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# Inflation: preparing income portfolios for a shifting environment

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*As the world emerges from the coronavirus pandemic, a combination of easy monetary policy, massive fiscal stimulus, a rebounding labor market and rising consumer spending has led to increased inflation pressures. How can investors manage the potential risks while also positioning portfolios to take advantage of the shifting environment?*

## HIGHLIGHTS

- As the world emerges from the coronavirus pandemic, a combination of easy monetary policy, massive fiscal stimulus, a rebounding labor market and rising consumer spending has led to increased inflation.
- Inflation might take time to moderate back to pre-COVID levels, but now is not the time to chase the recent performance of conventional inflation hedges such as commodities or inflation-linked government bonds.
- An effective way to improve after-inflation portfolio returns is to include private assets that offer attractive yields over public market equivalents and can weather various stages in the economic cycle.

## ARE INFLATION FEARS WARRANTED?

U.S. consumer price inflation has accelerated to more than 6% year-over-year, solidifying 2021 as a sustained period of high inflation that has not been seen since the early 1980s (see figure 1).

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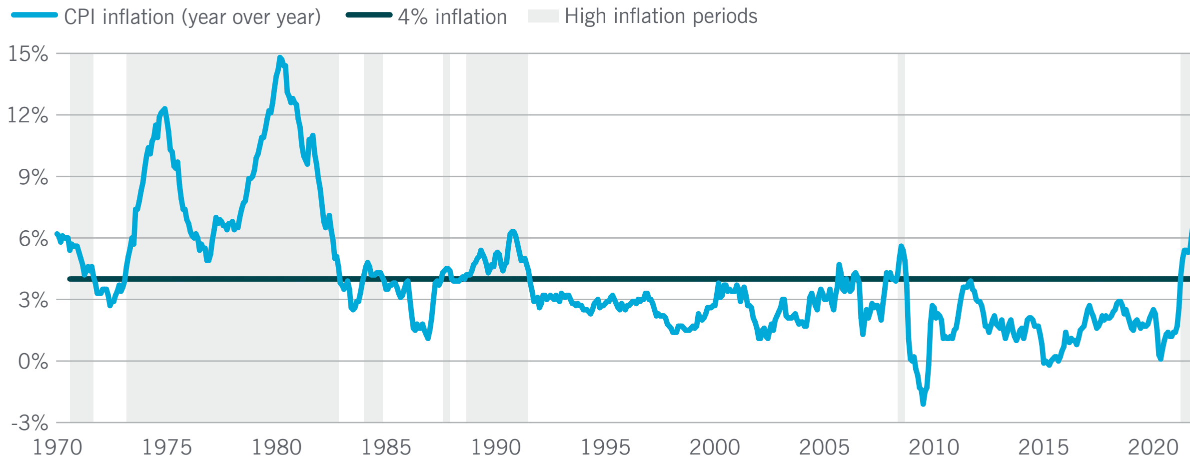
## Figure 1: Inflation is elevated, but for how long?

