Countering a Potential Inflation Threat

Our experts examine whether the current bout of inflation may be "transitory" or "persistent," along with potential investment approaches for the current environment.

Featured Contributors

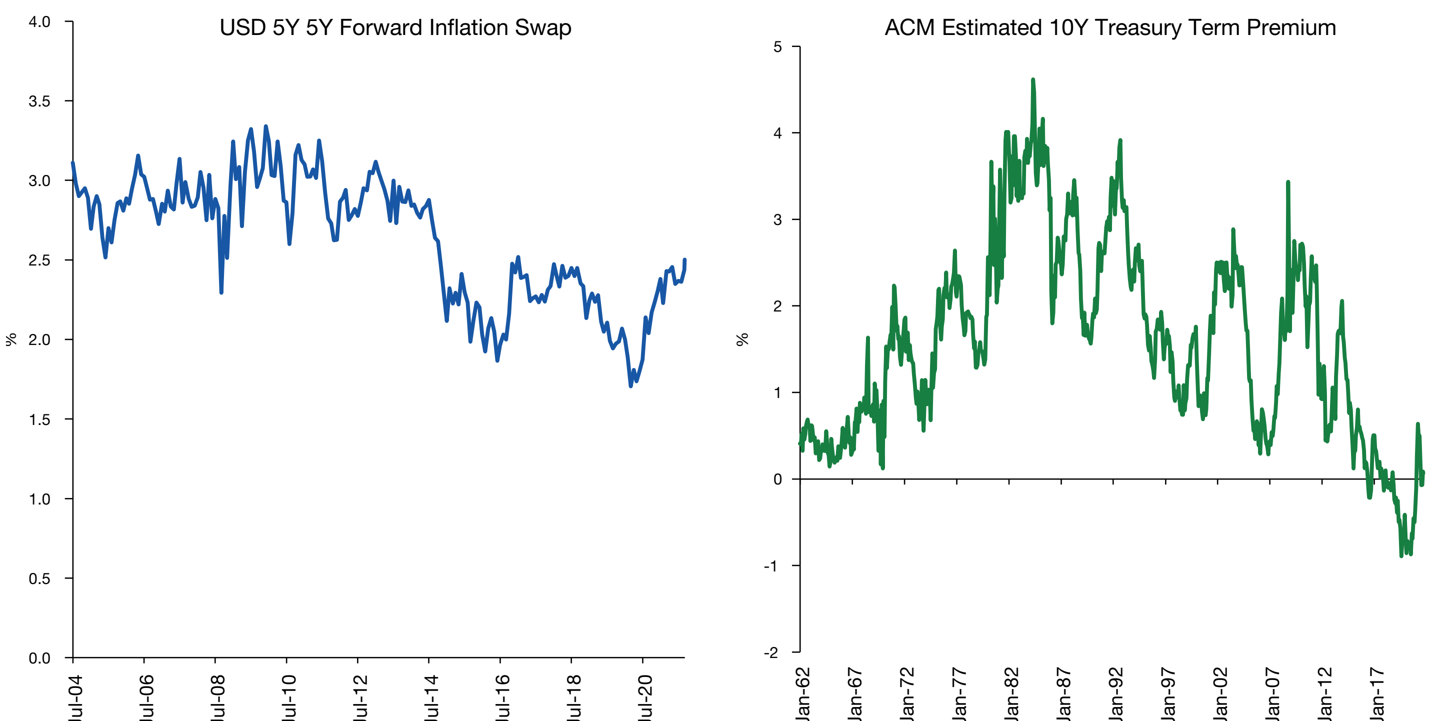
Giulio Martini
Partner and Director of
Strategic Asset Allocation

Jeffrey Herzog
Portfoli Manager

Timothy Paulson,
Investment Strategist

Figure 1. Investors Appear Complacent about Inflation Risk

U.S. five-year, five-year forward inflation swap (left panel; in percent), July 1966¬–September 2021, and estimated 10-year U.S. Treasury term premium (right panel; in percent), July 1961–September 2021



Source: Bloomberg and Lord Abbett. Data as of October 5, 2021.

An inflation swap is a contract used to transfer inflation risk from one party to another through an exchange of fixed cash flows; five-year, five-year forward inflation swaps are tied to a measure of expected inflation (on average) over the five-year period that begins five years from today.

