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Prepare, don't predict

LGIM's inflation toolkit

The trouble with inflation

Inflation is a major concern on everyone's mind. The recent geopolitical conflict in Ukraine deepens the inflationary narrative further, given Russia's position not only as a major energy producer but also as a leading producer of metals and agricultural commodities. But while inflation is such a hot topic, there are often more questions than answers dominating discussions.

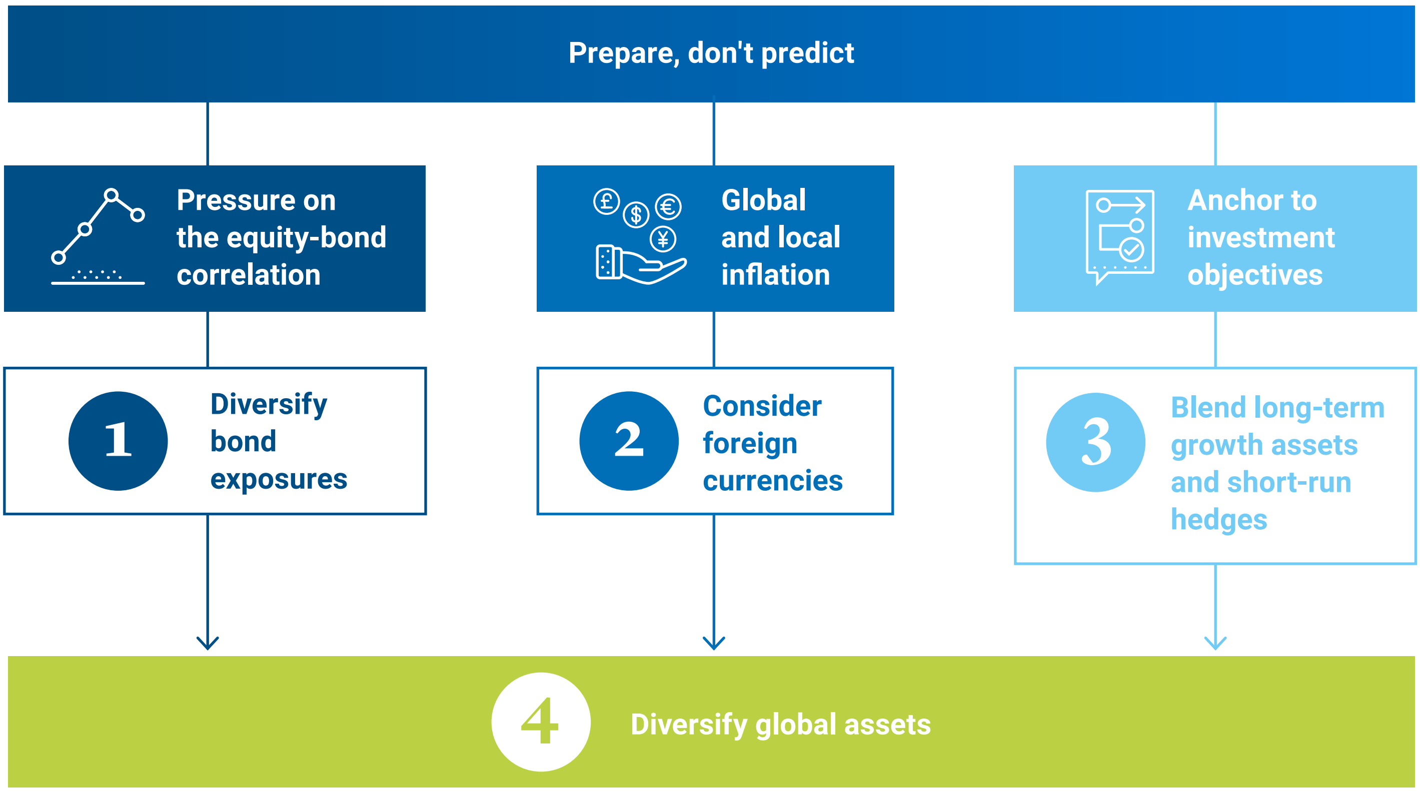
Historically, investors and economists alike have struggled with inflation forecasts. Even with vast resources, central banks have been unable to either predict or guide inflation with much success over the past decades.

We think embracing this uncertainty is the first step to managing it. We believe is it dangerous to get caught up in a particular inflation story, no matter how convincing it sounds. In our view, it is important to ask the right questions, understand the objectives of your investments, and prepare for different inflation outcomes, not to predict them.

Our response to inflation is therefore more structural in nature and focused on creating and managing a truly diversified portfolio, which takes inflation risks into account, and seeks to perform in today's high inflation scenario but also in the uncertain scenarios that may lie ahead.

Below we outline the steps we've taken to tackle inflation in our multi-asset portfolios, including those within our Model Portfolio Service, as well as the L&G Multi-Index Funds and L&G Multi-Asset Target Return Fund.

Four steps we've taken to navigate inflation



Source: LGIM as at 9 March 2022.

It should be noted that diversification is no guarantee against a loss in a declining market.
Assumptions, opinions and estimates are provided for illustrative purposes only.
There is no guarantee that any forecasts made will come to pass.