*U.S. Consumer Price Index Urban Consumers, year-over-year*



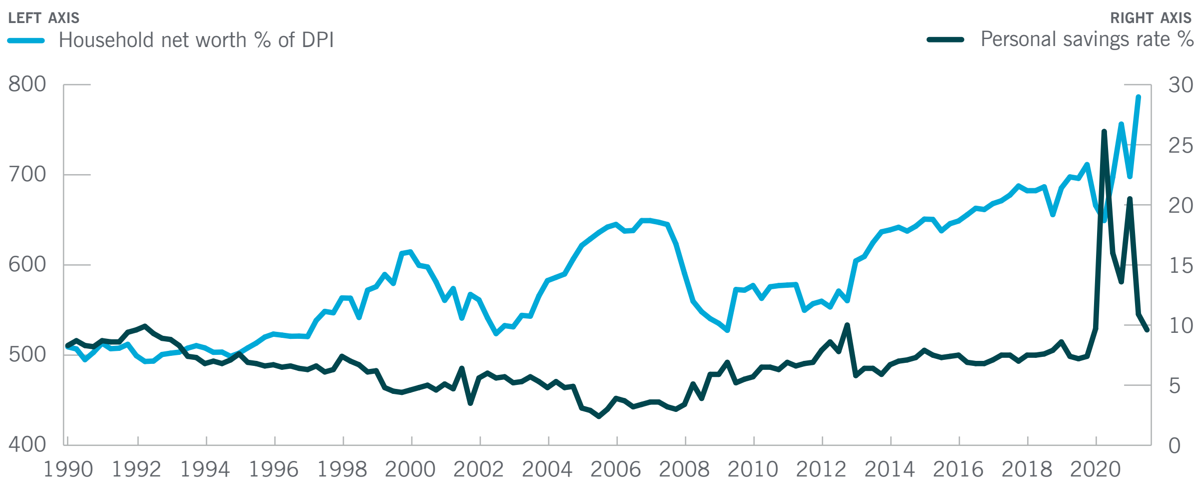

Data source: Bloomberg, L.P. U.S. CPI Urban Consumers year-over-year, not seasonally adjusted, 01 Jan 1970 – 30 Nov 2021. High inflation periods are periods where year-over-year inflation remains above 4% for six months or longer.

## WHAT CAUSED THIS INFLATION SPIKE?

**Historic stimulus programs were implemented** by governments around the world throughout 2020 and 2021 to combat the expected economic fallout of COVID-19 and work-from-home policies.

**Major central banks quickly cut rates** to zero in 2020 and engaged in direct purchases of fixed income securities, known as quantitative easing (QE). QE reduced the supply of high quality fixed income securities on the open market, pushing fixed income investors out on the risk curve. In turn, corporations had access to easier financing to continue their operations despite the economic shutdown. In fact, 2020 saw $1.9 trillion in U.S. investment grade corporate bond issuance, a 64% increase versus the previous 10-year average. In 2021, $1.5 trillion has come to market through the beginning of December.

## Figure 2: U.S. consumers are still supported by growing wealth, rising incomes and excess savings




Data source: Federal Reserve, Bureau of Economic Analysis, Bloomberg, L.P. Household net worth as of 2Q 2021. Personal savings rate as of 3Q 2021.



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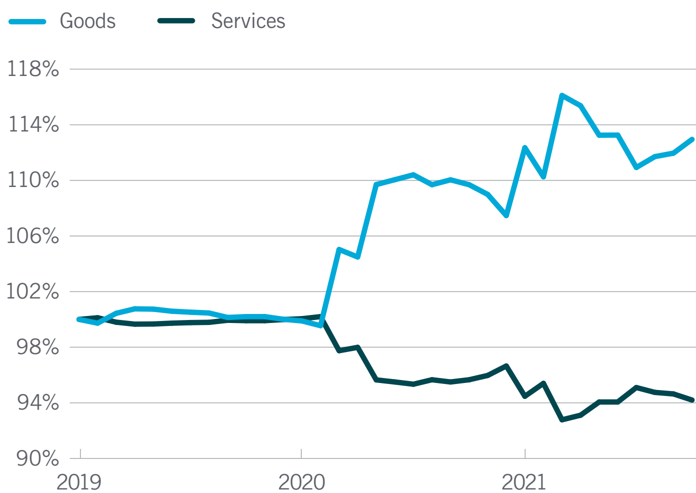
**Economic growth data is the strongest in decades,** fueled by vaccine rollouts and unprecedented federal fiscal stimulus. Household net worth has hit new all-time highs thanks to higher savings and rising asset prices (see figure 2). The trillions of dollars in savings amassed during the pandemic have supported robust spending growth.

**U.S. consumer demand for finished goods remains strong,** continuing to overwhelm global supply chains that are still hampered by COVID-19 (see figure 3 for the trend in the U.S.). We expect this dynamic to moderate in 2022 as supply increases and consumer preferences shift to services.

### Figure 3: Share of U.S. consumption spent on goods is still abnormally high

*U.S. personal spending, % of all spending by category, January 2019 = 100*




Data source: Bureau of Economic Analysis, Bloomberg, L.P., 01 Jan 2019 – 31 Oct 2021.

*Household net worth has hit new all-time highs thanks to higher savings and rising asset prices.*

## NO, WE'RE NOT RETURNING TO THE 1970S

In the early 1970s, the U.S. Federal Reserve misjudged how loose it could run monetary policy at a time of large budget deficits, wage and price controls and the U.S. dollar's departure from the gold standard.

