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November 2021

Economic Insights

Inflation Risk: Preparing Portfolios for a Potential Change

Lord Abbett investment leaders outline potential investment approaches that may provide tactical opportunities in an environment of persistent inflation.

by Giulio Martini, Partner, Director of Strategic Asset Allocation

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by Timothy Paulson, Investment Strategist

For the first time in many years, investors are faced with the prospect of accelerating–and persistent–inflation. Lord Abbett investment leaders Giulio Martini, partner, director of strategic asset allocation, Jeffrey Herzog, Ph.D., portfolio manager, and Timothy Paulson, investment strategist, convened on this important issue to provide a thorough assessment of current inflationary pressures, as well as their views on how investors may want to adjust their portfolios in response.

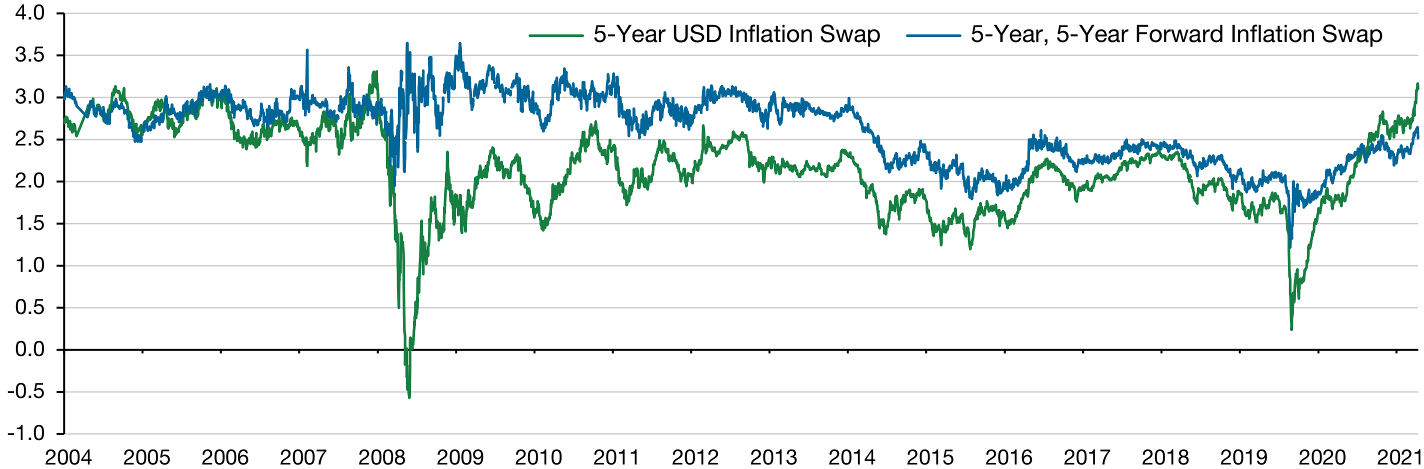
Markets Still Pricing a Transitory Spike

We think it is fair to say that inflation has been higher than it was expected to be at this point in time. But are we experiencing a short-term spike in inflation, or are we in the early stages of a regime change signaling a shift to a steady acceleration? Currently, investors and investment markets remain squarely in the temporary, short-term spike camp.

As you can see in Figure 1, five-year inflation swaps have moved up sharply recently to above 3%, driven in large part by rising oil and gas prices. But long-term inflation expectations, captured by five-year, five-year-forward inflation swaps, are well within the range that they've been in for most of the past 20 years, although they have modestly increased recently. Thus, long-term inflation expectations are not currently signaling that the market is shifting its view on inflation decisively in the "higher for longer" camp.

Figure 1. Markets are Pricing a Transitory Spike in Inflation, but Some Doubts Are Starting to Creep In

CPI inflation swaps using the 5-year, 5-year-forward USD inflation swap rate and the 5-year USD inflation swap for the period January 1, 2004-October 31, 2021



Source: Bloomberg and Lord Abbett. Data as of 10/31/2021. USD = United States Dollar. The 5-Year, 5-Year USD (United States Dollar) Inflation Swap Rate is a common measure, which is used by central banks and dealers, to look at the market's future inflation expectations. The 5-Year Inflation swap is a derivative used to transfer inflation risk from one party to another through an exchange of cash flows. In a zero-coupon inflation swap, only one payment is done at maturity where one party pays a fixed rate on a notional principal amount, while the other party pays a floating rate linked to an inflation index, such as the Consumer Price Index. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment and are not intended to predict or depict future results.

