IN SIGHT

HEDGING INFLATION EXPECTATIONS

The new year has brought with it a significant re-pricing of central bank risks. Financial markets are now assuming steeper and faster paths to normalisation by central banks, largely driven by the sharp rise in inflation expectations.

US consumer prices rose at their fastest pace in 40 years in December 2021. The sharp spike was initially attributed to the pandemic-induced supply constraints (which seem to be easing) and a low 2020 base-effect, followed by soaring energy costs, labour shortages and rising global demand.

01 | INFLATION REMAINS A CONCERN

Unfortunately, inflation has continued to be of interest, particularly in trying to determine how transitory or structural it is in nature. The economic reality is that 2022 will be shaped by many drivers, including those reacting to inflation expectations, such as:

- the expansion of the supply side to address supply constraints;
- the massive reduction in monetary and fiscal support (which stimulated economic growth); and
- a far less synchronised economic cycle (particularly between advanced economies and China) as the world focuses on deglobalisation.

In the medium- to long-term inflation will likely be higher than what is has been in the last decade; ***driven by strong demand, tight labour markets with rising wages, pressure on corporate margins,*** stretched supply chains (which are easing for now), and a continued drive towards ***deglobalisation*** as well as the drive for ***decarbonisation (a cleaner future).***

In the shorter-term inflation is expected to peak as the initial supply chain constraint issues ease but still settle at elevated levels relative to the more recent historical levels. However, it should still not pose a systemic risk for markets as central banks have clearly shown their willingness to raise rates, particularly the Fed, to temper more persistent inflationary pressures.

Is it that simple?

Can the break-even inflation (the difference between nominal bond yields and inflation linked treasuries) continue to increase materially in 2022, and more importantly is it really being driven primarily by higher inflation expectations?

02 | UNDERSTANDING BREAK-EVEN INFLATION

Why is it important?

Well, break-even inflation is still seen and used as the proxy for inflation expectations. We also know that a less negative (or potentially positive) real yield has real consequences for a broad set of assets. Currently, the US break-even inflation rate is around 2.6%. That is the highest it has been in over a decade!

What has been driving it higher? Is it just rising inflation expectations?

We believe investors must be careful to draw this simple conclusion that a higher break-even inflation is due to inflation expectations rising. There are other, maybe even more basic, forces at play that could justify some, if not most, of the current high break-even inflation level.

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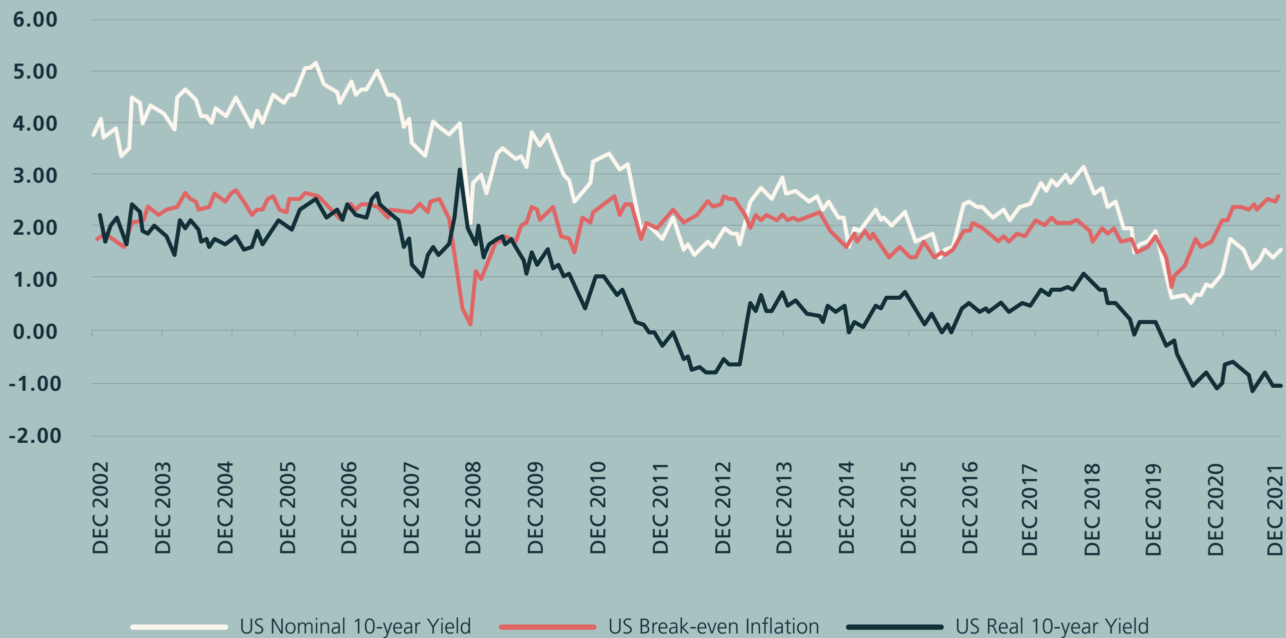
FIGURE 01 | US Real Yields around record lows