As a result, prices rose in the U.S. at a time of high unemployment. The so-called Misery Index — the sum of the inflation rate and the unemployment rate — peaked at 22% in 1980, with 14.4% inflation and 7.3% unemployment.

Today's scenario is much different. For the first time in decades, investors find themselves in a high-pressure economic system. Inflation is running high in developed economies, while unemployment continues to trend lower and wage growth is accelerating. The current Misery Index for the U.S. is 10.4% (6.2% inflation and 4.2% unemployment), slightly above the long-term average of 9% (see figure 4).

Further, the underlying components of the CPI basket showing the largest increases are different today. The Atlanta Fed publishes indexes that distinguish the rate of change of the sticky components of the CPI basket (e.g., housing, recreation, medical care, furniture, education) versus flexible items that change in price more frequently (e.g., new vehicles, gas and electricity, motor fuel, lodging away from home). Both indexes spiked in the 1970s, but today there is a clear divergence between the two.

These components of flexible CPI can certainly have a meaningful impact on consumer sentiment and discretionary spending. However, as figure 5 displays, since the 1990s flexible CPI items have proven that they can rise — and eventually moderate — without negatively impacting growth or becoming a headwind to equity and credit markets, as we've witnessed in 2021.



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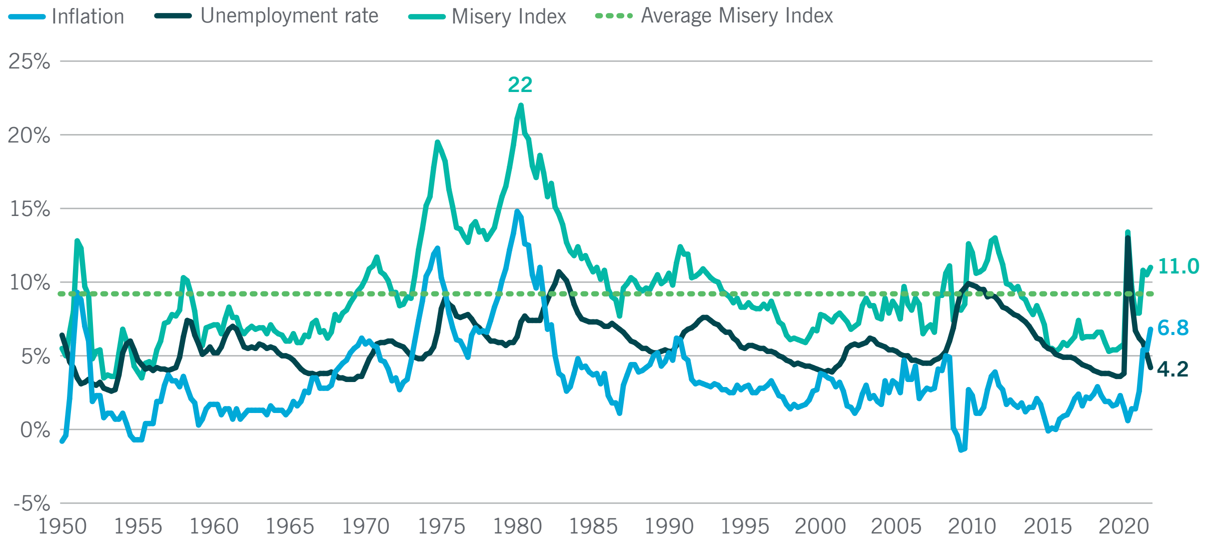
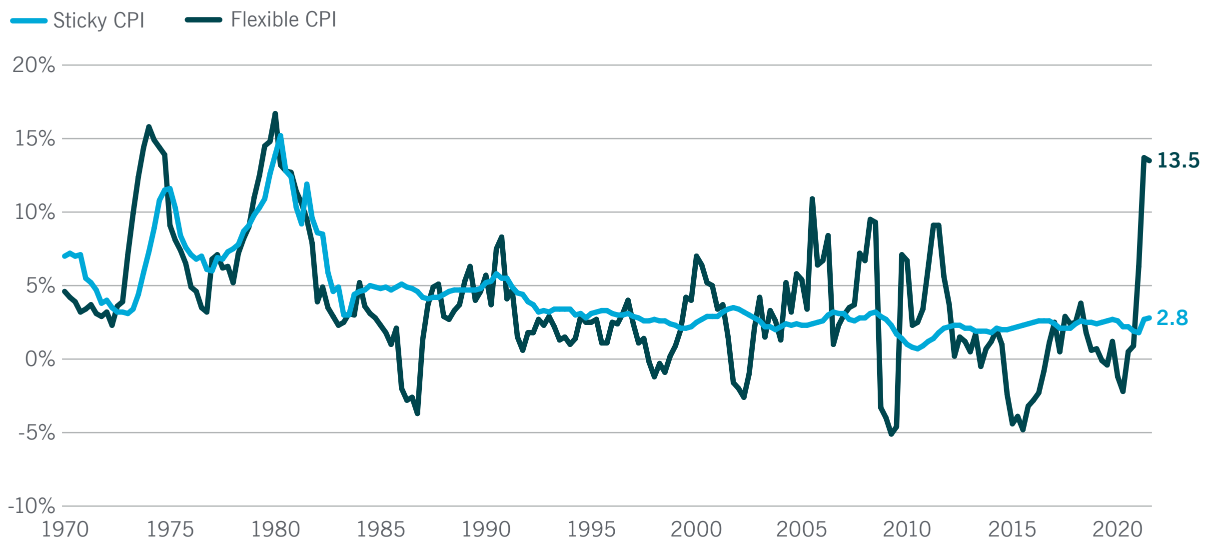
## Figure 4: Unlike in the 1970s, inflation and the unemployment rate are trending in different directions