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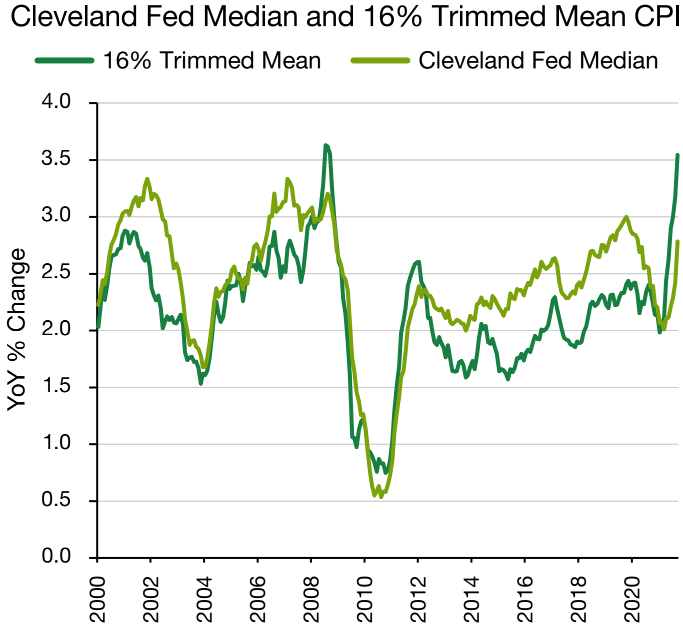
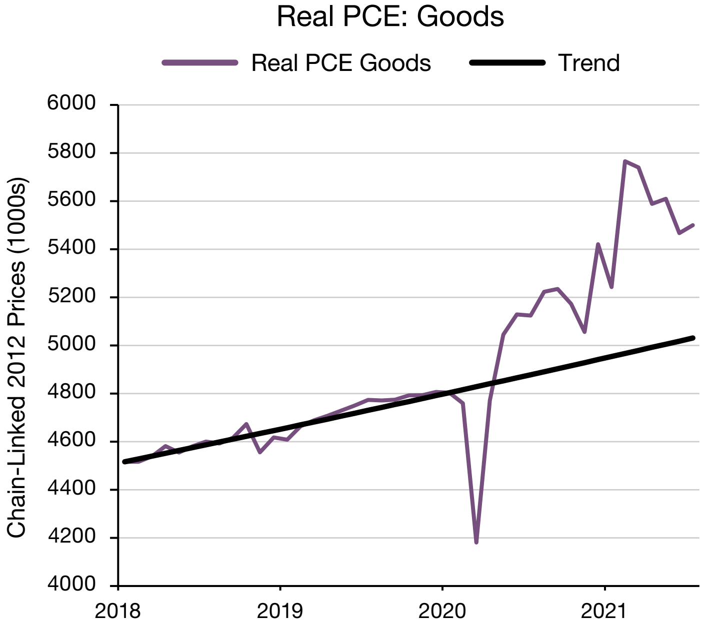
But Inflation Pressures are Proliferating

Clearly, however, inflation is broadening out in the U.S. economy, as rising prices are reaching a wider segment of goods and services with evidence of demand-driven forces contributing to the upward surge. The left panel of Figure 2 reveals significant increases in trimmed (as defined) measures of price changes. While the right panel displays the actual level of consumption of durable and non-durable goods that is above the pre-COVID-19 trend, indicating a substantial, demand-driven component impacting prices in addition to more transient supply-chain difficulties.

Figure 2. Inflation Pressure Is Broadening Out Across Goods and Services, and There Is More Evidence of a Demand-Driven Component.