Source: Factset

Economics 101 – supply and demand

There is currently an imbalance between the supply and demand for inflation-linked Treasuries, which could be misleading investors' interpretation of the break-even inflation measure.

There are also good reasons why this imbalance could ease into 2022, which would increase pressure on real yields and in turn help push down break-even inflation.

Again, why is this so important?

Well, there are many assets that have benefitted over the years from an environment of low real yields. In contrast, January emphasised the risk of prolonged higher inflation.

Higher inflation for longer is expected to attract higher rates, as central banks step in to temper inflation. This dramatically increased volatility for longer-term growth focused assets, particularly those trading at elevated valuations. The sell-off is in response to the negative impact higher rates (pushing up discount rates) has on valuations.

Higher demand. Lower supply.

Over the last two years the Fed has purchased over $245bn Treasury Inflation-Protected Securities (TIPS). Firstly, towards the end of January 2022, the Fed now holds over $381bn in TIPS, which is over 22% of the total TIPS market.

TABLE 01 | Open market Holdings

SECURITY TYPE	TOTAL ($Thousands)
US Treasury Bills (T-Bills)	326,044,000.0
US Treasury Notes and Bonds (Notes/Bonds)	4,907,631,699.0
US Treasury Floating Rate Notes (FRNs)	27,581,816.0
US Treasury Inflation-Protected Securities (TIPS)*	381,497,009.0
Federal Agency Securities**	2,347,000.0
Agency Mortgage-Backed Securities***	2,651,722,412.8
Agency Commercial Mortgage-Backed Securities***	9,097,648.3
Total SOMA Holdings	8,305,921,586.0
Change From Prior Week	-3,440,287.0

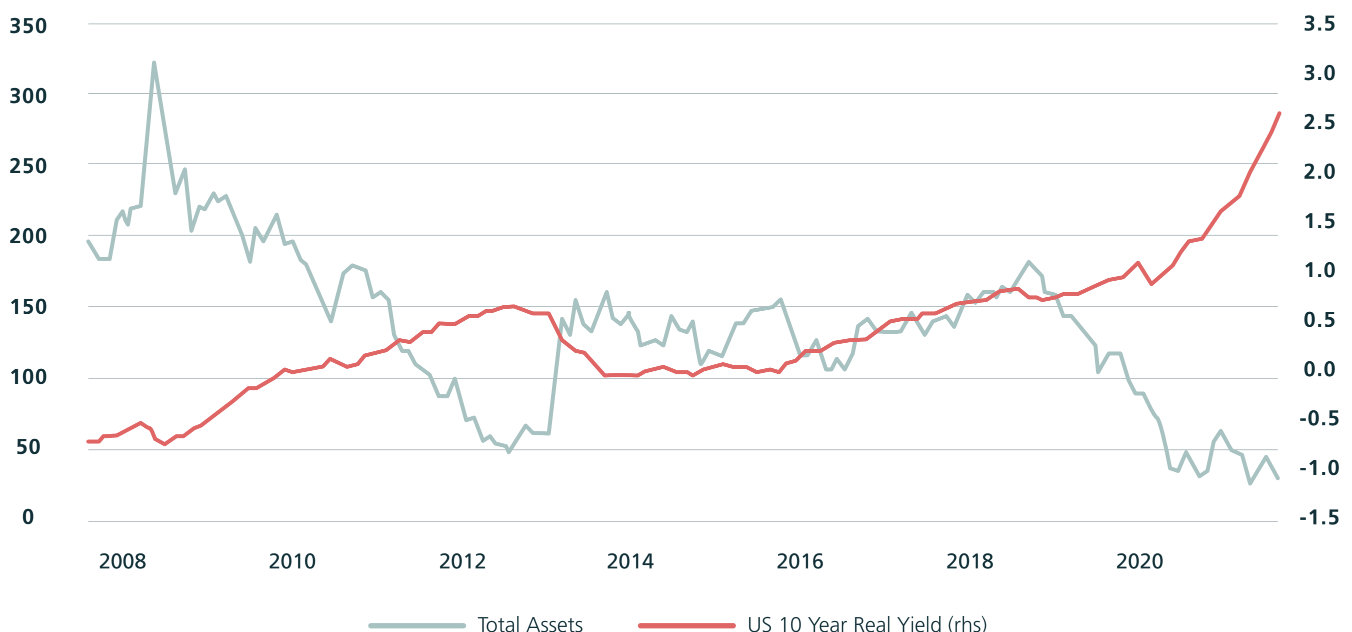
Source: Federal Reserve Bank of New York

