Episode 19

Inflation: what's an investor to do?

Inflation remains top of mind for many. The team gathers to discuss what investors can do to combat rising prices.

Kara O'Halloran (00:05):

Welcome back to FireSide, a podcast from FS Investments. My name's Kara O'Halloran. I'm a director on our investment research team here. On today's episode, we are going to talk once again about perhaps the most discussed topic in markets this year inflation, but more specifically with this focus on inflation has come a renewed interest in the investments designed to protect portfolios from rising prices, namely real assets. So we're going to touch on what real assets are, why investors have historically turned to them, and perhaps most importantly, what a well-designed real assets portfolio looks like in 2021. So with me to dig into all of this, our Lara Rhame, our chief U.S. economist, who has been on the podcast quite a few times by now, and Beth Anne Byrne, who is a liquid alternatives investment specialist here at FS and is making her podcast debut.

Kara O'Halloran (00:52):

Welcome.

Beth Anne Byrne (00:53):

Thanks guys.

Kara O'Halloran (00:53):

I hear you came with some jokes. I was warned that there were some jokes, so we'll see. Lara, I want to start with you as always, you know, that's my MO, we, along with the rest of the world have talked about inflation a lot this year, quite a few times. So we are recording this in early November. We're still seeing elevated CPI levels or hearing about supply chain bottlenecks, ports that are full of cargo ships. Everyone told me I'm already too late to have done my Christmas shopping or...

Lara Rhame (01:24):

Well, I need to buy a car so we're all facing inflation related challenges.

Kara O'Halloran (01:28):

Yeah, exactly. Exactly. So it's clear that inflation did not prove transitory, at least if we use the definition of a few months, that a lot of people had kind of called for back in the spring. What is your current outlook on inflation? What are you closely watching?

Lara Rhame (01:44):

Sure. You know, to your point, and I think we're, you know what, I'm going to reiterate this several times, because it's important to realize that CPI right now it's 5.4% year on year. And when you exclude food and energy, right, that core CPI number is 4%. It's the highest since 1991. So if right now the big inflation picture feels different, it's because it really truly is different. And when you look at inflation right now, you pointed to some really obvious supply bottlenecks that have caused, you know, I do actually have to buy a car. That's not a joke, unfortunately, but there's just some acute price pressure on durable goods where we know that there are supply shortages. And we know that there is enhanced demand because of the pandemic. But we're just kind of seeing it bubbling up from a lot of different areas.

Lara Rhame (02:37):

Food prices, for example, are up 4% year on year. That is really quite high, that's food at the grocery store and food at restaurants. Obviously, energy prices are high as well. And things like rents are rising. That's still really, hasn't added to price pressure yet, but it looks like it might over the next year. So it feels like a game of whack-a-mole. If you kind of explain one piece of inflation away, it's coming up from somewhere else. And I felt very negative six months ago when I was saying that I thought inflation could prove to be more lasting than just a sort of a transitory wave. And at the time I said, I expected inflation to be persistently higher through 2022. That's still my forecast. Although I think now it's looking more and more like something a lot of others are expecting as well.

Kara O'Halloran (03:30):

Yeah, and I think it also sounds like if you think about, you said rent inflation, I think wage inflation is starting to pick up. It's kind of these longer term, you know, stickier, stickier things. And it's a bigger ticket than say like, "oh, my cup of coffee is 10 cents more now".

Lara Rhame (03:44):

Right, exactly. And I think that's what, really the inflationary cycle that impacts company costs. It impacts our inflation expectations. You know, the longer that inflation sort of enters the psyche, the more lasting it could be. I think to the concerns that we're going to be facing another hyper inflationary, or rather just a really significant inflation jump like we had in the 1970s there. I don't think that is the primary concern. It's not my primary concern. I expect that the Fed really does understand what they're keeping an eye on. Rate hikes are an option. These are in many respects, the battle that they know how to fight, and markets are also onboard with that. 10-year inflation expectations are still there a little higher, but they're still pretty well anchored around 2% versus two-year inflation expectations where, markets are thinking that we could be facing inflation as high as 3% over the next year. It's a big difference from where we've been.