Cleveland Fed (Federal Reserve) Median and 16% Trimmed Mean CPI (Consumer Price Index), 01/01/2000-09/30/2021, left, and Real PCE (Personal Consumption Index), 01/01/2018-08/31/2021, right



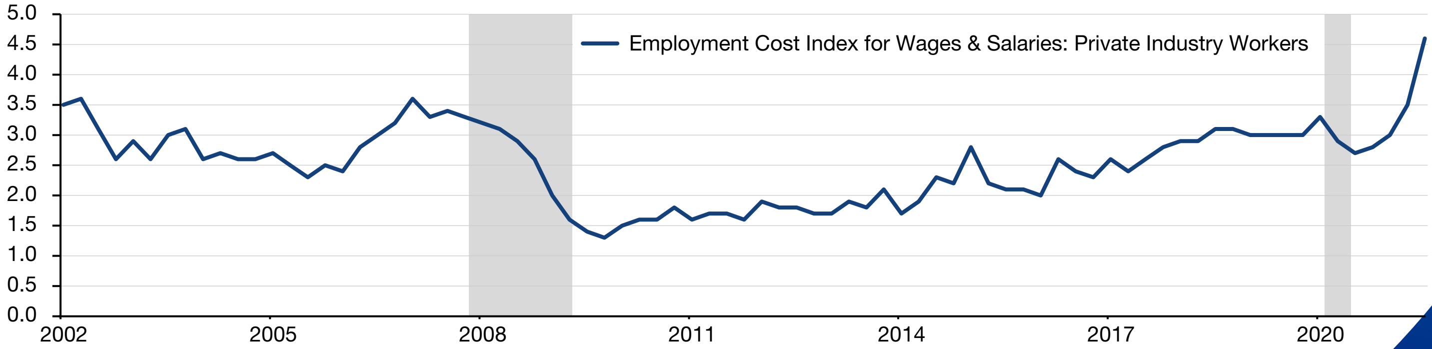


Source: Bloomberg and Lord Abbett. Left chart: data as of 09/30/2021. Right chart: data as of 08/31/2021. Trimmed data reflects inflation in both the median, which trims away price changes above and below the 50th percentile, as well as the 16% trim mean, which trims price moves at the very low and very high end of the distribution. The U.S. consumer price index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. PCE deflators track overall price changes for goods and services purchased by consumers. Deflators are calculated by dividing the appropriate nominal series by the corresponding real series. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment and are not intended to predict or depict future results.

Current labor market dynamics also are making a contribution to more persistent inflation as record job vacancies tap into a reduced labor supply, causing sharp increases in overall labor costs, shown in Figure 3.

Figure 3. An Upward Trend in Wages Suggests a Further Tightening in the Labor Market

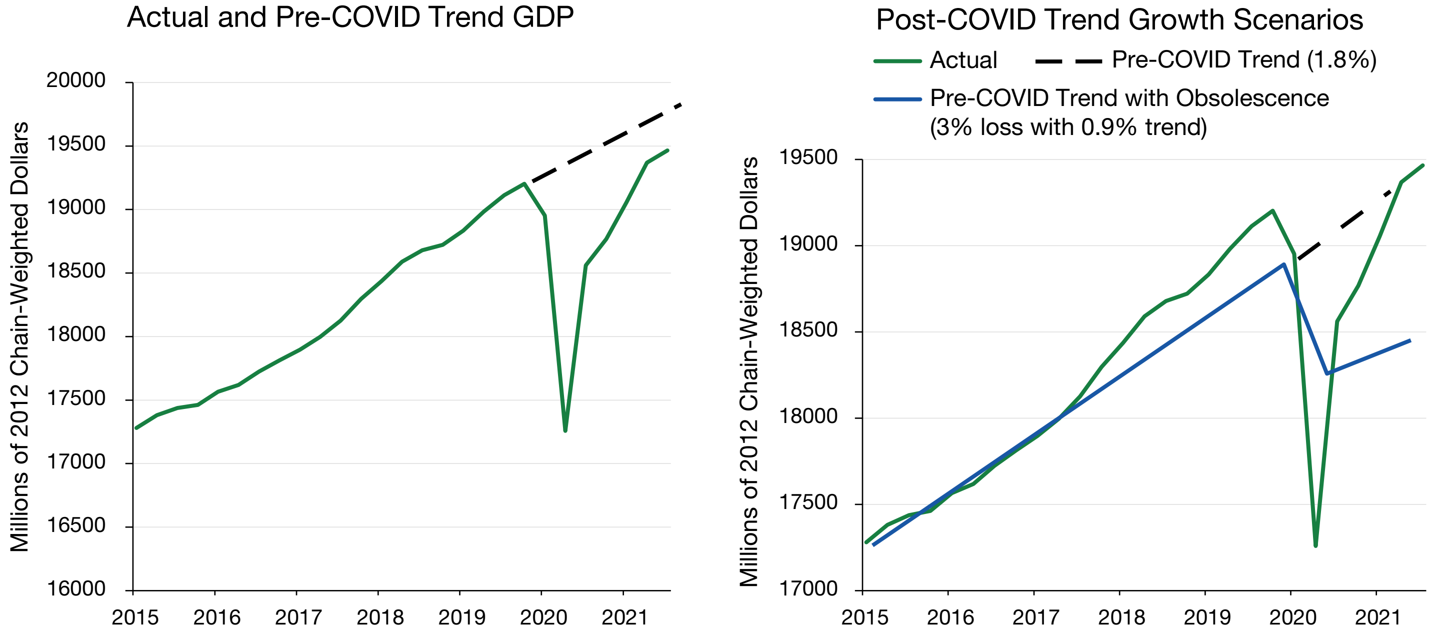
Quarterly Employment Cost Index for the period January 1, 2002-September 30, 2021