Data source: Bloomberg, L.P., 01 Jan 1950 – 31 Dec 2021.

## Figure 5: Only prices of flexible items are spiking today

*Atlanta Fed CPI Indexes (12-month)*




Data source: Bloomberg, L.P., 01 Jan 1970 – 30 Sep 2021.

## Figure 6: Asset classes have different sensitivities to inflation

| Asset class | Real returns in various inflationary environments (annualized, 1988-2021) | | | | Current income yield |
|---|---|---|---|---|---|
| | Deflation (CPI less than 0) 8% of quarters | Inflation less than 5-year average 40% of quarters | Inflation greater than 5-year average 40% of quarters | Inflation greater than 4% and accelerating 12% of quarters | |
| U.S. large cap core | -3.8% | 12.6% | 10.2% | -1.5% | 1.3% |
| U.S. large cap growth | 2.5% | 9.7% | 10.2% | 2.4% | 0.7% |
| U.S. large cap value | -10.5% | 12.7% | 9.6% | -6.4% | 1.9% |
| U.S. small cap | -3.3% | 8.0% | 13.0% | -4.3% | 1.3% |
| Non-U.S. developed | -10.3% | 6.0% | 8.4% | -13.3% | 2.9% |
| EM equity | -8.0% | 8.0% | 12.0% | 0.2% | 2.8% |
| U.S. core fixed income | 11.2% | 6.2% | 1.1% | -3.1% | 1.8% |
| U.S. treasuries | 14.6% | 6.1% | -0.1% | -3.8% | 1.2% |
| TIPS | 3.0% | 0.0% | 1.4% | -1.0% | 1.2% |
| U.S. corporate high yield | -1.1% | 10.0% | 5.0% | -3.1% | 4.4% |
| Commodities | -30.7% | -5.6% | 7.1% | 36.9% | 0.0% |
| Gold | 10.8% | -2.1% | 2.1% | 2.0% | 0.0% |
| Public REITs | -7.1% | 13.3% | 10.4% | -5.8% | 2.6% |
| Private Core Real Estate | 7.0% | 3.6% | 5.6% | 3.4% | 4.8% |
| Private Debt | 6.5% | 0.8% | 3.4% | -2.0% | 8.8% |

