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Inflation considerations: preparing income portfolios for the next risk

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Income investors are facing a risk that hasn't been an issue for decades: inflation. As the world emerges from the coronavirus pandemic, inflation pressures are on the rise. How can investors manage the possible risks while also positioning portfolios to take advantage of the shifting environment?

ARE INFLATION FEARS WARRANTED?

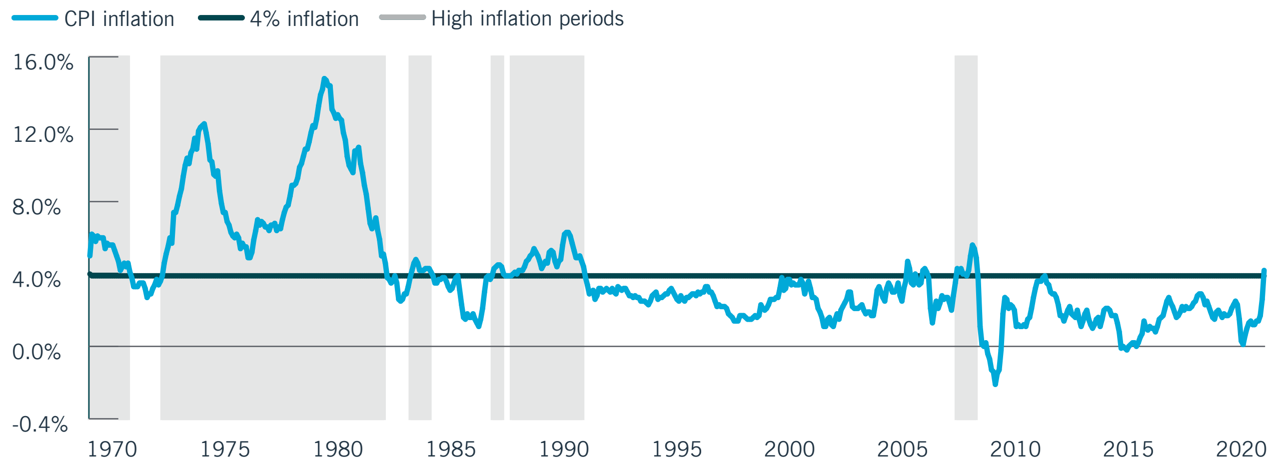
Already this year, inflation has reached 5% year-over-year. While this level exceeded expectations, keep in mind that the percentage change was calculated from a low base. The last 12 months included a period of rising prices, but not the sharp declines that preceded it. Inflation has mostly hovered at or below 2% for the past 10 years. We think the current inflation spike will prove to be transitory rather than the beginning of a higher inflation regime.

HIGHLIGHTS

- As the world emerges from the coronavirus pandemic, a combination of easy monetary policy, massive fiscal stimulus, a rebounding labor market and rising consumer spending may lead to increased inflation.
- Investors should consider allocating a portion of their portfolios to inflation-sensitive assets that can withstand moderately higher price pressures.
- Our approach includes taking on different risks, such as focusing on credit risk in fixed income and taking on illiquidity risk associated with real assets.

Figure 1: Inflation recently surpassed 4%, but for how long?

U.S. Consumer Price Index Urban Consumers, year-over-year



Data source: Bloomberg, L.P. U.S. CPI Urban Consumers year-over-year, not seasonally adjusted, 01 Jan 1970 – 31 May 2021. High inflation periods are periods where year-over-year inflation remains above 4% for six months or longer.