Source: Bloomberg and Lord Abbett. Data as of 09/30/2021. The Employment Cost Index measures changes in direct (wages, bonuses & benefits) and indirect (certain benefits & training costs) employee compensation costs. Shaded areas represent economic recession. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment and are not intended to predict or depict future results.

Figure 4. Possible Post-Pandemic Economic Growth Scenarios

Actual GDP growth (March 2015-September 2021) and potential post-pandemic growth



Source: Bloomberg and Lord Abbett. Data as of 09/30/2021. The pre-COVID-19 trend with a 3% obsolescence represents an estimate of output capacity that could have been potentially lost. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment and are not intended to predict or depict future results.

Potential Economic Growth Scenarios

With demand-driven inflation pressure pushing prices higher across a broader segment of goods and services, and labor costs moving up in response to a historically tight job market, imbalances have appeared that will be difficult to counter in the short-term. How long an extended period of elevated inflation might last may depend on the extent to which potential output declined because of the global pandemic.

In Figure 4, we present several possible scenarios that may explain why a period of elevated inflation may persist, as opposed to a short-term spike in prices. On the left side of Figure 4, actual GDP (Gross Domestic Product) growth is shown along with a dotted line representing GDP trend growth extrapolated from the pre-COVID-19 peak in the fourth quarter of 2019. If the pandemic did not change the underlying growth trend, and the economy was at full employment prior to the economic shutdown in March 2020, then inflation pressures may abate soon, as aggregate demand remains below the potential output of the economy.

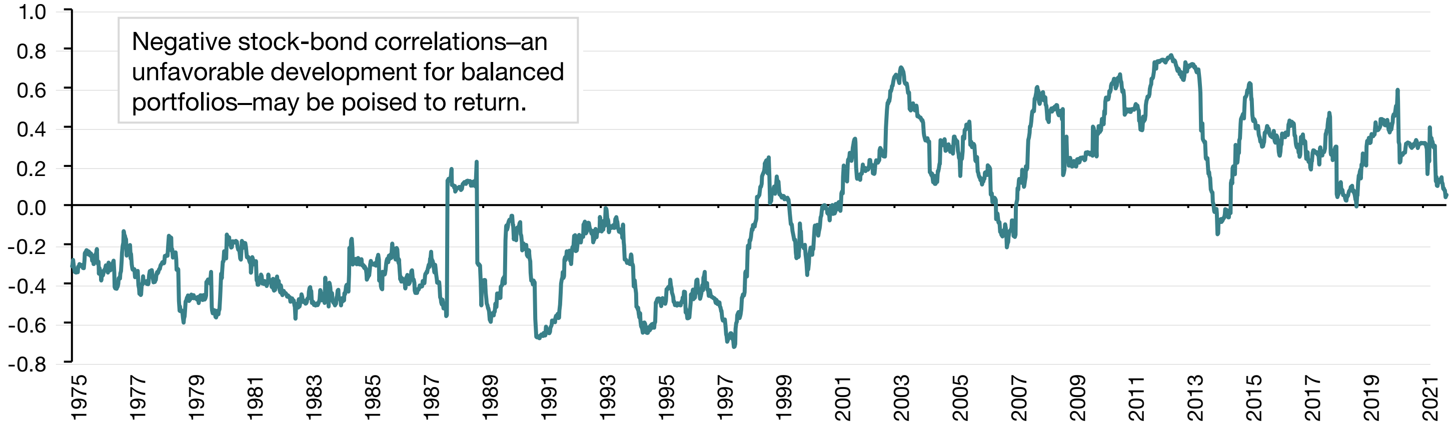
However, if the economy was above full employment prior to the shutdown and if it lost a portion of its potential capacity (illustrated by the blue line on the right side of Figure 4) due to pandemic-induced obsolescence of its productive resources, such as movie theaters that have closed, or workers who have retired, then a possible outcome may be that economic output is currently not sufficient to respond to the exceptionally strong demand.

