July 2021 Investment Insights

Inflation insulation? The outlook, threats, and moves insurers should consider to protect their portfolios

Emerging from the pandemic, economic expansion is off to a strong start, but inflation is rapidly rearing its ugly head. While there is much debate around the magnitude and duration of this resurgence and the Federal Reserve's actions, our experts outline measures insurers should consider to blunt inflation's damaging effects.

Executive summary

_ It looks to be a strong start to the economic expansion in both the U.S. and globally, with real growth of between 5 and 7 percent. While it is still hard to ascertain the length of the expansion, DWS is not forecasting a recession threat until after 2024.

_ We expect Core CPI for this year will be over 3%. However, there is upside risk to this forecast. DWS economists think inflation will ease a bit in 2022, but will probably stay at the higher end of the Fed's target rate of 2–2.5%. It should be noted that a number of other firms are forecasting 2.5–3% for Core CPI next year.

_ The inflation concerns we have and risks we see in this cycle and the coming years are the result of a "monetary phenomenon"—with deficits above GDP growth, overnight interest rates that are pushing zero, and cash in circulation growing at a double-digit pace. These are the things that make us think there may be longer-term inflation risk.

_ The Fed knows it, too, but did a great job of acknowledging the inflation risks and has been very effective at calming markets.

_ In the equity markets, there are two sectors we believe are being overlooked as effective inflation protection plays: Banking and Technology.

_ In fixed income, while it's been difficult to extract value in the investment grade space, we do see select opportunities in Mortgage-backed securities, CLOs, and high yield and bank loans for insurers with capacity to go below investment grade.

_ As for a sector that has historically been considered a hedge to inflation, real estate remains viable given current market fundamentals, with a preference towards U.S. apartments and industrial properties.

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The backdrop: economic growth and inflation outlooks

Our global economists expect U.S. GDP growth to be 6.7% this year and just over 5.2% in 2022. Globally we anticipate 5% this year and 4.6% in 2022. By those measures it looks to be a strong start to economic expansion. We are not yet sure how long this expansion will last, but we do not believe a recession is likely in 2022 or 2023.

Some market observers are discussing the possibility of the Federal Reserve (the Fed) having to fight inflation—and having to do so aggressively—perhaps causing a hard landing; DWS does not subscribe to that scenario at this point in time. We do think it is possible the Fed will have to take aggressive actions, but we want to wait and see if they do—and if they have the willingness and political support to do so. We think if the Fed does have to take more aggressive actions, that those actions really present more of a threat to risk markets than to the overall economy. Of course, the Fed is always going to be mindful of what their actions may do to the overall economy and employment.

That said, DWS is not in agreement with the view that the economy will experience a hard landing in the next few years. At the same time we are also not ready to forecast another 10-year-or-longer expansion such as what was just experienced, in part because of how severe the economic collapse was in the U.S. and many other parts of the world from the pandemic and from the huge fiscal and monetary response that is helping this economy get out of the gate so strongly.

Inflation threats

The U.S. and world currently are experiencing strong economic growth. And while there is a relationship between strong growth and inflation, they do not necessarily go hand-in-hand.

DWS believes CPI measures for this year will be over 3 percent, and maybe below 3 percent on a core personal consumption expenditures (PCE) basis for this year. However, there is upside risk to these forecasts.

We believe inflation will ease somewhat in 2022, but stay at the higher end of the Fed's target rate of 2–2.5%. We are also expecting Core PCE to be 2.5% in 2022, with risks balanced to the upside for that forecast.

Our analysis suggests the inflation we are currently experiencing is partly related to the stimulus and partly to the supply side slowly getting back on its feet. For example, inflation in certain commodities–such as timber, agriculture, copper and, more recently, oil—has been caused by surging demand. Those commodities are doing better than they have done in a long time, but we expect this type of inflation to be transitory. We believe that this inflation will pass, in large part because the pace of growth will slow down.

The supply side will pick-up and high prices will revert to the norm as they almost always do in an efficient economy.

Though DWS expects inflation from commodity and durable goods prices to fade, there is still significant risk of higher inflation, at least above the Fed's 2–2.5% target, for the next several years. However, we think that source of inflation traces back to fiscal and monetary policy, and this is where we are focused.

