March 2022 / Investment Insights

The Fed, the Inflation Picture, and the Potential Impact on Insurance Fixed Income Portfolios

A Q&A with Robert McCollum, Head of Portfolio Management—Fixed Income Solutions

Intro summary

For much of 2021, the Federal Reserve (the Fed) had expected that inflation would be "transitory." In previous discussions going back to July 2021, DWS's outlook for inflation was to the contrary—that it would be longer-lasting and not transitory. Since then, our inflation outlook hasn't changed.

Over the last few months, the markets have seen no shortage of headlines and speculation about inflation. Initially, the focus was on how the Fed would respond to the surge in inflation. Suddenly, that focus has shifted to how the Fed will respond to the fallout from the situation in Ukraine—and the economic and inflationary consequences of that conflict.

The Fed now finds itself in an even more precarious position than it was just several weeks ago. In this discussion, we shift our attention to the current challenges facing the Fed to offer perspectives on the fixed income markets and what insurance companies should focus on in positioning their investment portfolios going forward.

In the following Q&A with **Robert McCollum, Head of Portfolio Management--Fixed Income Solutions,** the rapidly changing dynamics of inflation are addressed, along with the increased attention on the Fed's interest rate moves, the market impacts we anticipate, and DWS's thoughts on positioning fixed income portfolios to adapt to this fluid situation.

You were not in the Fed camp that inflation would be transitory. What led you to that conclusion and how does that factor into your outlook going forward?

Putting aside the politicization of the Fed, we didn't believe inflation would be transitory for a number of reasons.

First is the unprecedented monetary and fiscal stimulus we've had. M2 money supply expanded about $6 trillion over the past year. Then, underscoring that money creation, was another $5+ trillion of fiscal stimulus.

On top of that are the ongoing supply chain issues. What's happening at the West Coast ports has not improved, and now will be further exacerbated by the conflict in Eastern Europe.

Housing is another significant issue that's going to drive inflation and the Consumer Price Index (CPI) for an extended period. We've had home price appreciation of roughly 18% in 2021. Underlying that was a shortage we estimated to be about 5.5 million units, with annual new home production running at about 1.4 million. We're seeing inflation also reflected in rental prices, with the most recent statistics out of New York City indicating that year-over-year rents there are up 33%, so this demand/supply imbalance should help keep this data firm despite rising mortgage rates.

Similarly, demographics is something we've been highlighting for a long time. The prime age workforce is shrinking, not only in the U.S., but also in China. A recent study from an economics research firm looking at the labor force participation rate suggested that 80% of the recent decline in the U.S. is structural due to immigration and retirement factors. Therefore, when you combine this with record job openings in excess of 11.2 million, these drivers will buttress continued wage pressures via a tight labor market.

With respect to the most recent developments in Ukraine, certainly the supply chain issues are going to be aggravated further. For example, Ukraine produces 70% of neon globally, which is a big component in the manufacture of semiconductors, impacting not just automobiles but durable goods like washing machines and refrigerators. Russia is a major producer of nickel, which is an important component for electric vehicle (and other) batteries and is also used in many other alloys including stainless steel.

Ukraine and Russia are large producers of wheat, with Ukraine also growing a significant corn crop. Additionally, Russia is also one of the biggest fertilizer producers, so this conflict is going to have a dramatic impact on food prices.

Finally, there is energy, with headline numbers that continue to go higher with the imposed sanctions. Exacerbating that is the decline in U.S. production to around 11.5 million barrels/day and a change over the past year to an unfriendly regulatory climate for exploration, production, and the import of Canadian oil.

The bottom line is that inflation is a pernicious tax, with benefits for debtors. With $30 trillion in debt, the U.S. is going to be a beneficiary. Frankly, we don't believe the Fed has the political will to tighten enough to bring inflation down to anything near the 2% target rate, so it looks like inflation is going to be with us for some time.

The strategy for insurance company investment portfolios is to be patient and let the bond market reprice itself. Continue to keep a close eye on what's happening in the risk asset markets, because if you get a replay of 2018 where equities and the credit markets seized up, then that's going to limit how much the Fed tightens policy, which is not going to help in terms of arresting inflation.

At the beginning of the pandemic, we saw a move away from risk assets. Now, with what's going on in Ukraine, we again have more market volatility, equities selling off, and widening credit spreads, which will likely continue for the near term.

With this inflation outlook, to what extent does the speed and magnitude of the Fed's rate increases form your investment decision-making and positioning today? And how does that factor into what you're seeing in the market?

The market has already priced in approximately eight additional Fed rate hikes for this year. The rally in U.S. Treasuries that occurred in early to mid March, to the 1.70% area in 10-year notes was driven largely by short covering. Now that a lot of the shorts have been covered, we're selling off. The risk if the Fed moves too slowly is probably a steepening of the yield curve.

If growth holds on, and the Fed is too cautious—and they've certainly been late to the party in terms of tightening—the yield curve steepening scenario could play out. The more likely scenario is that the Fed goes along with the anticipated number of hikes over the course of the year, growth does slow, and the yield curve flattens further. If we do get inversion in the yield curve, it's historically presaged a recession in a little over a year's time. Therfore, I'm cautious both in terms of rates and spread sectors.

