation expectations, or shocking markets with an earlier than anticipated rate move.

Of course, the Fed has been wrong before. As shown in figure 10, the Fed has consistently been wrong on inflation, expecting higher readings that never materialized. It could now be wrong in its current view that inflation pressures will not persist.

(Figure 10)



Source: Federal Reserve, JP Morgan

Hence, the risk of a policy mistake is high. The adverse scenario is that inflation moves materially above target in coming years and the Fed is slow to react, affecting future inflation expectations. Rising inflation and interest rates could make it more difficult to finance government deficits, and pressure valuations on equities, creating an environment where both stocks and bonds struggle to deliver positive returns. In particular, secular growth companies in the U.S. and China, which command large weightings in global equity benchmarks, could be challenged. This prospect raises the need for macro-economic hedges in client portfolios.

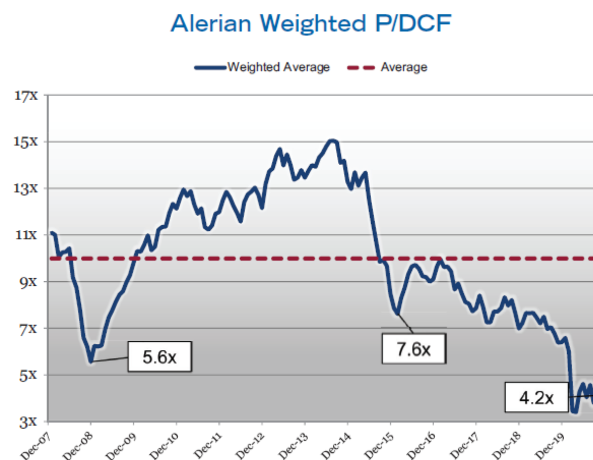
HEDGING INFLATION WITH REAL ASSETS

Liquid real assets traditionally include commodities and public real estate (REITs). We broaden the definition in our WA Real Assets sleeve to include the equity of commodity producing companies as well as energy infrastructure.

Natural resources companies tend to pass along commodity price increases to consumers, delivering higher earnings in inflationary periods. Similarly, real estate companies have the ability to raise rents in line with inflation. Finally, many energy infrastructure assets (e.g. pipeline operators) have explicit inflation hedges in their delivery contracts.

In addition to their intrinsic inflation hedging properties, this collection of assets is still trading at depressed levels. Overinvestment and excessive leverage led to a downturn across natural resources and energy infrastructure starting in 2015. As shown in figure 11, energy infrastructure is still trading at historically low valuations despite recovering fundamentals and balance sheet improvements.

(Figure 11)



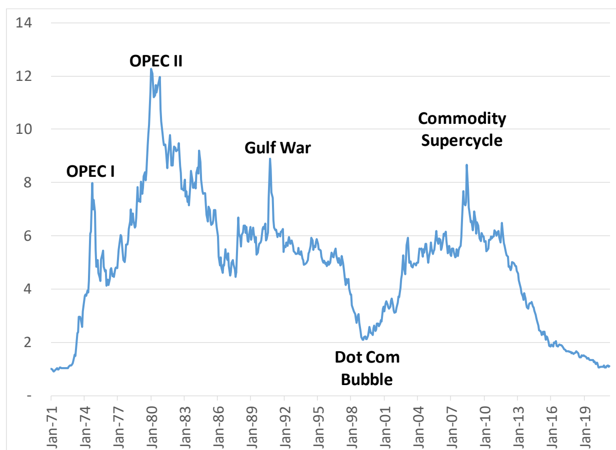
Source: Chickasaw Capital Management, December 2020

The same is true with natural resources equities, particularly in the energy sector. Similarly, REITs cheapened considerably in the wake of the pandemic.

A combination of low valuation and lack of interest from investors has resulted in historically low S&P500 sector weight exposures to Energy (2.3%), Real Estate (2.4%) and Materials (2.6%) so that equity investors are generally underallocated to these sectors. Obviously, cheap valuations imply challenges in these industries, hence active management is preferable to seek out the best opportunities.

Commodity futures tend to trade near the marginal cost of production over time. As demand for commodities outstrips supply, prices must rise to incentivize producers to deliver more resources to markets. Given the very long lead time to develop new resources, commodity "supercycles" tend to develop following years of underinvestment, leading to several years of tight markets and persistently higher prices. This is now happening at a point where commodities still look cheap relative to expensive financial assets (figure 12).