Kara O'Halloran (04:55):

Yeah, absolutely. And that brings me to my next question. Because I think that two years is still a decent amount of time, especially when we're thinking about a portfolio. Investors are going to have to contend with what we think to be higher inflation. So what does this actually mean for our investments?

Lara Rhame (05:11):

Let's just break down kind of the two legs that we traditionally think about investing. You've got the fixed income side. I think my expectation is that long-term interest rates are going to remain fairly low. Even though we may see inflation kind of resting around that 3% rate. That keeps interest rates very negative. And even if interest rates rise somewhat, even if you get the 10-year going from 150 to 175 to two. Given how long duration, so many portfolios are right now and have had to dig into that long duration position. That is going to really wreak havoc on the price side. You're getting no income, yet real yields are still negative, and you're getting beaten up on price. Then the equity side. I've been working with Brian Cho, who's one of the brilliant quantitative strategists at Chiron and he has done really important work on the impact of inflation on equity markets.

Lara Rhame (06:23):

And when you look at where we are, if you look at the regime of high inflation, rising inflationary pressures, the 12 months forward equity performance really suffers. You go from, in a decreasing inflationary environment, you're looking at 12-month forward returns historically of over 10%, but in a rising inflationary environment, you're looking at a forward 12-month performance, that's down over a percent and a half. When you look at Fed research, the negative coefficient on inflation for Cape ratios, it's one of the most important and statistically significant relationships. The point is that investors routinely fail to account for inflation in their present value calculations, and that's really the core of the issue.

Beth Anne Byrne (07:12):

And not to sound like negative Nancy, so inflation is negative for both your bond and your equity allocation.

Lara Rhame (07:19):

Right, and I think that's something that Kara, you've written about too.

Kara O'Halloran (07:23):

Yeah, I think it's... it's not even just, it's bad for both sides. It's actually bad for the relationship between them. So that negative stock bond correlation that we've always counted on in our traditional 60/40 portfolio, at higher levels of inflation that correlation breaks down. So your stocks and your bonds are moving together.

Beth Anne Byrne (07:41):

The likes of what we've obviously started to see in the market, in the last six, seven months you've seen rates certainly failed to deliver versus equity down days. And unfortunately, it looks like this narrative continues and we're in for a bit more turbulence.

Lara Rhame (07:55):

It's a really important point Beth Anne. And I think when you look ahead, this is what needs to be managed. This is the real, to me, this is the top challenge facing investors over the next year.

Kara O'Halloran (08:07):

Yeah, agreed. I think that's a perfect place to bring Beth Anne more into the conversation. One of the first places that people typically go when they're concerned about inflation is real assets. For our purposes, let's define traditional real assets as real estate, commodities, energy, and infrastructure, just to set the stage there. Beth Anne, first, maybe you could just walk us through kind of why these are good inflation hedges, but also what other roles these might serve in portfolios?

Beth Anne Byrne (08:33):

Yeah. I mean, as you said, in the simplest sense, real assets are tangible investments. Something you can touch, something you can hold. Whereas if you think about stocks and bonds, they're much more contractual in nature. They don't have these physical properties. Given that logic, obviously the four buckets that you outline make a ton of sense. You have real estate, land, buildings, right? You have commodities, raw materials like copper. Everybody's talking about energy. Obviously we've seen what's been going on in the oil market. Finally, infrastructure, something very, very relevant today. Your airports, your roads, the likes of which are being talked about down in Washington. With that backdrop, I think what's more pertinent to our conversation is the investment characteristics that they deliver. First income, these assets have historically generated steady cash flows. Given this, demand tends to be inelastic.

Beth Anne Byrne (09:26):

Revenues are generally contractually obligated, long-term in nature. And obviously in this market, as we're all talking about, income is a pretty attractive property, given where yields are and where they are potentially headed further down the road. The second, which is core to the conversation we were having around the 60/40 and the failures we've seen transpire and potentially can transpire in the future, real assets have low correlations to both equities and bonds. Particularly during periods of inflation and obviously more relevant than ever given these challenges Lara illustrated earlier. And of course, the obvious answer here, they offer inflation protection, the topic du jour. Demand tends to be inelastic and civically oriented, rising prices are often passed on without penalty, right? So cash flows are predictable and these assets offer attractive investments during periods of rising inflation.

