

On the Minds of Investors

Protecting against inflation: Part 3 – Protecting your capital

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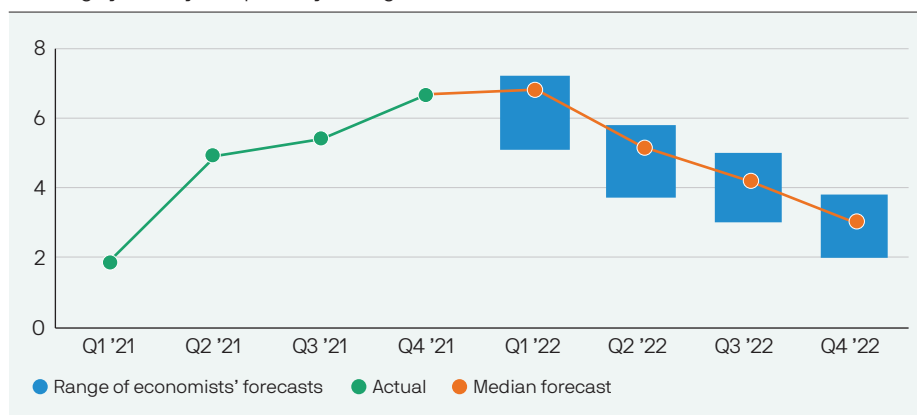
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In the first two parts of this series we outlined how continued supply problems and tight labour markets point to lingering inflation in the developed world. To be clear, we do not expect inflation to continue heading north. Headline inflation may have peaked – or will do so over the spring – and from there, base effects from higher energy prices will allow inflation to moderate. But we do believe the pandemic has dislodged us from the stubbornly low inflation that characterised the last cycle.

Exhibits 1 and 2 show that the forecasting community is split – the range of projections for inflation is unusually large. Our estimates fall in the upper part of this range. In this final part of this series we look at how to protect your capital in an inflationary environment.

Exhibit 1: US headline CPI forecasts

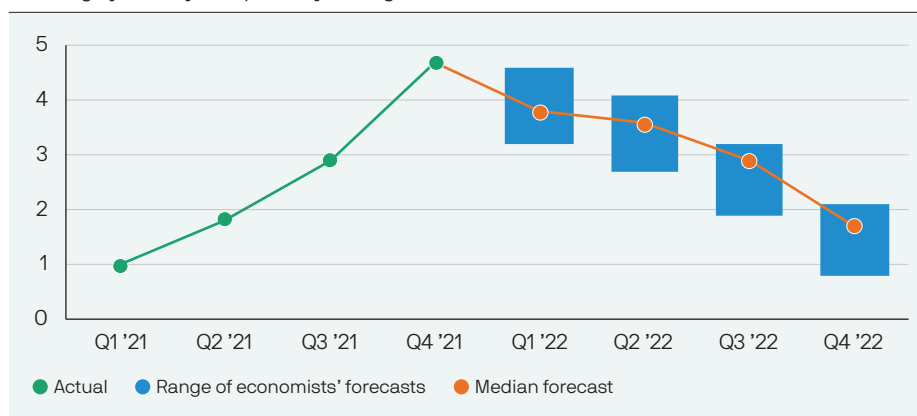
% change year on year, quarterly average



Source: Bloomberg, BLS, J.P. Morgan Asset Management. CPI is consumer price index. *Guide to the Markets - UK & Europe*. Data as of 20 January 2022.

Exhibit 2: Eurozone headline CPI forecasts

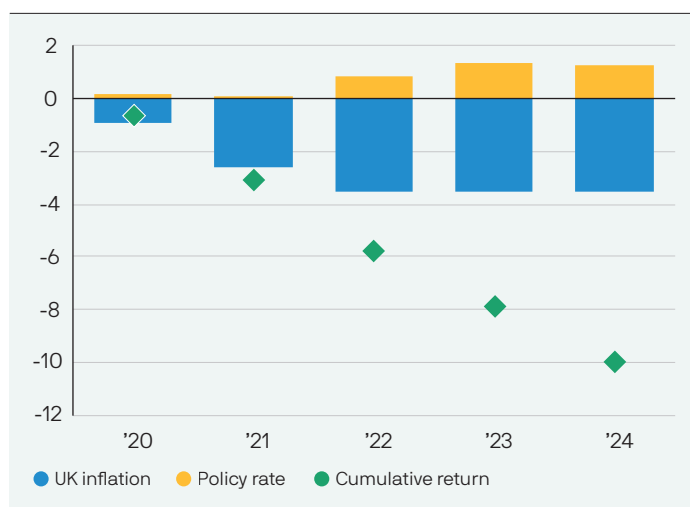
% change year on year, quarterly average



Source: Bloomberg, Eurostat, J.P. Morgan Asset Management. CPI is consumer price index. Data as of 20 January 2022.