Step one: diversify bond exposure

The current inflation environment threatens the long-standing negative correlation between equities and bonds that acts as a cornerstone of a traditional balanced portfolio. Between 2010-2020 this correlation stood at -0.5. Since the start of 2021 that has been around 0 and started turning positive, more reminiscent of the high inflation environments seen in the 50s, 70s and 90s[1]. In recent months, when equities have fallen significantly, bonds have not provided protection and have often lost money as well.

That leads us to question the role of sovereign bonds in our portfolios, traditionally been viewed as a 'safe haven' asset class. As a result, in the last few years, we have reduced the allocation to, and duration of traditional sovereign bonds in many of our portfolios. But to be clear, we shouldn't throw the bond baby out with the bathwater. In all of the last 12 recessions, bonds have performed well with yields falling[2]. If we experience a global recessionary shock, we still believe government bonds will help protect portfolios.

We also think it is crucial to diversify sovereign bond exposure across different regions, outside of the traditional areas. In 2021, we saw most central banks tightening policy and yields rising. But one central bank has been more dovish, fending off an economic slowdown against a backdrop of benign inflation: the People's Bank of China. Chinese government bond yields have fallen and offered a port in the inflationary storm. Therefore, we believe investing in a broad range of countries gives exposure to different market dynamics and different return profiles. For example, many of our multi-asset portfolios go beyond traditional markets and also invest in Chinese, Indian, Australian, New Zealand and South Korean government bonds.

1. Source: LGIM, Bloomberg as at 31 January 2022.
2. Source: Robert Shiller, Bloomberg as at 31 January 2022.

Step two: consider foreign currencies

Today's inflation story is truly global in nature. We are experiencing a ferocious inflationary cocktail of supply chain disruptions from the lingering impacts of COVID-19, rebounding global demand fuelled by consumers unwinding excess savings built up in the past two years and now a commodity squeeze as a knock-on effect of Russia's invasion of Ukraine. In addition, the UK has a long history of high inflation compared to the rest of the developed world. The pound sterling is also relatively susceptible to lose value in global growth shocks, compared to more defensive currencies like the euro, Japanese yen or the US dollar*.

When facing a domestic inflation shock, investors suffer a knock to their spending power relative to the rest of the world as the local currency will weaken and foreign currency will appreciate. By holding a strategic allocation to foreign currency, we believe investors can be compensated for the inflation shock they have experienced.

There is an additional dynamic layer to currency management that can also be considered, for example seeking out currencies of commodity exporting countries like Australia, Canada or even Chile and Peru, whose currencies should be relative winners from higher commodity prices*.

All our multi-asset portfolios have long-term overseas currency exposure. The L&G Multi-Index funds seek to actively manage currency positions while MATR is more unconstrained and therefore makes significant use of currencies in tactical trades.

Step three: blend long-term growth assets with short-run hedges

It can be easy to get swept up in the inflationary narrative and focus solely on this one risk, but it is important not to lose sight of other threats to a portfolio, as well as the overall investment horizon. Most investors seek long-term growth objectives from their multi-asset portfolios. To that end, we believe there is a need to balance allocations to assets that will provide short-term inflation hedging characteristics, versus assets that give long-term protection against inflation.

Commodities and inflation-linked bonds may give the best short-term results and show the biggest sensitivity to changing inflation, but they tend to offer poor long-term value and expected returns, in our view. Modest allocations can provide potential diversification and hedging benefits against immediate inflation risk, but are not a panacea and could be detrimental to meeting investors' long-term objectives.

High and rising inflation periods have historically been associated with lower real returns for equities, with the asset class typically performing its best in modest inflation and reflation periods. But company earnings and inflation are closely correlated, which means earnings rise with inflation, even though valuations multiples often decline in those periods, dragging on returns lower. Nonetheless, equities still tend to deliver positive real returns in high inflation periods and give the best chance of beating inflation in the long run. Should an inflationary spiral emerge, navigating the inevitable recession will be more important than the nuances of inflation linkages in the asset class.

We also favour structural allocations to listed alternatives with explicit or implicit linkages to inflation, such as infrastructure, real estate investment trusts (REITs) and forestry stocks with high real asset land values*. We believe there are fundamental reasons to like these assets in inflationary environments. For example, the majority of assets owned by listed infrastructure companies have effective means to pass on higher costs to customers through regulation, concession agreements or contracts. That includes utilities providers with regulated pricing and toll roads with inflation-linked pricing agreements[3]. REITs' dividends have also outpaced inflation, as measured by the Consumer Price Index, in all but two of the last 20 years[3].

To this aim, many of our multi-asset portfolios invest in REITs, forestry stocks, commodities and UK and global inflation-linked bonds.

Step four: diversify global assets

A common thread throughout our steps has been to seek global diversification across a range of asset classes. This exposes investors to different inflation dynamics around the world. Benefiting from the relative winners in high and rising inflation environments is of course desirable, but we believe the inflation process is hard to read and predict, so while it may be the theme of the day, a wider range of risks present themselves when considering overall portfolio objectives. That means we need to be prepared to manage the long-term growth objectives of investors by diversifying with the aim to create a less volatile experience and therefore aiming to protect against the destructive effects of inflation.

3. Source: REIT.com, as at May 2021.
* For illustrative purposes only. Unless otherwise stated Source: LGIM. Views current as at March 2022.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

Key risks

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The above information does not constitute as investment advice and depends on individual circumstances.

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