Kara O'Halloran (10:24):

Something that we talk a lot about at FS is just this kind of need to almost redefine, or maybe expand is a better word, the definition of real assets to kind of bring us into the 21st century. We have a very modern office building here. We're very into the modern thing, so why do you think we need to change the definition and how would you define real assets now?

Beth Anne Byrne (10:47):

So I'm going to answer that question with a question. Has the world...

Kara O'Halloran (10:52):

You're turning the tables on me, I'm the one who asks the questions here...

Beth Anne Byrne (10:55):

Has the world changed materially since the 1970s?

Kara O'Halloran (10:56):

Just a little bit.

Beth Anne Byrne (10:57):

And are there some people in this room who were not even born during the 1970s? So clearly the answer is yes, right? The world has modernized and at an accelerated rate of change, particularly over the last 20 years, thus...

Kara O'Halloran (11:17):

...and over the last year and a half with COVID....

Beth Anne Byrne (11:18):

Exactly, exactly. A lot of the secular trends we saw in place have obviously been exasperated or accelerated as a result of COVID. That kind of plays into exactly what we're looking to discuss here today, right? Though the real assets of old are still relevant, I think they're really only one piece of the puzzle. We need to redefine what I'll call this next generation of real assets, right? These assets tend to be a bit more growth oriented, but they are still inflation aware. Circling back to those four buckets you illustrated, Kara, earlier, maybe an example of the next gen of real assets would help?

Kara O'Halloran (12:02):

Perfect. Yeah.

Beth Anne Byrne (12:03):

So for real estate, think your data centers, right? Not the traditional farmland of the 1970s and prior. Commodities, you're looking more at lithium, right? Things that are going to fuel the new investments of the 21st century. You think energy, solar power, right? And you can barely get through a conversation these days without whether it's ESG tilts or explicitly clean energy topics, right? Both from a day to day and down in Washington and from a fiscal policy perspective.

And finally, infrastructure. That is not just airports and roads, that's cloud computing. It's the things that…

Lara Rhame (12:47)

Broadband…

Beth Anne Byrne (12:47)

Broadband, exactly. All the things that we've seen, again circling back to the COVID narrative, come back to front and center, as we've gotten to a remote working environment and things of that nature. I don't know if that helps illustrate the point, but I really think it's difficult to look at the real assets of old and think they're going to really deliver what you need in this new modernized world.

Kara O'Halloran (13:12):

I think the way I always think about real assets is, they were traditionally used to just build and power our nations and our economy. So we need to think of the world, as you said, we just pointed out how different the world is and going forward, COVID just accelerated these trends. This remote work is here to stay hybrid, whatever it looks like, you know, all of these trends, the clean energy, all of that was started. It's been accelerated, all of that. So these are just the things that are going to build and power our world and our economy going forward.

Lara Rhame (13:45):

I was going to layer onto that. I feel like what we've seen has only really intensified the need for this kind of investment. I mean, how behind are we on a lot of these initiatives. We knew we were behind on broadband, accessibility. We see that in the productivity numbers, but now all of a sudden, nothing throws that needed to have relief, like making everybody work from home.

Beth Anne Byrne (14:08):

Yeah its front and center.

Lara Rhame (14:09):

One small example of, you know, this really large universe of potential investments.

Beth Anne Byrne (14:14):

And I think what's really critical about that is it, it really does manifest itself across each of these four buckets, right? It fits into the investor need from an inflation perspective, but also it is going to offer you something that is beyond just an inflation solution. This modern approach should give you some durability throughout a full business cycle because cloud computing is not going away, whether inflation is 10% or 2%. Right? And so I think what's important to think about with this redefining real assets is you really have the opportunity to have something that's going to address inflation, but it's not limited to inflation. And that's exciting.

Kara O'Halloran (14:59):

So I also think about all of the tailwinds that are in place to kind of drive this new definition of real assets. Like I think about ESG and more and more investors are… yes, of course we're always looking for return, right? But investors are also making decisions based on more than just numbers. You know, they're looking at the ESG policies of these companies. I think about there's government tailwinds in place as well. Everyone is committed to decarbonization and at different varying stages of course, but there are social and governmental tailwinds that are driving these changes, and I think will for years to come.