Beware cash and government bonds. Inflation rapidly erodes the purchasing power of cash, particularly in an environment like today where the interest you get on basic savings accounts sits well below the rate of inflation (**Exhibit 3**). An individual who has had £100 in a deposit account for the last two years earning the Bank of England’s policy rate has already seen the purchasing power of that money fall to £96.50. If this individual leaves that cash in a deposit account in the hope that interest rates will start rising, then on current projections for inflation and interest rates, they will have lost more than a tenth of their purchasing power, in just five years.

Exhibit 3: Return on cash invested at the beginning of 2020
% return



Source: Bank of England, Bloomberg, ONS, Refinitiv Datastream, J.P. Morgan Asset Management. Real returns calculated using BoE policy rate minus CPI inflation. Policy rates for 2022 onwards are calculated using OIS forwards. CPI for 2022 onwards is calculated using UK 5 Y inflation swap. Data as of 20 January 2022.

The prospects for those holding government bonds aren’t much better. If the market comes round to the idea that inflation is persistent and central banks will have to tighten policy in the coming years by more than currently expected, then long-duration government bonds could be in for a rough year. For example, a 10 year US Treasury bond would be expected to have a negative total return of 7% were the 10 year yield to rise to 2.5% by the end of this year and negative return of more than 10% if it hits 3%.

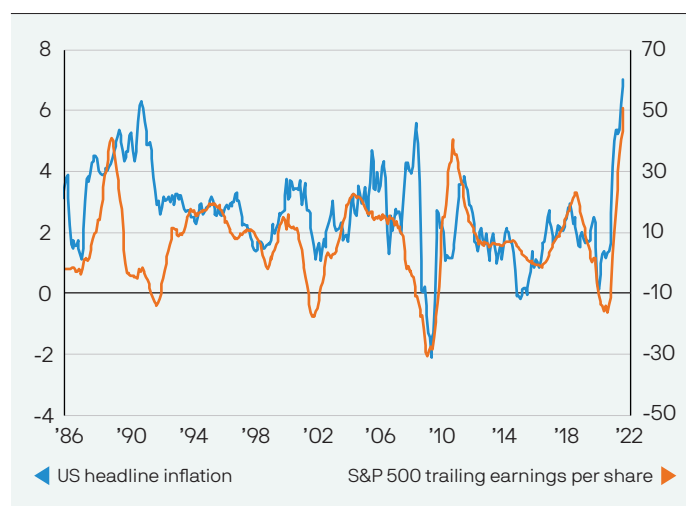
Index-linked bonds are not ‘inflation-protected’ bonds, as they are often perceived to be. Inflation-linked bonds are preferable to normal/nominal bonds if you expect inflation to be higher than is already priced in. But inflation-linked bonds are currently already pricing in inflation of 2.8% (CPI) on average in the US over the next five years and 4.1% (RPI) in the UK. If you expect inflation to be higher than that over the next five years you would be better off in inflation-linked bonds than normal government bonds.

However, they are all still bonds. And just as normal government bonds are vulnerable if yields rise, inflation linked bonds are vulnerable if real yields rise. Owning an inflation-linked bond could still lose you money in an environment of above target inflation if central banks tightening policy leads to a rise in real yields, as has often been the case. For this reason, we don’t think inflation-linked bonds are the best way to hedge against inflation at the moment.

What about equities? Equities often protect capital in modest inflation environments. Broad-based inflation is, after all, corporates demonstrating their pricing power and there is a strong relationship between inflation and corporate earnings (**Exhibit 4**).

Exhibit 4: US inflation and S&P 500 trailing earnings

% change year on year, earnings are last twelve months’ earnings per share



Source: BLS, IBES, Refinitiv Datastream, Standard & Poor’s, J.P. Morgan Asset Management. *Guide to the Markets - UK & Europe*. Data as of 20 January 2022.

However, there are two caveats to the ‘inflation is good for stocks’ narrative.