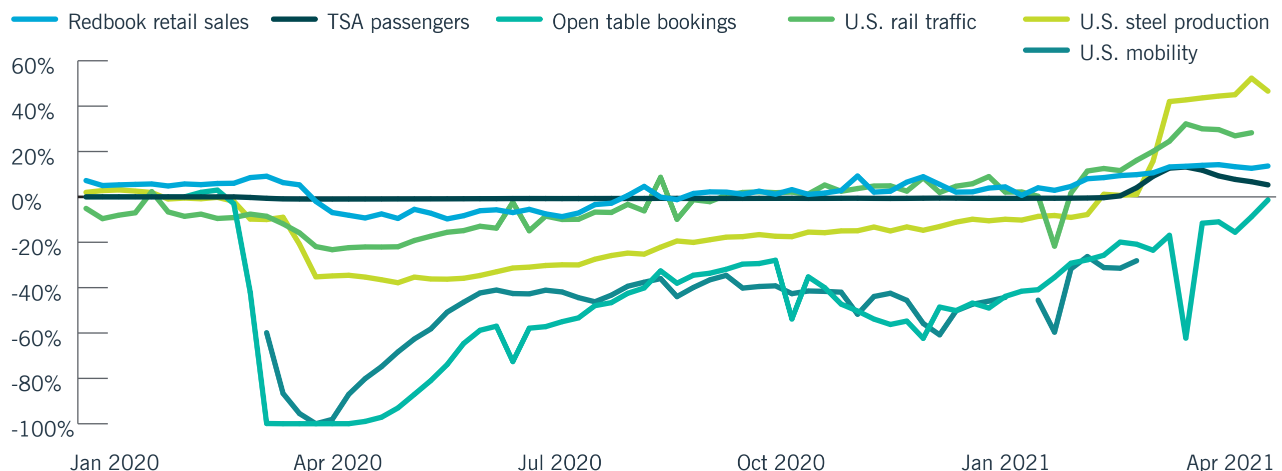
Vaccine rollouts and unprecedented federal fiscal stimulus have created some of the strongest economic growth data in decades. The U.S. has witnessed a marked acceleration in inflation during 2021 due to base effects and supply chain stress as the economy reopens. Across all markets, supply chain blockages, coupled with sharply higher demand from a post-pandemic economic bounce, could lead to temporary price shocks.

But this large one-time boost to demand will fade as supply catches up. At the same time, the U.S. Federal Reserve has pledged to keep monetary policy accommodative until unemployment falls further and inflation materializes above its 2% target.

Persistently high wage growth, a symptom of a tight labor market, would signal that higher inflation might soon be on the way. With unemployment close to 6% and millions yet to return to the labor force, we don't see significantly higher inflation happening in the near term.

Figure 2: High-frequency indicators reflect a reopening economy

Percent change, year-over-year

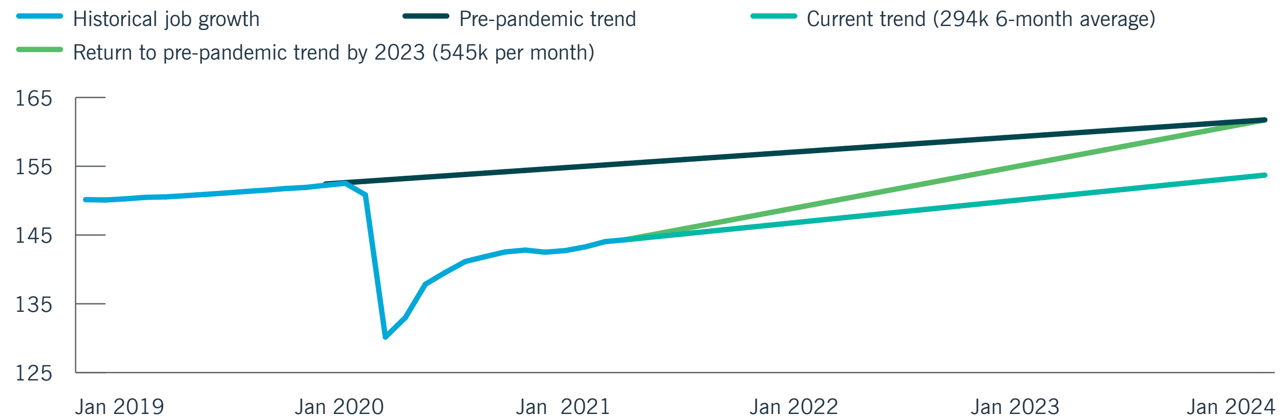


Data source: Bloomberg, L.P., Redbook retail sales, Transportation Security Administration, Open Table, Association of American Railroads, American Iron and Steel Institute, Federal Reserve Bank of Dallas, 01 Jan 2020 – 22 May 2021.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