“A monetary phenomenon”

We think it is fair to describe the inflation concerns we have and risks we see for the remainder of this cycle and the coming years as being heightened by recent monetary policy. If inflation exceeds the Fed's target persistently, certainly an increase of the money supply would be a crucial contributor. As economist Milton Friedman said, "Inflation is always, and everywhere, a monetary phenomenon." And when record fiscal policy is exacerbating the issue, the risks rise further.

This monetary phenomenon, particularly as it is tied to fiscal policy—with deficits above GDP growth, overnight interest rates that are nominal (or negative in real terms) and below a neutral Fed funds rate, and cash in circulation growing at a double-digit pace—are all factors that lead us to believe there may be longer-term inflation risk.

We believe that Fed Chairman Jerome Powell has done an excellent job acknowledging the inflation risks and has been effective at calming markets thus far. Chair Powell demonstrated this when the Fed raised the rate paid on bank excess reserves by 5 basis points, and via draining reserves simultaneously through reverse repos, which also provided some much needed rate relief in the money markets.

When it comes to tapering, DWS anticipates that to begin in early 2022 with no Fed Funds rate hikes until 2023. However, when those hikes come, they could be faster and climb to higher levels in 2023–2024 than many market observers might be anticipating; that is the risk. Of course, that is a risk to markets but would be serve to calm inflation. It may create volatility for the bond market in the short term, but the Fed fighting inflation is ultimately a good thing for the bond market over the long term. However, it remains to be seen if this unfolds—and if the Fed has the wherewithal, tools and political support to affect such actions in 2023–2024.

Inflation protection

As mentioned above, investors are running toward several commodity-related investments right now. They're excited about industrials, infrastructure an goods-based sectors as well, whether it be auto manufacturers or materials producers. However, we would argue that if inflation remains persistent, its impact is going to be broader. Inflation will not only affect all goods and services, but labor as well. It will likely not be seen in spikes of 10, 15 or 20% in specific areas, but rather in low- and mid-single digits—3, 4 or 5%—across multiple sectors.

Equity: two primary focus sectors

With this as a backdrop, we are analyzing equity markets and thinking about what sectors might be the most effective inflation protection plays against a more broad-based inflation phenomenon.

This is not the inflation we experienced in the economy of the 1970s. Today is a different economy—very digital—and in our view there are two areas of the equity market that are being overlooked as potentially effective inflation protection plays.

Banks

If inflation is going to tick up, more cash in circulation is going to be needed. That can happen through deficits, but it can also happen if inflation expectations become further entrenched and loan growth accelerates. If the market experiences stronger loan growth, a steeper yield curve, and if rates across the curve move up as the Fed eventually hikes rates in the coming years, this all has the potential to be very good for banks. Whether it is nominal rates going up because of inflation or real rates going up because the economy is stronger, loan growth should pick up. In short, if you like credit, look at the biggest underwriter of credit out there…banks.

As such, we believe banks are going to be in a stronger position to deliver earnings growth and dividend growth versus other sectors, such as energy, which needs to focus on transitioning to new business models to survive, not raising dividends or conducting buybacks. To that end, we would be cautious towards the energy sector and many industrial, capital goods, and materials names as plays for inflation protection. There are several reasons in support of that thesis: China slowing and shifting its economy to consumer services; the commodity complex (oil) unlikely to ramp up capex for many years; important end-markets for industrials—commodity construction equipment, transportation equipment, and non-residential construction equipment—likely to be slower in growth; a U.S. dollar that we think will be stable but with some downside risk because of domestic monetary and fiscal policy that could make foreign durable goods manufacturers more competitive; environmental and regulatory pressures that could raise the cost for heavy U.S. manufacturing; finally, a more modest infrastructure package when ultimately passed.

Technology

Companies in the technology sector have a distinct advantage during in an inflationary period—they do not need to replace their asset base. The asset base at technology and digital businesses is intangible.

Digital businesses can raise prices in line with inflation and not have replacement costs go up, which real economy businesses cannot. As a result, all that pricing power goes to the bottom line and their return on capital continues to grow. The other aspect to consider about digital businesses is they are accustomed to **not** actually raising prices at all, but rather lowering prices because of their huge economies of scale.

So, if these digital companies are not cutting prices as they continue to grow, it is effectively increasing their pricing power because they are keeping more of that growth, and the scale of that growth, for themselves. That is the important thing to remember about pricing power: it needs to be separated from broad-based inflation.