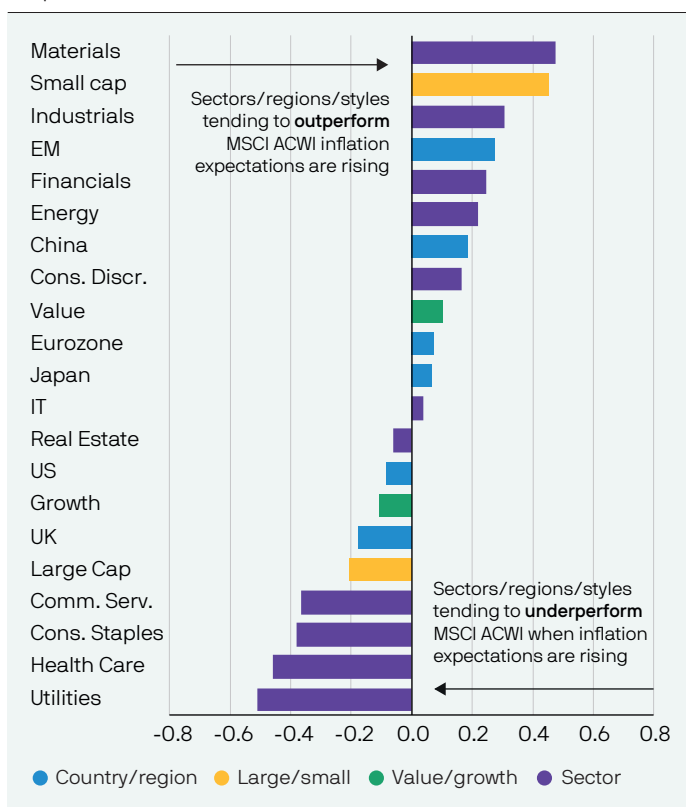
First, much higher inflation tends not to be good for stocks. Inflation is like chocolate. Too little doesn’t satisfy since it often signifies chronically weak demand in the overall economy. But too much inflation is equally troublesome. This is because, beyond a certain point, central banks generally have to step in and slow the economy down, a process that rarely runs smoothly and more often than not eventually leads to a period of recession during which margins get squeezed and corporate earnings and equities tend to fall.

So long as inflation turns quickly this spring and settles at around 3% in the US and UK, and 2% in the eurozone, then we do not expect this to be an inflation backdrop that will trouble stock markets.

The second caveat to bear in mind is that some sectors and, in turn, equity styles and regions, will benefit from higher inflation more than others. **Exhibit 5** shows the historical correlation between inflation expectations and the performance of various equity benchmarks relative to the MSCI ACWI Index of global large and mid- cap stocks.

Exhibit 5: Correlation of equity markets with the change in US inflation expectations

Correlation of the change in US inflation expectations and six-month rel. performance of indices vs MSCI ACWI, since mid-2000



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Correlations shown are the correlations between the six-month relative performance of each sector/style/region to the MSCI All-Country World Index and the six-month change in inflation expectations measured using US 5y5y inflation swap rates. All indices used are MSCI. Value and growth, size and sector indices used are for the MSCI All-Country World universe. Data as of 31 December 2021.

Cyclical sectors such as financials, industrials, materials and energy, tend to outperform the global benchmark in periods of rising inflation expectations. By contrast, defensives and growth stocks tend to struggle.

Technology is the sector that looks most vulnerable today, given their valuations have likely benefitted from the low interest rates and flat yield curves over the past couple of years.

Alternatives provide many options for investors to protect their capital from inflation. Inflation is ultimately caused by too much demand relative to available supply. When that imbalance extends to property markets they can provide a good inflation hedge as rents and capital values increase. However, one does need to distinguish between property markets where demand is strong relative to supply and those where demand is structurally challenged.

The long-standing shift to online shopping that has been accelerated by the pandemic, along with the pandemic driven shift to working from home, is putting structural pressure on demand for many retail properties. The other side of this is that demand for industrial/logistics properties that support online retail distribution remains very strong. We still believe there is strong demand for offices, a sector which benefits from having everyone together at the same time.

So a selective exposure to global property can help protect against inflation. Some infrastructure assets also have inflation protection written into their contracted returns and so can provide a good inflation hedge.

Investors typically view gold as a good inflation hedge, but this isn't always the case. Gold is an asset that provides zero income and so becomes attractive when bonds offer negative yields. This can be the case when inflation is high, particularly if central banks are seen to be losing control. But if inflation is high and central banks are increasing rates against a backdrop of robust growth, then real yields can rise – an environment that is usually more challenging for gold.

Conclusion

In summary, persistent moderate inflation poses a risk to cash and government bonds. Gold and index-linked bonds may not be as good a hedge as is often thought. So long as inflation looks on course to moderate and settle at roughly 3% we expect returns in stocks that will outpace inflation until interest rates eventually rise to a point which causes a recession. However, look to financials, energy and industrials to provide the best inflation hedge, as well as the options available in alternative markets.

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