Inflation and Asset Management

MARKET INSIGHTS DIVISION

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Abstract

Central banks have raised the interest rates to encounter increasing inflation, which brings concerns not only for consumers, but also financial investors. The purpose of this paper is to introduce the general concept of inflation and focus on the main determinants of the one we are currently experiencing. Then, we illustrate what a typical asset management portfolio looks like. At last, we analyse how asset managers update their strategies in response to the changes in the level of inflation, and what is the rationale behind such behaviours.

1. A Deep Dive into Inflation

1.1 What is Inflation

Inflation is a rise in the average cost of goods and services over time. It is determined by the Consumer Price Index, CPI, which measures the average change in price for a 'market basket' of consumer goods and services such as food, clothing, and gasoline, over such a period. (US Bank). In simpler terms, an inflation rate equal to a rise in the cost of living of 10% with respect to the previous year would mean that a pizza that cost €15,00 last year would cost €16,50 this year.

Rising inflation affects the value of money and thus the future value of an investment. To measure the change in spending or purchasing power over time and most importantly, the rate at which the real value of an investment depreciates, investors look at the inflation rate. Investors use the inflation rate to calculate exactly how much of a financial return (i.e., gain) their investments need to make so that they can maintain their current living standards (Investopedia).

Inflation is affected by supply and demand. Prices tend to rise when demand for a good or service rises or its supply falls. Factors that affect supply and demand both nationally and internationally include costs of the factors of production, availability of loans, and transport costs, among others.

To keep inflation in Italy low and stable, the Italian Government set an inflation target of 2.8% in 2022 (Bloomberg). Inflation targets provide expectations for investors, which they can use to plan for the future. If, however, inflation is higher than the inflation targets or proves too volatile, businesses may struggle to set the right prices and consumers to plan their consumption. In this scenario, investors may not be able to rely on the inflation target and may struggle to predict the market.

1.2. Inflation and COVID

Supply chain issues of many goods because of pandemic-related economic shutdowns have recently led to imbalances and higher price levels. For example, the supply of new cars has dropped significantly over the past year due to a shortage of microchips, and in turn, demand for used cars has risen noticeably. These factors have pushed prices higher for both new and used cars (US Bank). Figure 1.1 demonstrates the trend for inflation against time for the past years, with a noticeable difference in the stability prior to COVID and the escalating rate of inflation in the following and most recent quarters.

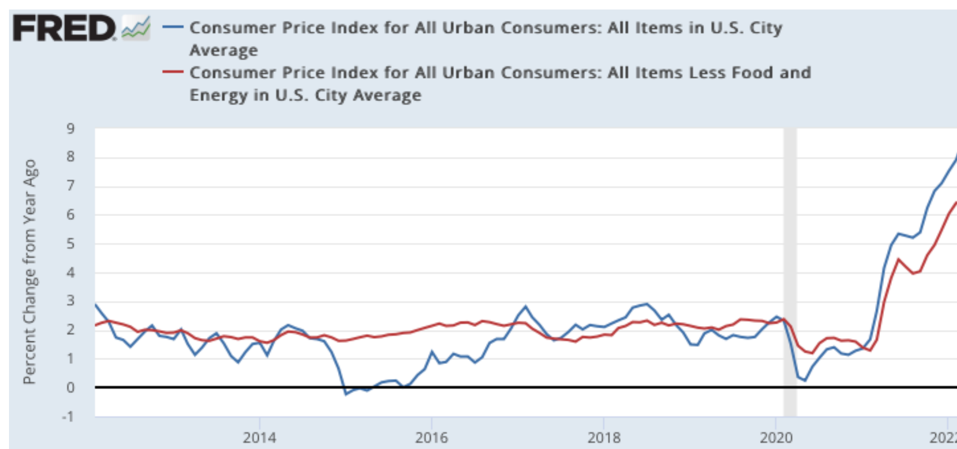


Figure 1.1: fred.stlouisfed.org: Inflation against Time

Out of all factors that influence inflation, the three most prominent and relevant to our case are: The monetary policies imposed by the Central Banks to change the interest rate; the average prices in energy, specifically oil; and regionalization, meaning when operations and production that are low-cost abroad are brought back to produce domestically at a sometimes less efficient rate and higher costs, which ties directly with the reduction in the dependence of imported goods and services. These factors have all been severed by the recent health crisis.