Currently, manufacturers may have some pricing power from consumers and it may be that labor gets more pricing power in the economy after not having had it for a while. But for inflation to be persistent, it needs to be broad-based, it needs to turn into a cycle that affects everyone equally, and that is where we think banks and the digital companies have an advantage.

For investors who are looking mostly to commodities for inflation plays, whether it be oil, gold or others, we believe equities, in a broad-based way, will provide more effective inflation protection.

Fixed income: quality and duration considerations

The growth in money supply mentioned above is paramount in any current bond market discussion. Fixed income markets have witnessed M1 rise from $4 trillion in February 2020 to about $19 trillion in the U.S. currently—a parabolic rise—making it one of the key considerations when evaluating fixed income options and positioning. While the velocity of money remains low currently, this money in the system is compressing yields despite inflation's move higher. Should velocity increase (given consumer psychology changing towards "buy/borrow now prior to prices rising further") and inflation remains at these more elevated levels, the bond market could face material headwinds.

The first quarter of this year experienced a significant rise in interest rates, resulting in some of the worst total return numbers for bonds in roughly 40 years as measured by the Bloomberg Barclays U.S. Treasury Index; not surprising given the low coupons and longer durations prevalent today. While the Fed continues to execute $120 billion a month in QE, real rates may remain highly negative in the near-term, but if inflation proves to be other than "temporary", tapering may not induce a "flight to quality" bond rally as seen in past tapering episodes.

Structured finance

With respect to fixed income investing, the view from DWS's fixed income management team is that this recent period constitutes the most difficult time experienced during our lifetimes. Trying "to extract a modicum of value" in the investment grade space is challenging. The amount of cash available for investment is extremely high given the ongoing Fed QE and M1 growth coupled with an anticipated slowing of corporate primary issuance and solid credit fundamentals

However, looking forward, an opportunity may present itself in the mortgage-backed sector. While we began to see excess returns suffer beginning in late May and into June, astute investors could see entry points as the current sell-off persists and likely accelerates with QE tapering. With that said, we are mindful of seeking better than average convexity since we may be facing potential rate increases.

Collateralized loan obligations (CLOs) have had a good run thanks to the upward move in rates this year and solid fundamentals driving spread compression. In the portfolio management team's view, the CLO returns going forward would be primarily driven by carry (income), but to the extent these are permissible investments, there is a yield advantage. For example (at the start of July), with an A-rated CLO deal from a top-tier issuer, an investor can pick-up nearly 20 basis points versus buying a 10-year A-rated corporate bond. Therefore, not taking the duration risk from a 10-year maturity and booking a yield slightly north of 2% in this environment seems to offer value.

Corporate bonds

DWS believes the high yield market has had a tremendous run, but is not down to the spread lows now seen in investment grade corporates, which are back below 2007 levels. The investment grade corporate market is "essentially priced for perfection." If we were to experience some equity market volatility with tapering, we believe this could lead to spread widening in investment grade bonds in 2022. Our investment grade credit team is fundamentally constructive on the sector and believes that scenario could present a buying opportunity.

Turning to high yield, this is where an investor might want to consider investing currently, but staying relatively shorter in duration given the chances of rate and spread volatility. Similarly, floating rate bank loans are another sector worth considering for investors who have the ability to go into the below investment grade space.

Real estate markets

Real estate is viewed as an effective inflation hedge, and for good reason. If we look at the inflation surge of the late 1970s and very early 1980s statistically (which happens to be the earliest period that real estate asset class data is available), we see strong correlations and strong sensitivity (or betas) to inflation.

Further, when you look at the performance of commercial real estate in that same period, it was quite strong on an unlevered basis, basically generating returns of about 20% (based on the NFCI-ODCE Index), which is remarkable given the double-dip recession during that period in 1980 and 1982. Typically, that scenario would pose a significant headwind for real estate because it curtails the physical demand. However, that period was also the last time we saw any meaningful inflation, and real estate performed exceptionally well.

Real estate has both demand and supply side effects. When there is inflation in the economy—in rising prices, wages, revenue, and profits—that increases the nominal buying power of renters, whether they are households renting apartments or businesses leasing space.

At the same time, inflation restricts new supply. It contributes to upward pressure on construction costs and makes it more economically difficult to pursue new building projects. Over the long term, it is actually this second factor that is most important. Over time, the price of real estate converges with the cost of replacing the asset, which is directly tied to inflation.