Some Daunting Implications for Investors

Since the mid-1990s, the correlation between bond yields and stock prices has been positive, a key tenet supporting diversification benefits of a balanced portfolio. As bond yields rose, stock prices increased, as shown in Figure 5. However, if higher inflation prompts investors to anticipate rising bond yields when GDP is strong, the correlation between stock prices and bond yields could potentially turn negative again, as investors associate rising yields in an inflationary environment with slowing economic growth, creating a negative outlook for stocks. That change in correlation would increase expected volatility in balanced portfolios, requiring a reduction in the allocation to higher return asset classes in order to avoid increasing exposure to negative expected returns.

Figure 5. Could the Correlation Between Bond Yields and Stock Returns Turn Negative?

One-year rolling correlation between the weekly change in the 10-Year U.S. Treasury note and the return of the S&P 500 Index, January 1, 1975-October 31, 2021



Source: Bloomberg and Lord Abbett. Data as of 10/31/2021. 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. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment and are not intended to predict or depict future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

How to Respond? These Asset Classes May Provide Tactical Opportunities

We believe there are 6 areas of opportunity that may provide investors a tactical approach to preparing portfolios for a period of rising inflation:

1) Commodities

Commodities are often viewed as beneficiaries of rising prices but selectivity among commodity industries is crucial and depends on the supply-and-demand dynamics that exist within each commodity sector.

Figure 6 shows total real price returns generated by commodity sectors from 1965 to 1980, a period when inflation was accelerating. Notable is the disparity in price returns, illustrating that not all commodities perform well in periods of rising inflation. Examples in the current environment may be the impact of alternative sources of energy on oil and gas prices or the impact of EV (electric vehicle) demand on certain metals and minerals used in the production of EVs. Decarbonization could reduce the inflation-hedging potential of energy commodities while the switch to battery-driven energy storage could increase the potential for certain industrial metals, such as copper, to stand out as an inflation hedge.

Figure 6. Some Real Assets Underperform in Inflationary Periods

Total real price return of commodity sectors for the period January 1, 1965 to December 31, 1980

	Total Real Price Return (%): 1965-1980
Energy	**820.4**
Non-Energy	**2.0**
Agriculture	**8.5**
Beverage	7.0
Food	13.3
Oils & Meals	-6.7
Grains	6.9
Other Food	63.9
Raw Materials	**-4.8**
Timber	5.3
Other Raw Materials	-12.3
Fertilizer	26.1
Metals & Minerals	**-19.0**
Base Metals (ex. Iron Ore)	-20.6
Precious Metals	**407.6**