1.3. Recent Inflation

Most recently, Central Banks around the world have committed to keeping interest rates low, to incentivize low-cost borrowing which is expected to increase aggregate output. Additionally, due to the high elasticity of oil as a vital form of energy for producing and transporting goods, oil demand has become closely related to economic activity. Oil prices have risen over the past year, reflecting the recovery in economic activity and demand as well as tighter supplies. Moreover, tensions between the international community and Russia have resulted in the implementation of tariffs and sanctions from the West to gas-exporter Russia. This has restricted gas exports to the West, which has tightened energy supply further.

Lastly, after decades of transferring production overseas aimed at seeking the lowest cost producer, major world economies like the US have engineered the return of factories to their own countries. This means that the cost of production, including goods and labour, is likely to rise, creating inflation. In addition, the supply shock caused by the crisis has forced these domestic efforts to be accelerated, some without the required infrastructure and strategy, which result in a price hike and contribute towards a higher inflation.

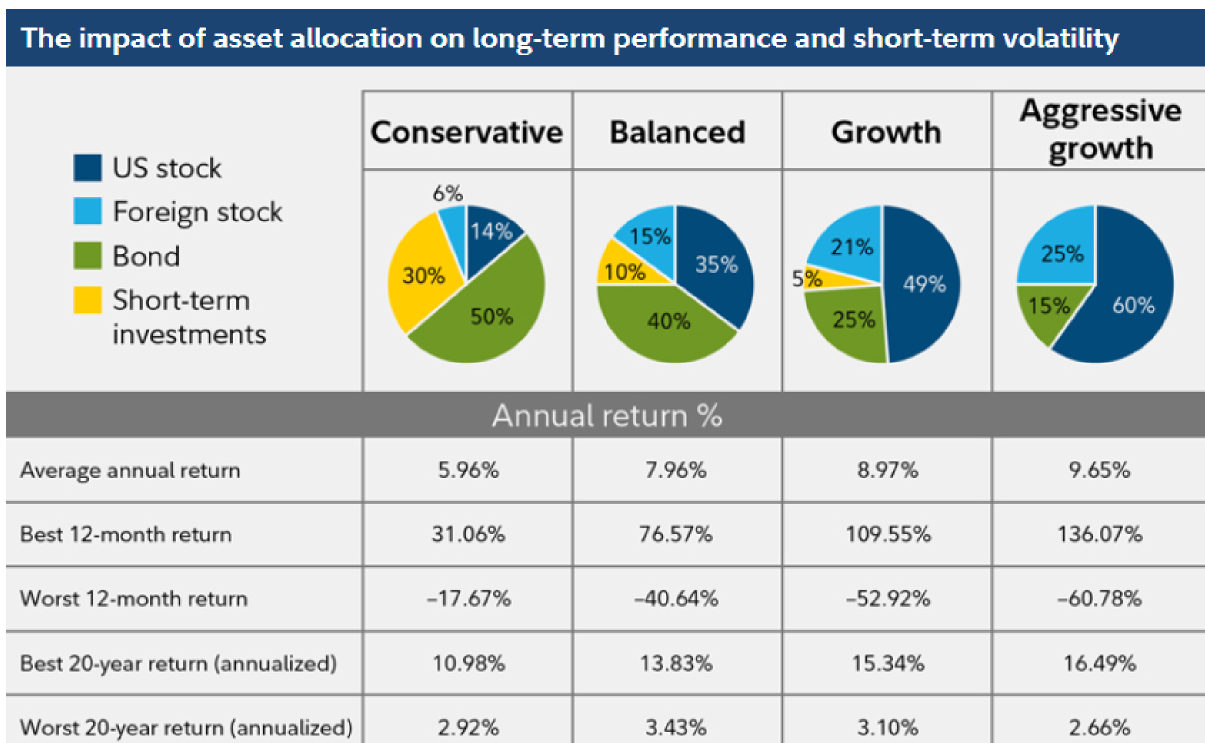
2. Typical Asset Management Strategies

2.1. Asset Management Portfolio

Asset allocation is the process of investing across diversified asset classes. The main asset classes, historically, have been equities (stocks), fixed income (bonds), cash equivalent or money market instruments. It is important to include in the asset class mix also commodities, real estate, futures, other financial derivatives and even cryptocurrencies.
Equities, bonds, commodities and cash or marketable securities are the most liquid asset classes and also the most quoted ones. There are also alternative asset classes such as artworks and real estate which are traded in illiquid markets.

Asset allocation is considered a process because the goal is to constantly balance the risk and return in an investor's portfolio.

In the last ten years the top asset classes ranked for their performance have been US equity, India equity (emerging markets), cash, bonds and gold.



The impact of asset allocation on long-term performance and short-term volatility

	Conservative	Balanced	Growth	Aggressive growth
Annual return %				
Average annual return	5.96%	7.96%	8.97%	9.65%