Term premium is a gauge of the level of risk inherent in holding a longer-term bond versus a series of shorter-term securities. It represents the estimated risk embedded in a longer-maturity bond that is determined by the difference between the actual yield and the "risk neutral" yield (represented by rolling a series of shorter-term securities extending to the same maturity at current rate expectations).

INFLATION THREAT

With numerous headlines about supply-chain bottlenecks and rising cost pressures in key areas of the economy, the potential for a sustained period of higher inflation remains a key topic in investment conversations. Recently, Lord Abbett Investment Strategist Timothy Paulson led a discussion on inflation and its implications for investors with Partner and Director of Strategic Asset Allocation Giulio Martini and Portfolio Manager Jeffrey Herzog. Edited excerpts from their remarks follow:

Timothy Paulson: You constantly hear talk of "transitory inflation" versus "persistent inflation." The U.S. Federal Reserve (Fed) has largely indicated that it doesn't see current inflation readings leading to something that will be more persistent. The market tends to agree. Can you just talk a little bit about those dynamics?

Giulio Martini: Inflation has risen much more sharply during this economic recovery than anyone expected. In the Fed's summary economic projections published in September 2020, they expected inflation to be 1.7%. That was the median forecast for the end of 2021. And the high forecast was 2.4%. Now, here we are through September 2021, and the actual outcome is that inflation has been 4.2%, driven by a sharp increase in goods prices, though services inflation is also contributing. The Fed's most recent, summary economic projections for 2022 versus the end of 2021 call for inflation at a rate of 2.2%, with a high forecast of 3%. That reflects the Fed's view that we are experiencing a transitory period of higher inflation, and inflation will come back down back into the range that it's been in roughly since the mid-1990s.

Now, I want to emphasize that the inflation we're experiencing right now is coming from multiple sources. We're seeing extremely strong demand for durable and non-durable consumer goods. Personal consumption expenditures are more than 10% above the trend level they would have expected to be at, based on pre-COVID-19 consumer spending. We've also had strains on capacity at multiple points along global supply chains, including soaring prices for shipping containers.

There are also pressures in the labor market. As people transition to better jobs, to higher paying jobs, in different sectors than they had worked in previously, that's putting pressure on labor costs. Meanwhile, supply-and-demand factors have driven home prices sharply higher. We expect that to translate very quickly into rising rental inflation because there's about a one- to two-year lag between rising house prices and rising rents. Transitory or not, we think these factors will press higher on inflation for the next one to two years.

Despite all these different sources of inflation in the short term, the broad forecast in the markets is that inflation will come back down. If you look at expectations baked into market prices, in this case, the five-year, five-year forward inflation swap, the left panel of Figure 1 on the first page, shows that they are still at a level close to or below what they were before the big drop in oil prices in 2014. Meanwhile, the risk premium that represents compensation for the uncertainty about future bond yields remains very low (right panel).

Basically, inflation has way overshot forecasts, but people really haven't revised the expectations they're building into financial market prices at all.

Bottom line, while the term premium has come up some in recent weeks and months, it's still extremely low by comparison with a very long history going back into the early 1960s. And so, inflation risk is not priced into bond yields now. And by virtue of not being priced into bond yields, inflation risk is not priced into stocks in our view either. We think the prospect of a significant, sustained rise in inflation is probably the most significant threat to asset prices that exists right now.