Figure 3: The employment gap will take time to recover

Number of new jobs produced (by thousands)



Data source: Bloomberg, L.P., Bureau of Labor Statistics, 01 Jan 2019 – 30 Apr 2021. Future dates indicate projections.

But what if we're wrong? Diversification is the key. Portfolio assets should be selected to perform well not only in our expected scenario of modestly higher inflation, but also during bouts of deflationary and inflationary pressures. Thus, investors should consider allocating a portion of their portfolios to inflation-sensitive assets that can withstand moderately higher price pressures.

Are we returning to the 1970s?

Rapid inflation occurs when demand rises quickly and supply cannot catch up. Preventing this mismatch is the primary job of central banks.

In the early 1970s, the Federal Reserve misjudged how loose it could run monetary policy at a time of large budget deficits, wage and price controls and the U.S. dollar's recent departure from the gold standard. Unemployment fell, but prices rose in uncontrolled fashion. Consumer price inflation averaged just over 7% for the decade. This eventually forced the Fed to aggressively raise interest rates, which succeeded in bringing down inflation but also caused two painful recessions.

The elements are different this time around. The world's largest economies are still running well below their full capacity.

How do investors guard against inflation risk?

Inflation risk can be difficult to quantify. We have not seen persistently high inflation during the modern Fed era of quantitative easing, forward guidance and anchored inflation expectations. For that reason, correlations must be calculated over longer time periods.

It's also important to distinguish between investors' inflation expectations (and, related, what these expectations may mean for shifts in central bank policies) and actual inflation surprises shown in economic readings. Recent reflation has been driven by rising inflation expectations from a low level, reflecting investor optimism around economic growth, as well as eventual prospects for a less accommodative policy environment. This trend has been positive for most risk assets, but less so for rate-sensitive fixed income.

Inflation surprises, in contrast, come when realized inflation does not match expectations. As such, emphasizing assets correlated to inflation surprises might help a portfolio better withstand inflation-induced market volatility.

For income investors, inflation protection must be weighed vs. a) the yield of a given asset class and b) the broad volatility introduced into the portfolio. Why are inflation-sensitive income producing assets important in a portfolio? They can provide the dual benefit of generating solid real returns and offering broader diversification.

Figure 4: Asset classes have different sensitivities to inflation

	Inflation sensitivity (correlation between asset classes and inflation expectations and surprises)			
	Inflation Expectations	Inflation Surprises	Yield (%) as of 31 Mar 2021	Volatility (Standard deviation)
Commodities	0.35	0.52	0.00	17.2
Leveraged loans	0.45	0.47	4.84	8.0
1-10 year TIPS	-0.02	0.36	0.80	4.2
Municipal high yield	0.23	0.35	3.44	7.5
U.S. corporate high yield	0.30	0.30	3.99	9.8
Global infrastructure	0.28	0.19	3.41	17.3
Global REITs	0.23	0.15	3.33	19.6
U.S. REITs	0.21	0.15	3.14	20.7
Emerging markets equities	0.21	0.14	2.42	24.5
Developed non-U.S.	0.29	0.11	2.84	18.8
Gold	-0.09	0.11	0.00	13.4
U.S. small cap	0.23	0.10	0.88	22.3
U.S. large cap	0.27	0.09	1.36	17.4
Emerging markets debt (hard currency)	0.12	0.07	3.89	9.9
Preferred securities	0.15	0.05	2.74	17.4
Investment grade municipals	-0.09	-0.04	1.04	3.6
U.S. core bonds	-0.24	-0.27	1.51	3.5