Best 12-month return	31.06%	76.57%	109.55%	136.07%
Worst 12-month return	-17.67%	-40.64%	-52.92%	-60.78%
Best 20-year return (annualized)	10.98%	13.83%	15.34%	16.49%
Worst 20-year return (annualized)	2.92%	3.43%	3.10%	2.66%

2.2. Asset Allocation Strategies

The two most commonly used asset allocation strategies are: Age-Based asset allocation; Risk Profile Based asset allocation.

In the age-based asset allocation technique, the investment decision is based on the age of the investor using the following formula:

$$\text{Percentage of Equity in Portfolio} = (100 - \text{Age of Investor})$$

The risk profile-based asset allocation uses the investor’s risk tolerance in order to determine how investments need to be allocated across different types of assets. This method identifies five types of investors based on their ability to tolerate risk:

1. Conservative
2. Income
3. Balanced
4. Growth
5. Aggressive

	Conservative	Income	Balanced	Growth	Aggressive
Domestic Equities	15%	25%	35%	45%	55%
International Equities	0%	0%	10%	15%	20%
Debt (Bonds)	80%	65%	40%	20%	5%
Gold	5%	10%	15%	15%	20%
TOTAL	**100%**	**100%**	**100%**	**100%**	**100%**

Investing in equities can be diversified across different markets, which can be divided into Developed markets; United States; Europe; U.K.; Japan; China; Emerging markets.

Asset allocation strategies:

1. Strategic Asset allocation: this method establishes and adheres to a base policy mix—a proportional combination of assets based on expected rates of return for each asset class. Investors can set their targets and then rebalance the portfolio every now and then. A strategic asset allocation strategy may be akin to a buy-and-hold strategy and also heavily suggests diversification to cut back on risk and improve returns.

2. Constant-Weighting Asset allocation: with this approach, investors continually rebalance the portfolio. For example, if one asset declines in value, investors would purchase more of that asset. And if that asset value increases, investors would sell it.

3. Dynamic Asset allocation: with this strategy, investors constantly adjust the mix of assets as markets rise and fall, and as the economy strengthens and weakens. With this strategy, investors sell assets that decline and purchase assets that increase.

4. Tactical Asset allocation: this strategy adds a market-timing component; when economic conditions are favourable to one asset investors buy more of it, until those conditions ran their course.