(Figure 12: Bloomberg Commodity Index vs S&P500 Index)



Source: Bloomberg

Commodities are traded in the futures markets and present their own challenges as returns depend not only on the direction of spot prices but also on the shape of the futures curve. Therefore, passive solutions are often sub-optimal for investors. Active management, in the form of private partnerships trading commodities long or short based on the fundamental and technical details of futures markets, present a much more attractive investment opportunity.

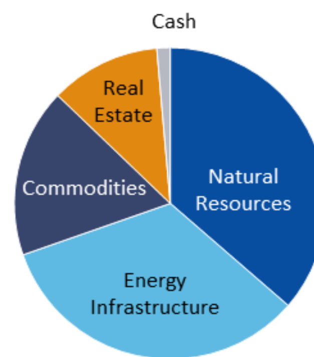
CONCLUSION

Investing in real assets is ripe with opportunities yet requires professional management to properly evaluate. We have patiently built the WA Real Assets sleeve one undervalued investment at a time while diversifying across four broad sectors in Natural Resources, Midstream Energy, Commodities and Real Estate. As is often the case with value investing, we were early in these positions. However, our ongoing research is now paying off as our sleeve provides the ideal asset allocation building block to complement broader portfolios in need of inflation hedging properties.

Having endured the pain in real assets, we are now enjoying the gains. While our sleeve has returned a meager +1.42% since inception in July 2017 (beating our blended benchmark by 0.07%), it has generated +67.03% over the past year through March 2021 (outperforming its benchmark by 4.22% and global equities by 2.92%). In the first quarter of 2021, which saw inflation concerns come to the fore, the Real Assets sleeve returned +14.74%, more than triple the +4.57% return of global equities (MSCI ACWI index).

The WA Real Assets sleeve is currently diversified across eight strategies over four broad sectors, as shown in figure 13. We continue to research unique and overlooked managers, benefitting from our head start in areas almost abandoned by other allocators.

(Figure 13)



As always, while we can't predict the direction of markets, we can still work to ensure asset diversification across macro-economic cycles. In this particular case, investors are presented with a basket of securities that are suddenly desirable from a portfolio construction standpoint and happen to be relatively cheap investments. This is a rare enough convergence that we encourage clients to explore without delay.

INDEX KEY

Indexes are unmanaged, statistical composites and their returns do not reflect payment of any brokerage commissions or fees an investor would pay to purchase the securities they represent. Such costs would lower performance. It is not possible to invest directly in an index. The indexes include a different number of securities and have different risk characteristics than the model. Past performance of the indexes and benchmark is no indication of future returns.

Global Equity (MSCI All Country World-USD), Domestic Equity Large Cap (S&P500), Domestic Equity Small Cap (Russell 2000), International Developed Equity (MSCI EAFE), Emerging Market Equity (MSCI EM), Energy Equity (MSCI ACWI Energy) Broad Fixed Income (Barclays Aggregate), U.S. Government Debt (Barclays U.S. Treasury), U.S. Inflation-linked (Barclays U.S. Treasury Inflation Notes), U.S. Corporate Debt (Barclays U.S. Corporate), U.S. Securitized Debt (Barclays U.S. Securitized), Emerging Debt U.S. Dollar (JP Morgan Emerging Market Bond Index Global), Emerging Debt local currency (JP Morgan Global Bond Index Emerging Markets), High Yield Debt (Barclays U.S. High Yield), Municipal High Yield (Barclays U.S. Municipal High Yield), Municipal Debt (Barclays U.S. Municipal), Natural Resources (S&P North America Natural Resources), Energy Infrastructure (Alerian MLP) Commodities (Bloomberg Commodity Index), Public Real Estate (MSCI U.S. REIT), Global Hedge Funds (HFRI Fund Weighted Composite), Directional Hedge Funds (HFRI Fund of Funds Strategic), Absolute Return Hedge Funds (HFRI Fund of Funds Conservative), Venture Capital (Cambridge Associates Venture Capital Index), Private Equity (Cambridge Associates Private Equity Index), Private Real Estate (Cambridge Associates Private Real Estate).

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