As inflation expectations rose demand for TIPS also rose dramatically over the last year. The net flow of assets into US inflation-protected funds increased more than $110bn since the second quarter of 2020 to a total value of almost $290bn – surely this explains some of the strong returns achieved by TIPS over this period.

Yet the outstanding TIPS available in the last two years only increased by $188bn – that implies that the net supply actually decreased by almost $57bn! Bottom line: Supply - net decrease. Demand - net increase.

Demand, however, could materially change in 2022, as the Fed winds down its asset purchases (including TIPS), while supply continues to rise.

FIGURE 02 | Investment has flowed into inflation-linked bond funds



Source: Morningstar

However, we must remember that TIPS are also sensitive to changes in yields - rising real yields negatively impact the returns on TIPS! Then there is also the impact of the liquidity premium. Simply put:

TIPS inflation compensation = Expected inflation + Inflation risk premium + TIPS liquidity premium

Inflation risk premium has been positive but has fallen as investors become less worried about inflation and more confident that the Fed is able to manage inflation. Hence why it has picked up recently.

TIPS liquidity premium

It is important to understand that the TIPS liquidity premium is actually not directly related to inflation expectations and, as in 2008, the Fed quickly steps in to temper it when it rises. The TIPS liquidity premium merely relates to the typically lower liquidity nature of TIPS relative to nominal Treasuries.

While the TIPS liquidity premium historically has typically been positive, it is currently negative (around -0.7%) – ***why?*** Simply – this is due to the combination of lower supply and higher demand of TIPS.

But here is the catch (or circular reference!). As investors demand more TIPS, real yields are depressed, which pushes break-even inflation higher. Higher break-even inflation is then typically interpreted as a sign of rising inflation rates, which leads back to an even higher demand for TIPS - and so the cycle repeats!

03 | TRANSITORY INFLATION FORCES ARE EASING

Supply chain disruption

Supply chain disruption was substantial in 2021, however, these should reduce further as we head into 2022 as they were largely caused by Covid-related capacity shutdowns and subsequent logistical constraints. Supply backlogs have historically adjusted quite rapidly after periods of stress, as companies respond to pent-up demand and rebuild inventory as confidence returns.

We have already started to see freight shipping rates fall sharply. The Baltic Dry Index comprises the cost of shipping major raw materials around the world. The index is believed to be a good economic indicator because it is based on real-time updates of brokered price quotes.

FIGURE 03 | Baltic Dry Index – global shipping index signals easing supply chains

Source: Factset

Energy costs rising

However, energy prices may remain elevated, as the economic recovery increases demand for energy while supply growth remains fairly static. Energy companies have been reducing spend on traditional exploration and production as governments encourage them to spend more on renewables to meet emission targets.

The consequence has been rising traditional energy prices, which are likely to remain elevated for longer as supply not only tightens, but in many situations could rapidly decline.

In time new technologies will alleviate the situation, making alternative renewable energy not only more efficient but also more cost effective, but for the foreseeable future, traditional energy demand will continue to grow, resulting in higher cashflows and profits.