5. Insured Asset allocation: With an insured asset allocation strategy, investors establish a base portfolio value under which the portfolio should not be allowed to drop. As long as the portfolio achieves a return above its base, investors exercise active management. If the portfolio should ever drop to the base value, investors invest in risk-free assets, such as Treasuries (especially T-bills) so the base value becomes fixed.

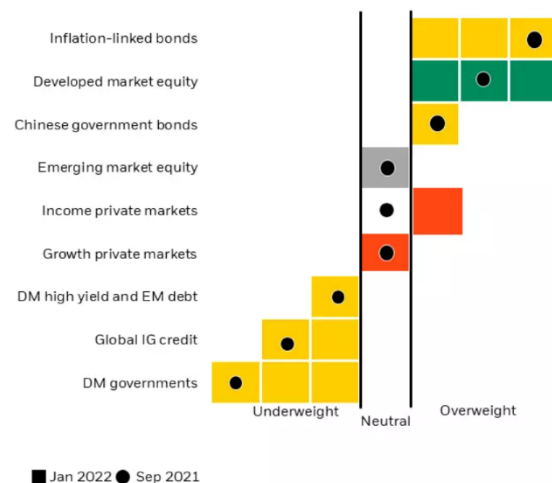
6. Integrated Asset allocation: This strategy includes aspects of all the previous ones, accounting not only for expectations but also actual changes in capital markets and investors' risk tolerance. Integrated asset allocation is a broader asset allocation strategy.

3. Asset Management under Inflation

For asset managers, the investment theme under the inflation is to live with it.

The world is now in a fundamentally different market regime with respect to the last decade, which is driven by higher supply-driven inflation and a more muted cumulative central bank response to such inflation. This macro backdrop reinforces a significant asset reallocation in favour of equities and away from fixed income. The dislocations in markets so far in 2022, which are driven by an adjustment to this regime shift and by near-term confusion, stemmed from the unusual economic restart, a surge in inflation and new central bank frameworks. All these present long-term investors with a strategic opportunity to bump up equity allocations.

Therefore, asset managers add to their developed market equity overweight following their year-to-date selloff and keep their strong underweight to nominal government bonds.



Below is an example of how asset managers in Blackrock change their strategies. They expect central banks to quickly normalize policy, with rates rising from historically low levels. They see a higher risk of the Fed slamming the brakes on the economy as it has struck a hawkish tone. Therefore, they prefer equities over fixed income and overweight inflation-linked bonds.

Asset	Strategic view	Tactical view
Equities	+2	+1
Credit	-1	-1
Government bonds	-1	-1
Private markets	Neutral	-

Equities

Asset managers increased their strategic equities overweight in the early 2022 selloff. They saw an opportunity for long-term investors in equities because of the combination of low real rates, strong growth and a change in valuations. Incorporating climate change in the expected returns brightens the appeal of developed market equities given the large weights of sectors such as tech and healthcare in benchmark indices. Tactically, they favor developed market equities over emerging market stocks, with a preference for the U.S. and Japan over Europe.

Credit

Asset managers underweighted credit on a strategic and tactical basis against a backdrop of rising interest rates and high valuations. They prefer to take risk in equities instead. Tactically, they overweight local-currency debt on attractive valuations and potential income.

Government Bonds

Asset managers underweighted nominal government bonds given their diminished ability to act as portfolio diversifiers with yields near lower bounds. Investors are demanding higher compensation for holding government bonds amid rising inflation and debt levels. Therefore, asset managers prefer inflation-linked bonds instead. Tactically, they also underweighted government bonds as there is the direction of travel for long-term yields as higher – even as yields have surged in 2022. Inflation-linked bonds as portfolio diversifiers in the higher inflation regime are preferred.

Private Market

Asset managers believe non-traditional return streams, including private credit, have the potential to add value and diversification. They hold a neutral view towards private market, which is based on a starting allocation that is much larger than what most qualified investors hold. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks. But private markets are a complex asset class and not suitable for all investors.

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