BONDS ARE FOR BOOMERS

RISK MITIGATION IN AN INFLATIONARY ENVIRONMENT

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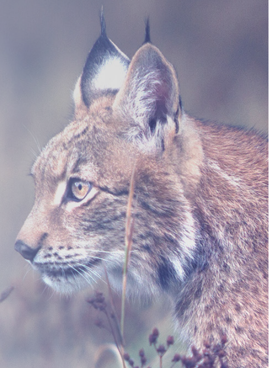


From a peak of 15.8% in 1981, 10-year US Treasury yields have fallen dramatically over the past 40-years. Rates hit a record low close of approximately 50 basis points during the depth of the coronavirus pandemic, with yields in Europe and Asia similarly falling to historic lows. Those owning bonds over this time profited not only from the coupon payments they received but also from capital appreciation as rates have declined. This has been particularly true during market crises, most of which have been deflationary in nature. However, with nominal sovereign yields hovering near the lowest levels ever recorded – remarkably remaining below the "zero bound" in some nations – that benefit may not be as significant as in the past.

While we have experienced relatively short-lived inflationary pressures, the cyclical trend has been decidedly lower. What if this were to change?

The impact of the coronavirus on society has been dramatic, as has the response to combat the pandemic. The long-term implications are difficult to forecast, although the willingness of governments to use any means necessary to support their populations is clear. Deficit spending has risen across the globe and government debt will likely continue to rise over the coming years. As crisis-era accommodative policies remain in place across much of the developed world, the compounding effect of recent stimulus will likely exacerbate an already imbalanced fiscal situation.

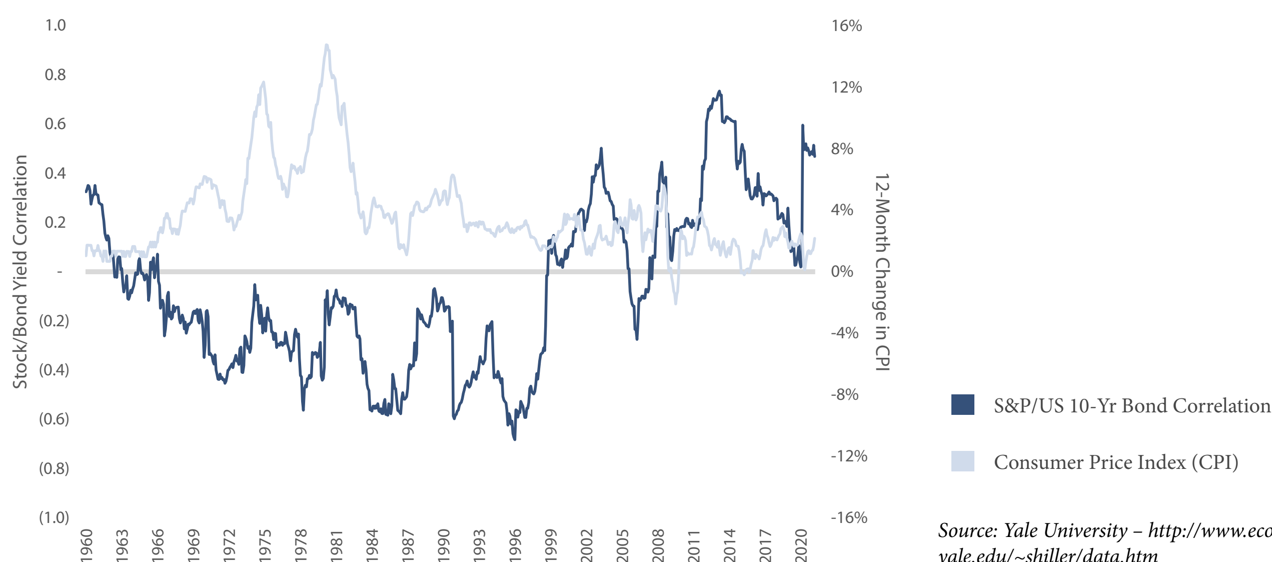
COVID-19 vaccinations are currently being distributed across much of the globe and while logistical issues abound and availability in some areas of the world remains limited, many are beginning to envision life without pandemic restrictions. As we return to a degree of normalcy and employment rates recover to pre-pandemic levels, consumption will likely increase and economic expansion accelerate. Central banks are seemingly less concerned about price stability than creating the growth that has remained below trend for the past decade. For example, the US Federal Reserve notably changed their focus from current to average inflation in a statement released on August 27, 2020, allowing for observations "above 2% for some time" following periods when inflation has fallen short of their target.[1]