Looking at it both theoretically and historically, real estate has been effective in hedging inflation. Another remarkable data point worth noting from 1980 is that Treasuries were yielding approximately 15% and real estate was at a yield—or a cap rate—of about 7%. So, there was a minus 800 basis point spread between Treasuries and real estate yields, and the reason for that is investors were buying real estate to hedge the inflation risk. They believed that although they might accrue a lower yield, that principal would be protected from inflation over time in a way that Treasuries would not.

All of this depends on what kind of real estate one is considering. The efficacy of real estate in hedging inflation risk does hinge to a large degree on the lease term of the asset. For example, a building that is occupied on a 15-year lease to one single tenant offers very little capacity to adjust the cash flow, so that kind of asset is less effective in hedging inflation risk.

Apartments, however, where the leases typically roll every year, are very effective in hedging this risk–and data supports this as well. Apartments historically have been the best inflation hedge. Conversely, retail as a category has been the worst and the reason—if you look at shopping malls or other retail centers—is a number of the anchor tenants, like department stores or grocery stores, have very long leases of 10, 15, or 20 years.

Office and industrial are somewhere in the middle, and it really depends on the lease profile of those assets. If you have a majority of tenants on short-term leases, then that kind of asset might work very well as a hedge. If, on the other hand, you have single tenants with very long leases, then it might not be as effective.

Inflation is not the only thing we are considering when we are devising our investment strategy. Within the office sector, the big debate now is about remote working, working from home, and whether that is going to be damaging to the office sector. DWS believes that this will be detrimental in some way but that the risk ca be overstated. Looking to other sectors, e-commerce has been a boon for industrial assets, but a major headwind for malls.

Within residential real estate, we have seen a surge in single-family home prices this year. Some of that might be due to low interest rates but it really comes down to an imbalance of supply and demand. On the demand side, aging millennials are looking for more space to raise young families, and with the advent of the pandemic, to work and perhaps work-out at home. On the supply side, construction has been very slow to pick up since the global financial crisis over a decade ago. That mismatch is driving appreciation of both single-family and multifamily homes in the suburbs.

Considering inflation and other factors, we are constructive on apartments because of the strong fundamentals and inflation fighting ability, as well as industrial because of the boost from e-commerce.

On a geographic basis and looking at real estate globally, our preferred region currently is the U.S., as a result of a combination of pricing levels, yields generated and the strength of the demand-side support for the asset class – essentially economic growth being stronger in the U.S. than in other parts of the world.

On inflation specifically, the limited amount of data that exists suggests that Europe might be even more effective as a hedge, primarily because in Europe and especially in the U.K. the leases more often have explicit inflation adjustments. At one point this was also true in the U.S. but as inflation started to dissipate, a number of those clauses were removed. Now U.S. leases tend to be either at a fixed rate or increase at fixed amounts at intervals over the length of the lease. As an inflation hedge, Europe might be, at the margin, a little bit better. But given all the considerations from pricing levels to growth, we continue to favor the U.S. right now.

Finally, a few notes on valuations. DWS's view is that valuations in real estate are quite attractive as we start to enter the summer months. The average yield on real estate is around 4.2 percent (as of June 30, 2021, based on the ODCE Index). We believe the most effective way to evaluate yield is as a real yield, because real estate is a real asset. Its cash flows do grow over time, driven by the fundamentals, but also by inflation.

Comparing that real yield of 4.2 percent against 10-year TIPs of about minus 80 basis points (at June 2021 month-end) gives you a 500 basis point spread to TIPs, which historically is very attractive. The long-term average is about 400 basis points, and at times it's gone as low as zero basis points (0%), which is exactly what we saw in the inflationary 1970s and early 1980s as everybody was flocking to real estate in order to guard against inflation.

In our view, this means that while real estate is not cheap on an absolute basis, it is on a relative basis. It also means that if investors see upward pressure on interest rates and even real interest rates, upward pressure on TIPs, the current spreads can absorb much of that pressure.

Conclusion

While DWS views today's inflation situation as predominantly transitory, there is greater inflation uncertainty than we have faced in decades. It is likely to persist for some time, despite the Fed's best intentions and efforts to keep it under control. However, our economy has evolved tremendously—and the inflation we are experiencing is different from what we have faced in the past, including the Great Financial Crisis. Tactical inclusion of different assets with timely portfolio repositioning into certain sectors of public markets, as well as private real estate, can help insurers insulate against a surge in inflation.

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