Lara Rhame (15:34):

I think it's also political because the trade war has not gone away. I think tensions with China continue to build, and we've seen with the supply chain disruptions, companies, large companies, really rethinking the way that they re-onshore or onshore some of their investment, which I know, I'm guessing would align with some of these strategies you're talking about.

Beth Anne Byrne (15:58):

Yeah. I mean that's what's beautiful about this modernization, right? You're able to kind of tap into the old. The things that are a stable source of income and return, particularly during times inflation, but then also work through a very dynamic trend that we're seeing with companies in terms of supply chain going remote, ESG becoming an UN financial objective, almost in a sense, right? So an investment that can kind of have the stalwarts of real asset investing, but then also look to incorporate this ever changing dynamic in terms of modernization. I think it's exciting. Again, not to beat a dead horse, but it's exciting beyond just inflation, right?

Kara O'Halloran (16:46):

Oh, absolutely. It is exciting. I mean, I think about just the magnitude of the opportunity in front of us. Let's look at electric vehicles, just as a simple example. You can get, you can buy the electric vehicle maker itself, but then it's also solar panels, it's batteries, it's charging infrastructure. Like the minerals, the little metals in the minerals that going into these are different. There's just, every industry has these knock-on effects that, you know, it's just a massive, massive opportunity in front of us.

Beth Anne Byrne (17:17):

Yeah. And I think what's extremely exciting about this opportunity is, I don't think there's a lot of people out there thinking of real assets in this lens. I think that a lot of the playbook is to go back to the traditional real assets, right? It worked in the seventies. That's when we had inflation leave the conversation there. Whereas I think it's almost, you know, it's ignorant in a sense, or I think it's misinformed to think that the investment characteristics that we employ today are the same as of the 1970s. I mean, think of what growth was in the 1970s versus what growth investing is today. They're not the same. I really feel like the ball's being dropped if you limit your investment universe to the real investments of old.

Lara Rhame (18:14):

But Beth Anne is part of that because inflation just has not been a concern for 20 years? And I think when I hear you talk about, this really changed and complete innovation of the real asset space. It strikes me that this has been kind of a neglected sector simply because the sort of the knee-jerk connection is when inflation's higher, we need to think about this. I know that you've been talking to me about the importance of real asset investing a year ago when inflation wasn't as high as it is now. So, and I think the reality is we haven't been shining as much light on this area because of the inflation dynamics, but in reality, this innovation goes so far beyond just what inflation is doing.

Beth Anne Byrne (19:09):

A hundred percent. And that's a hundred percent. I think of, if I were to really highlight my punchline, it's that this is not just an inflation solution, right? What modernizing your approach to real asset investing does is allow you to have something that's going to have differentiated returns, regardless if you get 2%, 5%, 10%. And some of that will be moving, toggling the levers between more of the traditional and more of the new, next generation investing, real asset investing. But if you have something that's dynamic that can move between these two paradigms, you really don't even, I mean, I don't want to make you irrelevant because you're the economist talking about inflation, but you really don't need to have the economists come in and tell you what their inflation forecast is. Sorry.

Lara Rhame (20:05):

Well, it sounds like if there's an upside to inflation, it's that it causes people to start a conversation about real life.

Beth Anne Byrne (20:13):

Exactly and you don't have to get into the nitty gritty.

Kara O'Halloran (20:17):

All right. Well, I think that was a great conversation. Thank you both so much for joining. I'm super excited. You got me excited even more so about real assets Beth Anne, so I think you did your job.

Beth Anne Byrne (20:28):

I mean, as I said, I really think the punchline here is this new paradigm gives you the ability to design something that is inflation aware or provides an inflation heads, gives you income, diversification, is a hedge to equities and bonds, but can do so throughout a full business cycle. Right? And that, if there's one thing I want you to take away today, it's really, there is the opportunity to have a durable inflation solution through a full business cycle. And I'll say it one more time in case.

Kara O'Halloran (21:12):

All right. Well, thank you both so much for joining.

Beth Anne Byrne (21:15):

Thank you so much.

Kara O'Halloran (21:23):

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