The 3 I’s: inflation, interest rates and investing

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A statement along the lines of – “*All asset classes are expensive, the opportunity for diversification is low, and the expected return of nearly all asset classes is depressed well below long-term expectations”* probably featured in some form at the beginning of many managers’ annual investment outlook commentaries over the past decade.

Investment professionals have spent a lot of time managing clients’ return expectations because each year seemed to keep delivering strong returns raising expectations of performance repeats. However, we all know that returns can’t keep going up endlessly, especially against a backdrop of subpar economic and company earnings growth.

Yet, shares have provided upbeat returns for most of the post GFC era because interest rates kept falling, making shares look more and more attractive. Of course, interest rates can’t keep falling forever. At some point, they must plateau and ultimately rise.

That said, interest rate cycles can be very prolonged. They can also change very quickly. Furthermore, when interest rates rise capital losses can result, having profound impacts across portfolios.

This leaves investors in a bind of needing to increase exposure to riskier assets to meet return expectations that were set in an environment when interest rates were falling and boosting returns from shares. Having greater exposure to risk in the current environment where interest rates are more likely to rise than fall further, leaves portfolios vulnerable to losses if the interest rate regime suddenly shifts higher.

How long can interest rates stay so low?

Continuation of the current disinflationary environment, where inflation rates are falling, requires maintenance of supply as well as demand factors, both of which are at risk of change. Governments’ aggressive spending in response to COVID-19 might eventually spur a rise in demand for goods and services, at the same time as supply and productivity increases may be losing some of their tailwinds over the past two decades. Even before COVID-19, deglobalisation had begun emerging as a supply restriction. Think of Brexit. That’s now been accelerated by the pandemic.

‘Onshoring’, by bringing back ‘home’ production of essential items, selective restrictions on overseas investments (think of boundaries on some Chinese investments), increased taxes and tariffs, all undermine productivity and increase the cost of supply.

But, just because threats to disinflation are in place and easy to identify, doesn’t guarantee that a changed inflation outlook is near. A lack of demand is probably the weakest link on the path to higher inflation. Despite large government economic stimulus, it’s unclear how consumers will behave once more normal life resumes post COVID-19. Perhaps consumers might save more. If that happens, will government spending be able to overcome the potential loss in household consumption? These are possibilities that can’t be accurately estimated.

What’s clear though, is that maintaining low interest rates is important for highly indebted governments. Low ‘real interest rates’ (interest rates after deducting inflation) facilitate a slow and less painful pay back of debt than the extreme alternative of outright default. If this is true, then whatever the outcome for inflation, we can be more certain about the path forward for real rates – they’re, on balance, likely to stay lower than inflation. Thus, at this stage of the investment cycle, assets with ‘real cash flows’ that are derived from the production of goods and services, are significantly more valuable to us than assets with financial cash flows (such as interest income). Assets with real cash flows will grow if inflation rates pick up. The problem, however, is that real cash flows are either safe and expensive, or cheap and risky (eg energy companies).

Investment implications

Rather than betting on higher inflation and simply buying expensive assets that are linked to inflation (eg inflation-linked bonds), and hoping we’re right, we prefer to invest time to identify investments that are likely to react positively

to an inflationary environment but are not as sensitive to a continuation of what is now a very long period of low inflation.

This obviously brings with it a series of trade-offs that limit the reward of being ‘right’, but at the same time reduce the consequence of being wrong. Given that it’s impossible to have perfect foresight, and that we are ultimately risk managers, we believe this is the right way to invest in these highly unusual times.

Shares in general are a source of real cash flows, but there is significant diversity amongst companies and between sectors. Energy companies have the strongest relationship to changes in inflation expectations, providing a good hedge to rising inflation but brings with it the potential for significant losses if inflation falls.

Listed infrastructure asset returns, on the other hand, are *less* sensitive to the rise and fall of inflation expectations compared to other investments, and more sensitive to changes in the real interest rate, probably because they’re leveraged. The push-pull relationship of inflation sensitive revenues and leveraged balance sheets from listed infrastructure provides an exposure profile that we think makes sense, at this time.

Portfolio positioning

Sensible portfolio construction should avoid dogmatism and over reliance on narrow, concentrated solutions. Consistent with this, portfolio positioning is characterised by flexibility and pragmatism.

Facing into a profoundly low real-rate environment, with the risk of both inflation and continued disinflation at the fore, we continue to take measured steps to embrace risk where we believe it will be rewarded and build as much exposure as possible to real cash flows into the MLC Inflation Plus portfolios.

In this context, listed infrastructure exposure was introduced to the MLC Inflation Plus portfolios over the December quarter. This plays a dual role, bringing an element of inflation sensitivity, but low cyclicality and a robust real yield. The allocation to infrastructure complements cyclicality added in 2020 via metals and mining stocks, as well as controlled risk-taking through strategies deployed in Chinese shares and emerging markets.

During the quarter, we took some profits from our Australian dollar/US dollar option and reduced our US dollar exposure due to its risks.

We also exited from IVA, a value manager, but put in place an option providing exposure to the potential outperformance of value stocks versus growth stocks. The beauty of this option strategy is that it will be profitable if value shares outperform growth shares but not create additional losses over and above the premium paid for the option if value shares underperform growth shares.

Positioning of the MLC Horizon portfolios was little changed in the December quarter. The portfolios achieved a relatively defensive orientation partly from exposures to Inflation Plus, and partly from exposure to foreign currency through unhedged global shares. Likewise, there were few changes to the MLC Index Plus portfolios in the December quarter. Exposure to fixed income continues to offer some defensiveness, but lower yields mean that the scope for interest rates to protect the Horizon and Index Plus portfolios under adverse economic conditions remains challenged.

More information on each portfolio’s positioning is available in the fund commentaries available on the Fund Profile Tool on https://www.mlc.com.au/fundprofiletool**.**

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