ifm investors

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INSIGHT

# Inflation: considerations for real assets

**Summary:**
Inflation concerns have been front and centre in conversation for global investors and consumers alike in recent months. Since the beginning of the pandemic, supply-side constraints in the face of strong demand have created disequilibrium, driving inflation higher, and now the conflict in Eastern Europe will likely exacerbate that risk by boosting commodity prices further. Such a spike in inflation in advanced economies has not been experienced for decades and there is uncertainty as to how and when it will be resolved. For asset owners such as IFM Investors this adds a further challenge of navigating the maze of regional and global inflationary pressures confronting them daily. This paper explores the inflationary pressures we face today, the outlook for those pressures and what it means for asset owners, such as IFM.

**by Darren Pasco, Ryan Weldon, Alex Joiner** April 2022

DEBT INVESTMENTS

FIGURE 01 ADVANCED ECONOMY INFLATION

**Source:** IFM Investors. BLS, Federal Reserve Bank of Dallas

## Bottom line:

1. **Inflation pressures continue to build beyond 2022** and will be with us for some time yet. Even as near-term pressures may ease (once the pandemic ends, supply chain issues are resolved, and more restrictive monetary policy takes effect), structural forces such as larger budget deficits and de-globalization risks are likely to continue to exert upward pressure on inflation over the medium term.
2. **Tail risks arise:** a delicate balancing act confronts central banks as they look to engineer a soft landing by raising rates to combat higher inflation. History suggests this is a difficult task, particularly for

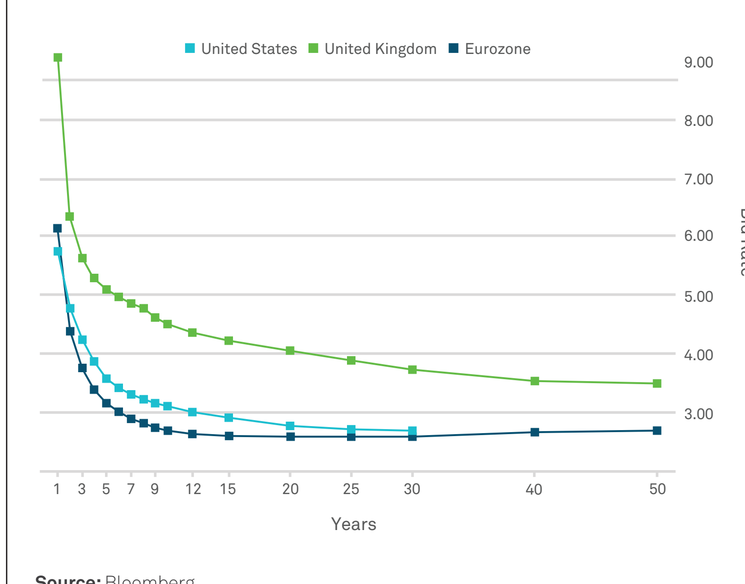
those economies or sectors that are levered. A hard landing would see rates remain low whilst higher inflation would put upward pressure on rates.

3. **Asset owners need to manage debt facilities carefully:** traditional floating rate exposures have assisted in minimizing the cost of debt facilities over the last few decades. In order to manage interest rate exposures in this environment, we believe it is prudent to seek advice on the relative levels of interest rates (fixed and floating), the structure of debt facilities, and hedging alternatives.

## Inflation Pressures

Inflation rates have accelerated and inflation forecasts from central banks continue to be revised higher (chart below). Globally central banks underestimated the persistence of inflation, which stems largely from supply factors beyond their control.

FIGURE 02 INFLATION YIELD CURVES (BREAKEVEN RATES) GLOBALLY




**Source:** Bloomberg

**This is the most challenging period for monetary policy since inflation targeting began in 1992.**

Ben Broadbent, Bank of England Deputy Governor

While above-trend economic growth, underpinned by healthy household balance sheets, will continue as economies recover from the pandemic, central banks must remain cautious in how they remove pandemic-related accommodation. Raising interest rates is aimed at reducing strong demand to take pressure off supply side factors that are largely exogenous. But central bankers must be careful not to go too far and undermine full employment objectives. This is a reversal of the post-pandemic paradigm in which central banks were attempting to push inflation upwards to targets, as they are now seeking to push inflation lower. As Deputy Governor Ben Broadbent from the Bank of England noted recently: "*This is the most challenging period for monetary policy since inflation targeting began in 1992*."

## Inflationary pressure ahead

**Near term pressures**:

Central banks forecast they will be successful in taming inflation over coming years however there is clearly a risk that inflation remains elevated for the remainder of 2022 driven by:

- Ongoing supply chain issues and higher commodity prices. These issues have been compounded by the risks relating to China re-opening and the Russia-Ukraine conflict. Some points of note:
  - Ukraine is a sizable agricultural producer. Russia is a key producer of a variety of fertilisers– expect higher food prices ahead.
  - Ukraine exports specialized products such as neon, which is used in the semiconductor industry, compounding supply chain issues.
  - Energy price increases are well-documented but have region-specific impacts. For example, British households are currently expected to see energy bills rise an extraordinary 54% in April as the regulator passed on higher energy costs.
- Households are likely to spend accumulated pandemic savings on goods that remain relatively scarce due to supply constraints, this demand being a key driver of higher inflation.

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**Structural inflationary pressures**:
Beyond 2022 it is worth considering whether there has been a regime shift in the structural forces impacting inflation - either accelerated or introduced by the after-effects of the pandemic and ongoing geopolitical tensions. Some of these factors include:

**Fiscal stimulus – does debt matter anymore?** Governments have injected large amounts of money into economies to ensure they remained afloat during the pandemic. This fiscal largesse may continue to support advanced economies as central banks remove stimulus.

**De-globalisation**: Seeking greater supply chain security is a catalyst for governments to pursue some degree of economic sovereignty and 'onshore' key sectors of production.

**Term structure impacts**: As inflationary pressures persist, volatility in various assets classes is likely to rise, making the case for a higher term-premium in bonds.

- **New projects:** there could be a need to factor in higher discount rates and it will be necessary to think through our view on this aspect of valuation when considering investment over the long term. While we expect that risk free rates will cycle around a lower average than historically observed for an extended period, it is clear that in the current environment interest rates will be approaching a cyclical peak.
- **Existing assets:** The three-decade-long tailwind to valuations appears to have come to an end. However, as noted above, we are of the view that rates will cycle around a lower average than historically observed. We'd also stress that privately held infrastructure asset valuations tend not to price in literal moves of risk free rates and are assumed by independent valuers to be very slow-moving. This reduces volatility in asset valuations and ensures extreme moves do not have to be retraced.

## How to manage inflationary pressures ahead

### Real assets and companies

- **Existing companies.**
  - Revenues: Real assets and companies that can pass on inflationary costs to the end consumers will benefit in this environment.
  - Expenses: Treasurers will need to navigate rising interest expenses. Seeking advice on the relative levels of interest rates (fixed and floating) and ways to manage various debt exposures via the structure of debt facilities, and hedging alternatives will likely become increasingly important.

## Implications for investors

**Asset owners need to manage debt facilities carefully.** Traditional floating rate exposures have worked for debt facilities over the last few decades. We believe it is prudent to seek advice on both the structure of debt facilities, any hedging required and the level of interest rates (fixed and floating) in order to address interest rate exposures in this environment.

**Real assets and companies that can pass on inflationary costs to the end consumers will benefit in this environment.**

Darren PascoBroadbent, Bank of England Deputy Governor

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