Source: Bloomberg, The World Bank, and Lord Abbett. Data as of 10/31/2021. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment and are not intended to predict or depict future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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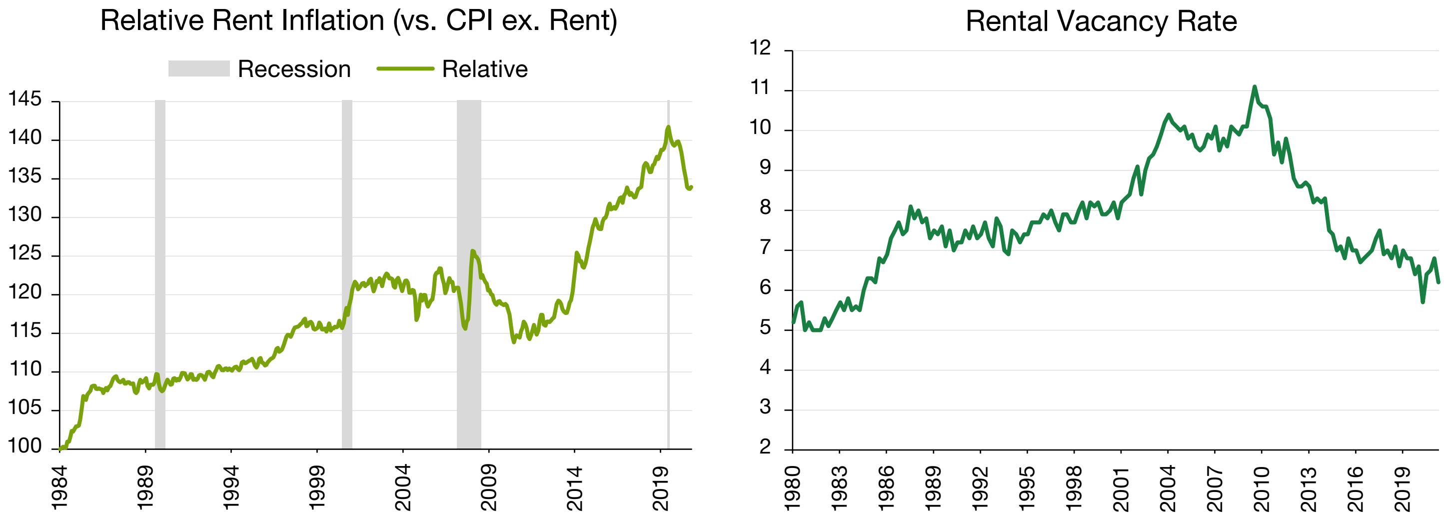
2) Real Estate & Housing

Supply-and-demand forces also play an important role in determining potential investment opportunities in the real estate sector. We believe the structural deficit in housing may continue for some time, as builders catch up to strong demand for homes. In Figure 7, the chart on the left depicts the ratio of rent inflation, which includes the cost of home ownership, to total inflation, based on the CPI. The change in rent inflation corresponds to the chart on the right of Figure 7, which indicates that a decline in rental vacancy rates is generally supportive of the demand for homes and the rise in rent inflation.

Figure 7. U.S. Housing Remains in Short Supply and May Outperform if Inflation Persists

Relative rent inflation (left) and rental vacancy rates (right) for indicated periods.



Source: Bloomberg and Lord Abbett. Data as of 09/30/2021. Relative rent inflation measures the ratio of rent inflation to the CPI. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment and are not intended to predict or depict future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

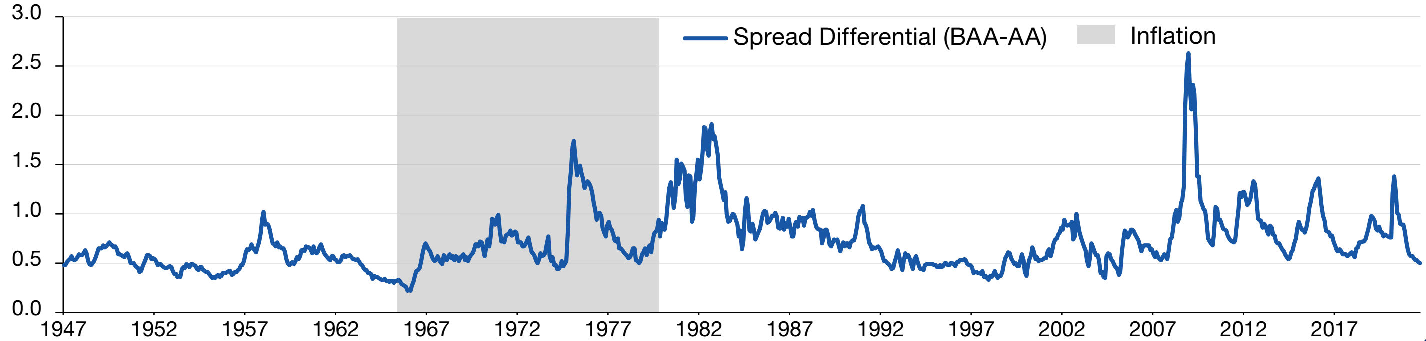
3) Lower-Quality Credit

Credit may also provide a potential opportunity in periods of accelerating inflation. Similar to the way inflation increases balance sheet leverage for homeowners, as the value of homes rise, periods of rising inflation reduce the constraint of leverage on businesses, as pricing power increases.