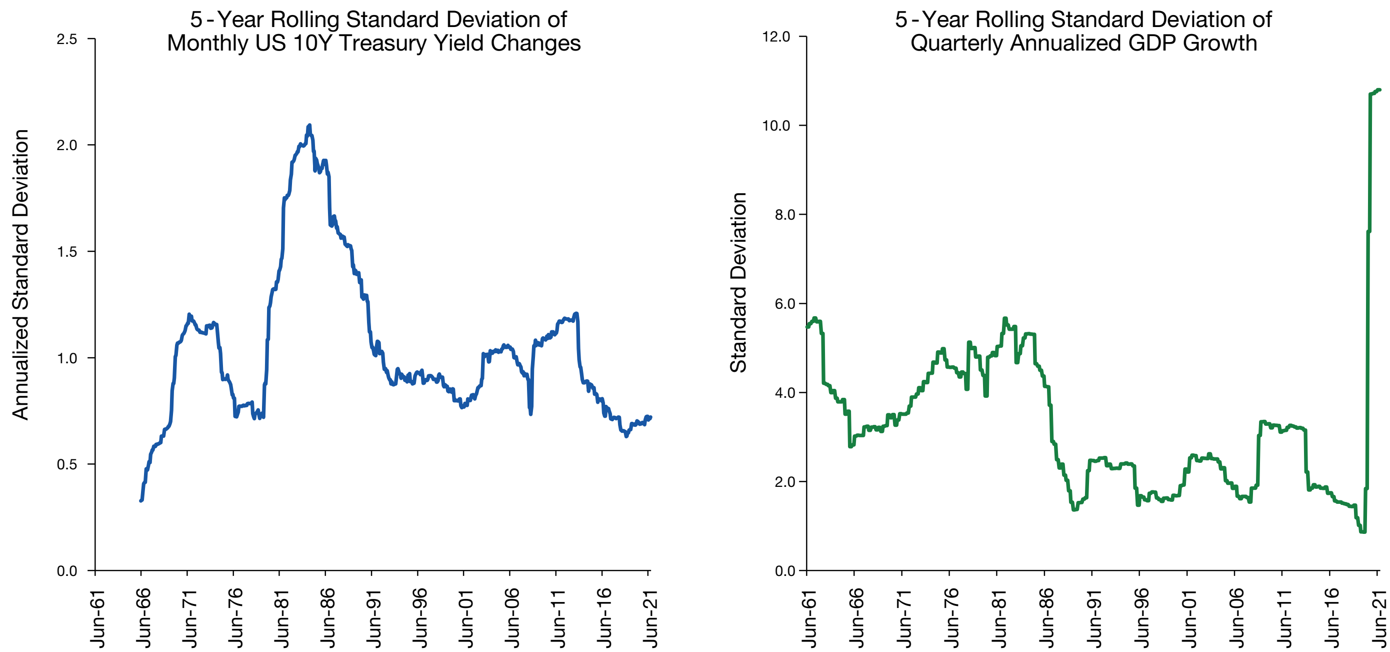
Paulson: For investors, what are the implications of hotter-than-expected inflation and a rising risk premium?

Jeffrey Herzog: To answer that, let's take a step back and think about what inflation does to us in the aggregate: it creates more frequent repricing. The potential difficulties for investors are twofold. First, it makes it harder to forecast; it makes it harder to see what's coming around the corner. Second, it makes it that much harder to value assets.

That difficulty springs from the potential impact that inflation can have on economic growth. Figure 2, on the next page, shows the standard deviation of Treasury yield changes in a five-year window, and the standard deviation of GDP in a similar timeframe. In a nutshell, periods of rising inflation can lead to volatility in the economy.

Figure 2. Periods of Sustained Inflation Have Led to Higher Rate and Economic Volatility

Five-year rolling standard deviation of monthly 10-year U.S. Treasury yield changes (Left panel), July 1966–September 2021; five-year standard deviation of quarterly annualized GDP growth (right panel), July 1966–September 2021