Going into the March Federal Open Market Committee (FOMC) meeting, were there certain statements you were looking for from Fed Chairman Jerome Powell?

The quantitative easing (QE) the Fed commenced during the pandemic resulted in about $6 trillion in total securities purchased. Now that QE has ended the Fed has a significant balance sheet that also could be utilized to tighten policy. In terms of anticipated comments, I was looking for how their outlook changed on inflation and how this would move the median forecast for the Fed Funds rate. The Fed clearly has been more focused on tightening policy via raising the Funds rate rather than on balance sheet reduction; they haven't wanted to pull those two levers simultaneously at the onset. However, with the balance sheet at around $8.5 trillion, we're certainly in uncharted waters.

I am anxious to see more clarity on the balance sheet in May. We believe the Fed is going to want the balance sheet runoff to happen quietly, with caps and operating in the background. However, a more aggressive course of action, though unexpected, could serve to tighten policy more quickly.

As a bond investor, what are the macro or market factors influencing your outlook and driving your portfolio decisions?

From the macro standpoint, there are a number of factors that influence our outlook and decisions.

Inflation is clearly one of them. Many investors had expected inflation to peak in March, but with ongoing issues in the energy and commodity sectors a decline in that trajectory may occur more slowly.

Growth of the economy is another. There's been a lot of talk about stagflation unfolding, and policy tightening should cause a moderation in growth. Consumer sentiment has been moving down and recently was the weakest since 2011, so that is something to monitor.

Energy policy is a third factor. While we saw a recent pivot with the political pressure to sanction Russian energy imports, there's obviously more the U.S. can do in terms of domestic production versus relying on "less-than-friendly" countries for energy supply. However, with recent comments about oil company "profiteering," we are not holding out a lot of hope for a policy shift. That will further impact both growth and inflation unless there is any policy reversal.

In terms of the markets, there are a number of other things we are watching. The Equity Volatility Index (VIX) peaked at just above 36 in early March, but risks remain that this Index could move higher after the recent retrace. The forward S&P 500 price-earnings (P/E) ratio is around 18, with 3x price-to-sales numbers. If interest rates move higher, those numbers could fall. Currently, and granted the markets are moving quickly, U.S. equity markets look to be a bit oversold, and we could be range-bound for a bit. That will impact corporate spreads**,** which were at 124 basis points (bps) in option-adjusted spreads over U.S. Treasuries for the corporate index on March 1. That number gapped up to 142 bps about a week later. Corporate issuers have pulled back a little, although we continue to see some deal flow. Some have posited that corporate spreads broaching +150 bps may give the Fed pause, and perhaps that level will cap spreads near-term. In any event, as real rates become less negative during the tightening cycle, spread assets could remain under pressure.

For people who had been paying attention to it, the Commodity Research Bureau (CRB) Index really told the inflation story—and it's one of the indicators we've been monitoring closely. If you go back to two years ago, the CRB Index was 80% lower than where it was in early March.

We believe those are the most important trends to keep an eye on both from the market and macro standpoints.

In navigating through an environment like this one, do you make investment decisions with more of a "wait-and-see" approach, where you tactically adjust to what the market is doing? Or do you think about it as a longer-term change in strategy, where you are making a macro-positioning decision?

When we're speaking to insurance companies about investing their fixed income portfolios, we sometimes use the analogy that it's similar to being at the helm of an aircraft carrier. You are not aggressively making short-term, total return-type trades, like using derivatives, holding very large cash positions, or taking lots of gains and losses. Rather you are trying to build positions and a portfolio that can capitalize on a longer-term plan and can then change course when necessary—whether that's in terms of duration, sector, or credit quality—as you see opportunities to add risk or be more defensive.

As we've watched yields move to levels we haven't seen in a few years, it's tempting to be aggressive adding risk here. Given that the fundamental backdrop remains quite good, it's probably okay to "nibble around the edges" and add some portfolio book yield via spread sectors, but ultimately today's environment is one that requires patience.

It's clear from what we just discussed that there are a lot of flashing red and yellow signals. We've anticipated a number of these and felt comfortable with decisions such as being short duration and barbelled, with positions in floating rate bonds and an underweight to mortgage-backed securities. We continue to believe there will be opportunities to add value, but we must remain patient to make sure we're maximizing that opportunity.

Lastly, what should investors consider either from a "market observation" or asset class standpoint?

Given the various factors we've cited that may limit the Fed from tightening aggressively to arrest inflation, investors must be prepared for inflation to be with us for a while.

From an asset class standpoint, while our focus is predominantly on fixed income, we also keep our eyes on other markets to maintain a broader perspective and provide context. It's not necessarily too late to diversify one's portfolio into asset classes that can offer protection against sustained levels of inflation, whether that's opportunities from real estate via appreciation or higher income from rent increases, or from investments in other real assets such as infrastructure, commodities, etc. From a capital efficiency standpoint, mezzanine private debt with an investment grade wrapper can offer yields that keep pace with current inflation.

These are some areas to consider where one can add diversification and income while helping insulate a portfolio against long-term inflation headwinds.

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