Courtesy of Moody's, Figure 8 shows that the spread differential between BAA-rated and AA-rated corporate bonds holds up well during periods of rising inflation, outside of periods of cyclical downturns in economic growth.

Figure 8. Lower-Quality Credit Exposure May Outperform as Inflation Rewards Leverage, Outside of Periods of Cyclical Downturns in Economic Activity.

Spread differential between the Moody's BAA-Rated Corporate Bond Index and the Moody's AA-Rated Corporate Bond Index for the period January 1, 1947-September 30, 2021



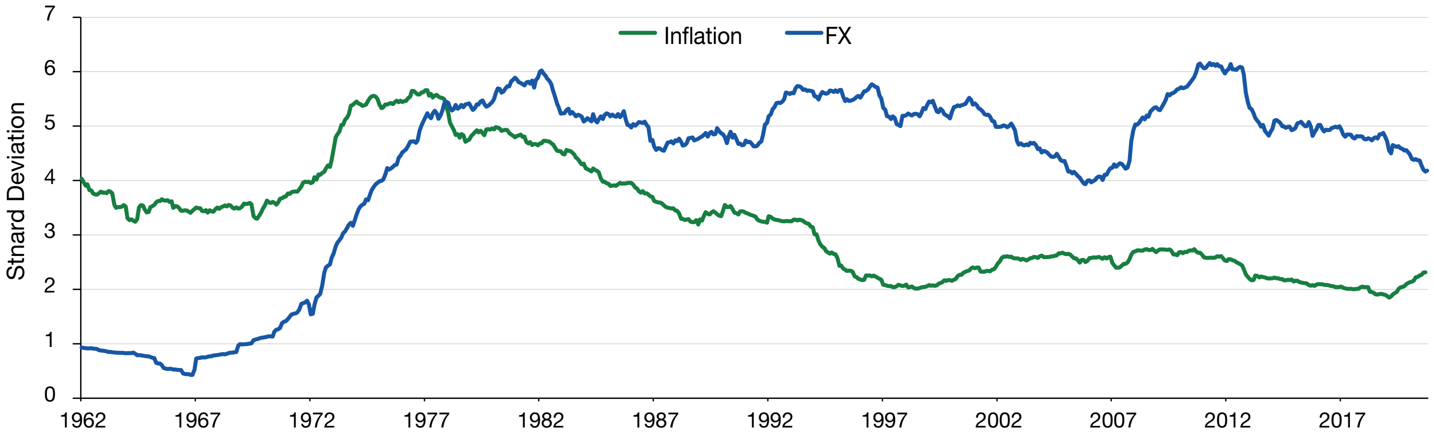
Source: Moody's, Bloomberg and Lord Abbett. Data as of 09/30/2021. Spread differential measures the difference in yield of the Moody's BAA-Rate Corporate Bond Index and the Moody's AA-Rated Corporate Bond Index. The Moody's BAA corporate bond yield measures the yield on corporate bonds that are rated BAA. The Moody's AA corporate bond yield measures the yield on corporate bonds that are rated AA. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment and are not intended to predict or depict future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

4) FX (Foreign Exchange) Volatility

Greater macroeconomic variability among countries may also contribute to increased financial volatility. We think a potential opportunity exists within foreign exchange markets if periods of inflation dispersion among countries, and subsequently, macroeconomic conditions, create variability in currency exchange rates.

Figure 9. Higher Divergence in Inflation Between Countries Leads to Greater Movements in FX

Five-year monthly mean cross-sectional currency rates and five-year rolling, monthly standard deviation of inflation measures across countries for the indicated periods