Fixed income Equities Real assets

Data source: Bloomberg, L.P., Nuveen, quarterly data 01 Apr 1996 – 31 Mar 2021 (emerging markets equities began 01 Apr 1999, global infrastructure 01 Jan 2002, 1-10 year TIPS 01 Apr 1999 and preferred securities 01 Oct 2002). **Past performance is no guarantee of future results. Representative indexes: commodities:** Bloomberg Commodity Index; **leveraged loans:** Credit Suisse Leveraged Loan Index; **1-10 year TIPS:** Bloomberg Barclays U.S. Treasury Inflation Notes 1-10 Year Index; **high yield municipals:** Bloomberg Barclays High Yield Municipal Bond Index; **U.S. corporate high yield:** Bloomberg Barclays U.S. Corporate High Yield Bond Index; **global infrastructure:** S&P Global Infrastructure Index; **Global REITs:** FTSE EPRA NAREIT Developed Index; **U.S. REITs:** MSCI U.S. REIT Index; **emerging markets equities:** MSCI Emerging Markets Index; **developed non-U.S.:** MSCI EAFE Index; **gold:** Bloomberg Gold Subindex; **U.S. small cap:** Russell 2000 Index; **U.S. large cap:** Russell 1000 Index; **emerging markets debt:** J.P. Morgan EMBI Global Diversified Index; **preferred securities:** S&P Preferred Stock Index; **investment grade municipals:** Bloomberg Barclays Municipal Bond Index; **U.S. core bonds:** Bloomberg Barclays U.S. Aggregate Bond Index. Correlation with inflation calculated using each index's quarterly total return and the net change in the Cleveland Fed's 1-Year Expected Inflation Index (inflation expectations) or the difference between annualized quarterly CPI and Cleveland Fed 1-Year Expected Inflation one quarter prior (inflation surprises). Yields represent the yield-to-worst for fixed income indexes and dividend yield for equity indexes. Commodities and gold yields exclude any cash flow from roll yield that may result when the futures market is in backwardation, meaning the current price of the underlying asset is higher than prices trading in the futures market.

INVESTMENT IDEAS: PREPARING PORTFOLIOS TO GUARD AGAINST INFLATION RISKS

Focus on credit risk within fixed income, rather than taking on duration risk.

- Consider plus sectors with higher yields, including high yield corporates and high yield municipals. Spread compression can potentially damp the impact of higher rates.
- Leveraged loans have floating coupon payments reset with short-term interest rates, meaning minimal interest rate sensitivity and an asset class that may be sought out by investors if and when the Fed begins rate normalization.
- Such changes may increase fixed income volatility, but we believe this tradeoff is worth it to benefit from stronger inflation protection and better income prospects.

Rotate toward areas of the equity market that benefit from reflation.

- Focus on areas that have lagged over the past decade-plus of low, stable inflation. While we see opportunities in select growth areas, consider increasing exposure to more economically sensitive cyclical areas and select value opportunities.
- A focus on non-U.S. equities could benefit from relatively higher U.S. inflation, particularly developed and emerging economies that present attractive dividend yields and are tied to the commodities cycle. And given likely downward pressure on the U.S. dollar, we think these exposures should be unhedged to currency risk.
- Of course, increasing exposure to equities comes with its own risks, including increased overall volatility.

Increase allocations to real assets, including real estate and infrastructure.