Also provides a hedge against inflation.

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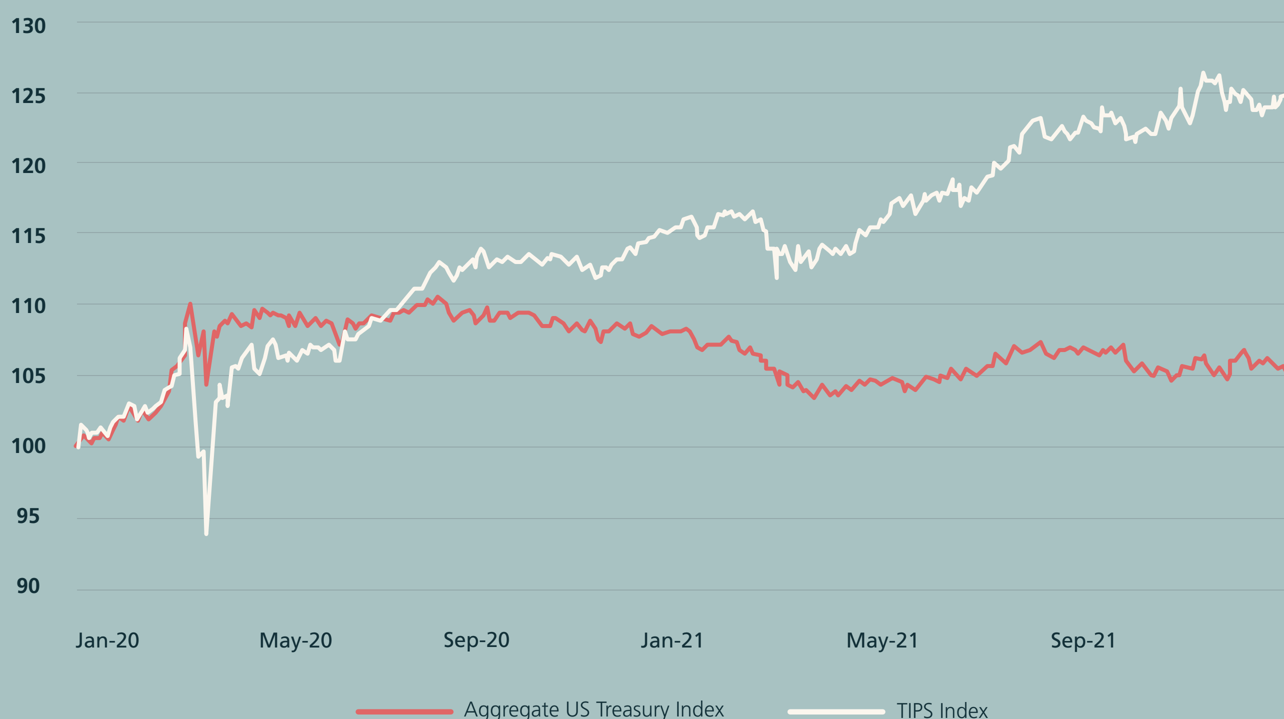
04 | WHAT SHOULD INVESTORS DO?

Real yields could move higher in 2022 as the Fed ends its asset purchases - in this case nominal treasuries would typically outperform TIPS.

While a higher US 10-year yield (still the standard rate used as the risk-free rate for valuation calculations) could impact higher valued and longer-duration growth assets negatively, it would still be more broadly accommodative - low enough for companies to be able to borrow in order to invest and drive growth.

Lastly, there is the behemoth government debt overhang to factor in, which rose dramatically to offset pandemic risks. This could justify or force the Fed to keep interest rates low, to ensure high debt levels remain sustainable. Real negative yields allow the Fed to inflate away some of this massive debt - over time!

FIGURE 04 | TIPS have out-performed nominal Treasuries the last 2 years funds



Source: Factset

In short, TIPS do serve their purpose to hedge against higher inflation expectations, and they have done exactly that over 2021. However, as we have detailed above, there are factors that indicate that it is likely they have already served their purpose. If inflation peaks and expectations of higher inflation for longer eases, then nominal treasuries are likely to outperform TIPS.

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