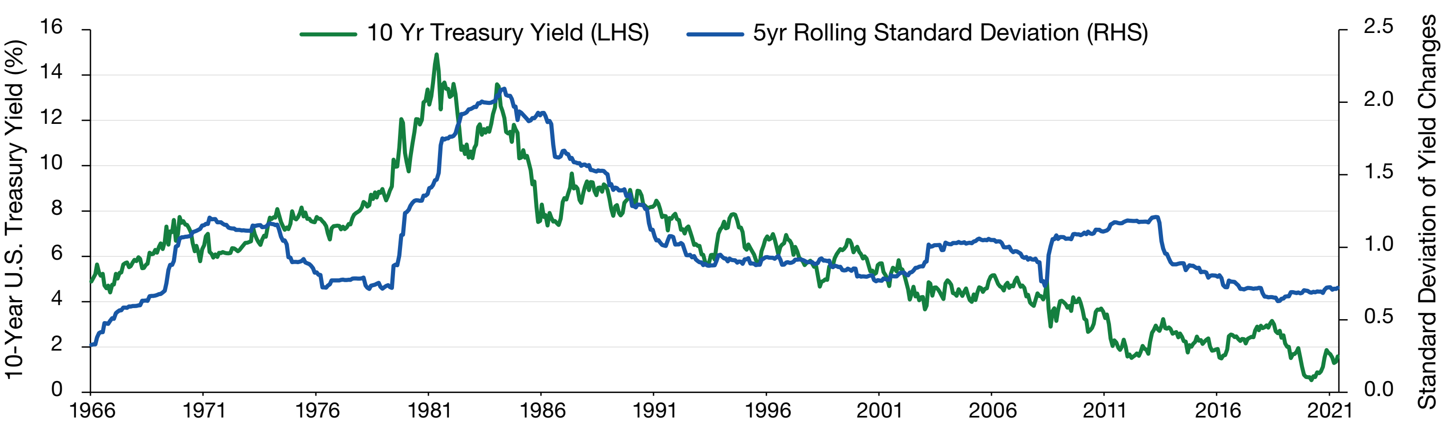
Source: International Monetary Fund (IMF), Haver Analytics, and Lord Abbett. Data as of 10/01/2021. Note: Country sample is U.S., Germany, Japan, Sweden, Norway, United Kingdom, Switzerland, and Canada. Each month a standard deviation is calculated for the change in inflation and spot FX for each country. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment and are not intended to predict or depict future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

5) Interest-Rate Volatility

We believe exposure to higher-rate volatility may also be a potential opportunity during periods of accelerating inflation. Simply put, as yields rise during inflationary episodes, shown in Figure 10, interest-rate volatility increases, reducing the Sharpe Ratio (a measure of return efficiency relative to volatility) of investments in duration. We think several tactical moves, such as short-duration credit or interest-rate swaps, may provide opportunities to protect portfolios as inflation rises.

Figure 10. Higher Yields Are Generally Associated with Higher Rate Volatility

10-Year U.S. Treasury yield and the 5-year rolling, annualized standard deviation of 10-Year U.S. Treasury yield changes for the indicated period



Source: Bloomberg, Federal Reserve Bank of New York, and Lord Abbett. Data as of 10/01/2021. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment and are not intended to predict or depict future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

6) Equity Considerations

In equities, two types of equity factors that have historically been favored during inflationary periods are value and momentum. Broadly speaking, value equities are less sensitive to rising interest rates than growth equities. In an inflationary environment where the discount rate is increasing, value equities provide some defense because these firms' cash flows are more near-term and therefore less impacted by discounting. Value equities are also often leveraged firms and inflation tends to lessen the constraint of leverage through higher nominal growth rates in business activity. Momentum factors have also held up well when inflation is accelerating. Momentum tends to reveal those companies that are able to maintain pricing power and navigate through changes in the economic environment.

Putting it all Together

The forces that contributed to a prolonged period of low and stable inflation since the mid-1990's are still present. Productivity gains and efficiencies stemming from technological advancements, for example, remain in place and may work to dampen the inflationary forces outlined in this report. But we do think higher inflation will persist longer than a short-term spike in prices, and investors may want to consider tactical approaches to prepare portfolios for a period of inflation above the Fed's 2% target rate over the medium term.

Unless otherwise noted, all discussions are based on U.S. markets and U.S. monetary and fiscal policies.

Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets.

No investing strategy can overcome all market volatility or guarantee future results.

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Equity Investing Risks

The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

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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.

Personal Consumption Expenditures (PCE) is a measure of price changes in consumer goods and services. Personal consumption expenditures consist of the actual and imputed expenditures of households; the measure includes data pertaining to durables, non-durables and services. It is essentially a measure of goods and services targeted toward individuals and consumed by individuals.

International Monetary Fund is an international organization created for the purpose of promoting global monetary and exchange stability, facilitating the expansion and balanced growth of international trade, and assisting in the establishment of a multilateral system of payments for current transactions.

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