■ Fixed income ■ Equities ■ Real assets

Data source: Bloomberg, L.P., Nuveen Portfolio Strategy, 1988 – 2021 (TIPS began 01 Mar 1999, private debt 01 Jan 2005). **Past performance is no guarantee of future results. Representative indexes: U.S. large cap:** Russell 1000 Index; **U.S. large cap growth:** Russell 1000 Growth Index; **U.S. large cap value:** Russell 1000 Value Index; **U.S. small cap:** Russell 2000 Index; **developed non-U.S.:** MSCI EAFE Index; **emerging markets equities:** MSCI Emerging Markets Index; **U.S. core bonds:** Bloomberg U.S. Aggregate Bond Index; **U.S. Treasuries:** Bloomberg U.S. Treasury Index; **TIPS:** Bloomberg U.S. Treasury Inflation Notes 1-10Y Index; **U.S. corporate high yield:** Bloomberg U.S. Corporate High Yield Bond Index; **commodities:** Bloomberg Commodity Index; **gold:** Bloomberg Gold Subindex; **U.S. REITs:** MSCI U.S. REIT Index; **private core real estate:** NCREIF Open End Diversified Core (ODCE) Fund Index; **private debt:** Cliffwater Direct Lending Index.

## PREPARE PORTFOLIOS FOR INFLATION ABOVE PRE-PANDEMIC LEVELS, NOT FOR STAGFLATION

The majority of investors — particularly those who are retired and perhaps living on fixed budgets — are equally concerned about their savings eroding in the near-term as they are about outliving their savings in the long-term.[1] Portfolios should be constructed to address both these concerns by diversifying across assets that can perform in a range of economic environments, regardless of the near-term inflation outlook. That means allocating to strategies that can provide real, after-inflation returns during deflationary environments (column 1 in figure 6), periods where inflation is closer to its long-term trend (2 and 3) as well as periods where inflation is elevated and rising (4).

At the extremes (columns 1 and 4), daily liquid risk assets generally do not fare particularly well after inflation. This is to be expected, as investors collect a risk premium (total return or income) for owning assets that will periodically experience drawdowns during challenging economic environments.

But these time periods are outliers, representing only a fifth of all quarters over the past 33 years, and markets do recover. While inflation might remain above trend in 2022 (something more akin to column 3), we believe this has already been priced into the markets. Therefore, we don't believe this is the time to overweight conventional inflation hedges like TIPS or commodities which have already performed well in response to the recent acceleration in consumer prices and today offer negative carry (income yields below the rate



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of inflation). Perhaps most importantly, now is not the time to be overweight cash, which may be a way to mitigate near-term volatility but not without hindering the portfolio's real return potential and long-term purchasing power.

## INVESTMENT IDEAS: PREPARING PORTFOLIOS TO GUARD AGAINST INFLATION RISKS

There are two ways to generate real returns in an inflationary environment: I) own positive carry investments that generate an income rate higher than the rate of inflation, and II) own investments that tend to experience positive price appreciation in response to inflation.

The first category is harder to come by these days in traditional fixed income, but opportunities still exist. We have a favorable outlook for owning lower-quality fixed income sectors that can better withstand a gradual rise in interest rates, such as **floating rate loans** and **preferred securities**, particularly those with fixed-to-float coupon features. The prospect for higher marginal U.S. tax rates should continue to support flows into the tax-exempt space, benefiting **high yield municipals**.

As for the second category, public equities over the past 30 years have lived up to their reputation as a hedge against moderately higher inflation and should continue to do so. Heading into 2022, our equity team is favoring sectors with a cyclical tilt that should benefit as the rest of the developed world catches up to the U.S. economic reopening, and are more favorable on a valuation basis, such as **non-U.S. developed equities** and **U.S. small caps**.

What about strategies that have the potential to fall in both categories? For investors who do not require 100% of their portfolio to be invested in daily liquid strategies, private markets can provide more stable real returns and competitive distribution yields over public market equivalents. **Private real estate** stands out as a category that can fill this role. While inflation has different implications depending on the geographic region and property type, most long-term leases have built-in rent escalators that are tied to inflation, which protects the income generation of in-place leases.

## BOTTOM LINE: EXPECT (BUT DON'T OVERREACT TO) ELEVATED INFLATION AND HIGHER INTEREST RATES

Our bottom-line view about rising rates and high inflation: We think markets have mostly priced in the likelihood of elevated inflation in 2022 and Fed tightening. Public equity and credit markets can still thrive in environments of low-but-climbing rates and elevated inflation. Real assets and real estate remain important inflation hedges in addition to their fundamental attractiveness.


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**For more information, please visit nuveen.com.**

### Endnotes

#### Sources

1 Cerulli Report, U.S. Retirement End-Investor 2019.

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