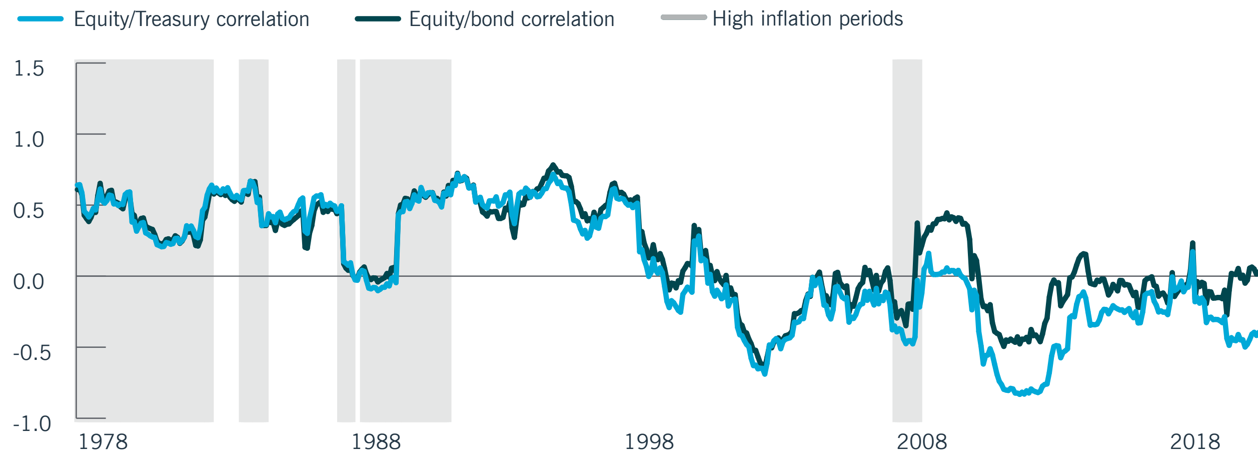
- These asset classes are tied to economic growth, tend to pay high and stable cash flows (often exceeding equities) and provide a better cushion against rising rates compared to traditional bonds.
- Private real estate and infrastructure tend to have low correlations with traditional asset classes and with each other, which may strengthen the risk/return profile.
- Note that real assets can also be more volatile, and some (like commodity funds and gold) do not typically provide income.

Consider how asset classes work together and be prepared for different risks.

- As shown in Figure 5, stock/bond correlations may change with the inflationary environment. Over the past decade-plus, this correlation has been relatively low. But that relationship may diminish or even reverse if inflation rises, meaning a traditional portfolio of stocks and bonds could be subject to greater risks.
- One way to guard against this risk would be to increase exposure to less liquid private investments that are less sensitive to daily public equity market volatility. Private assets provide different risk exposures that are more difficult to estimate. However, for investors who do not require 100% daily liquidity, these idiosyncrasies may effectively boost portfolio yield and damp volatility.

Figure 5: Bond market correlation with equities approaches zero, with Treasuries remaining negative

Rolling 24-month correlation



Data source: Bloomberg, L.P., 01 Jan 1976 – 30 April 2021, rolling 24 month correlation. **Past performance is no guarantee of future results. Representative indexes: equities**: S&P 500 Index; **Treasury:** Bloomberg Barclays U.S. Treasury Index; **bonds:** Bloomberg Barclays U.S. Aggregate bond Index; **inflation:** Consumer Price Index year over year, not seasonally adjusted.

INVESTORS MUST TAKE ON DIFFERENT RISKS

We expect inflation to climb modestly over the next couple of years. Over the longer-term, inflation will likely fluctuate depending on cyclical conditions. Future recessions will put downward pressure on inflation, but investors may need to prepare themselves for a inflation environment higher than the sub-2% level that has been in place for so long.

While we don't expect these shifts to have major immediate implications for portfolio construction, it is important for investors to take on different risks. These include focusing on increasing credit and real assets while also considering less liquid assets to improve a portfolio's volatility profile. Most importantly, investors should remain flexible and focus on in-depth research, as careful planning is necessary to address shifting dynamics.

For more information, please visit nuveen.com.

Endnotes

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A word on risk

Equity investments are subject to market risk, active management risk, and growth stock risk; dividends are not guaranteed. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. These risks are magnified in emerging markets. The use of derivatives involves additional risk and transaction costs.

Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, tax risk, political and economic risk, derivatives risk, income risk, and other investment company risk. As interest rates rise, bond prices fall. Credit risk refers to an issuer's ability to make interest payments when due. Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Foreign investments involve additional risks as noted above.

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