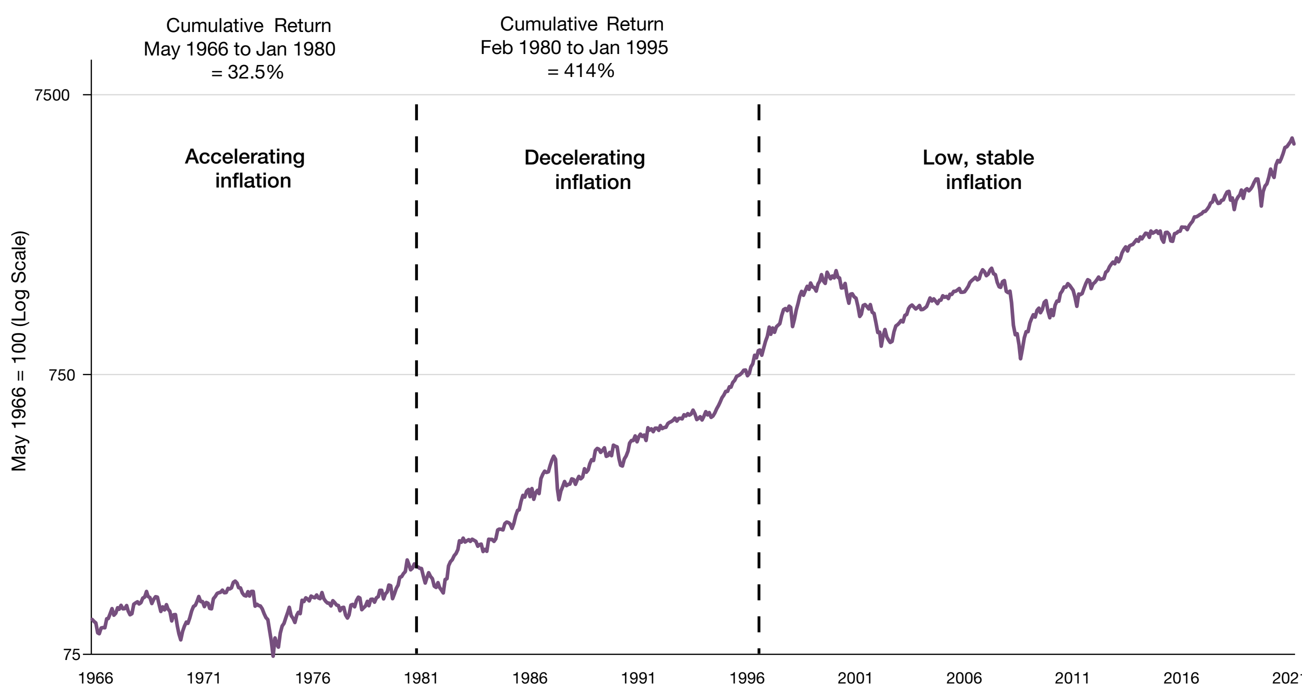
Source: Bloomberg and Lord Abbett. Data as of October 5, 2021.

Standard deviation measures the dispersion of data from the mean and is an indication of the volatility of a data series. For illustrative purposes only. **Past performance is not a reliable indicator or guarantee of future results**.

The historical risks from a period of accelerating inflation are clear for risk assets such as equities, as Figure 3 shows.

Figure 3. Tracking Stocks' Performance Through Various Inflation Regimes

Cumulative return of S&P 500 Index, June 1966–September 2021



Source: Bloomberg and Lord Abbett. Data as of October 5, 2021.

For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. **Past performance is not a reliable indicator or guarantee of future results.**

The first portion of the chart covers a period of accelerating inflation from 1966–1980. During that 14-year period, the S&P 500® Index had a cumulative return of only about 32%. During the period of decelerating inflation from 1980-early 1995, its cumulative return was 414%. (The results from the long-term regime of low and stable inflation from 1995 onward speak for themselves.)

But the data that we are looking at now do not point to a period of decelerating inflation. I think this really underscores the importance of being adaptive and creative in formulating investment approaches during periods when inflation may be poised to accelerate.

Paulson: There's a lot going on in the world of inflation. It's clearly a risk. It destabilizes virtually every portfolio. To Jeff's point, what approach can investors take to prepare their portfolios for a potential period of accelerating inflation?

Martini: In equities, we think value and momentum are favored during periods of rising inflation. We think the general idea of shortening duration in your fixed-income and credit exposures is a good idea. We think focusing on spread product[1] is a good idea because it could potentially benefit from higher economic growth in that period, which is something that risk-free yields do not do. Those bonds may be poised to do better because of their greater sensitivity to changes in the rate of economic growth, although I would add they may be vulnerable to cyclical downturns.

Of course, many investors may consider commodities in such an environment, but we would note that all commodities respond well during inflationary periods. Certain areas within real estate may also perform well.

We envision an effective overall response to rising inflation as kind of a cross-asset exposure to rising volatility, something that may prove effective as you move from a period of low inflation to higher inflation.

Paulson: As we wrap things up, I think one important point to note is that it's extremely difficult to forecast inflation, let alone very long-term inflation. As Giulio has said, inflation is a process, not an event. Ultimately, what we're saying here is not that inflation is bound to move sharply higher for a sustained period. Rather, it's that some of the risks around inflation may not be adequately priced into the market right now.

[1]Spread product refers to taxable bonds that are not Treasury securities. They are evaluated by the professionals who buy and sell them based on the difference between their yield and the yield of a comparable Treasury security.

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Glossary & Index Definitions

Gross Domestic Product (GDP): The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates.

The **yield** on a security is the amount of cash (in percentage terms) that returns to the owners of the security, in the form of interest or dividends received from it.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

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