[1] 2020 Statement on Longer-Run Goals and Monetary Policy Strategy - www.federalreserve.gov

STOCKS AND BONDS

Many view fixed income as an integral portfolio allocation to mitigate risk in adverse equity market environments. Stocks and bonds have exhibited a generally negative correlation over the past couple of decades and market crises that have spurred deflationary fears have reinforced that relationship. In recent years, however, there have been a handful of times when the two have correlated to the downside largely due to inflationary concerns. As economies across the world continue to emerge from the aftermath of the global financial crisis – and, more recently, the coronavirus pandemic – and the extraordinary monetary and fiscal policy measures meant to spur growth begin to take effect, this could potentially be more prevalent in the future.

36-Month Rolling Correlation of the S&P 500 Index Returns with Changes in US 10-Year Bond Yields Against 12-Month Changes in the US Consumer Price Index (CPI) Since 1960

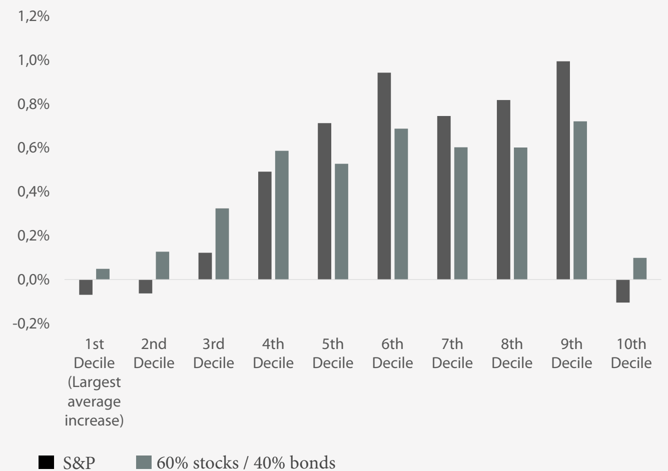


Source: Yale University – http://www.econ.yale.edu/~shiller/data.htm

As noted earlier, most equity market crises over the past 40 years have been caused by deflationary shocks. The 60/40 portfolio of stocks and bonds, or any other similar approach pairing passive long exposure in equities with fixed income, will likely be challenged in an inflationary environment as the asset classes could correlate to the downside. A review of how these traditional portfolios performed during inflationary time periods in the past could serve as guide for how diversified a portfolio of stocks and bonds may be if these pressures were to increase again in the future.

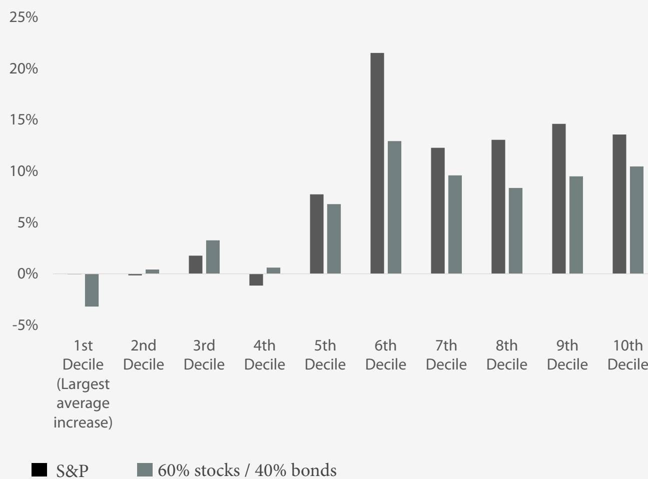
The chart to the right illustrates the performance of the S&P composite index and a balanced portfolio of 60% S&P and 40% long-term US bonds ranked by 12-month changes in the US Consumer Price Index ("CPI") since 1871. While other related factors such as growth and monetary policy have also played a part, sharp increases and decreases in the CPI have historically accompanied below average returns for traditional investments. Over this period, the best results were realized when consumer prices remained relatively muted, within a few percentage points of unchanged.

Performance of US Equities and a Balanced Portfolio of US Stocks and Bonds Ranked by 12-Month Changes in the US Consumer Price Index Since 1871



Source: Yale University – http://www.econ.yale.edu/~shiller/data.htm

Real Returns of US Equities and a Balanced Portfolio of US Stocks and Bonds Ranked by Annual Changes in Inflation Since 1928



Source: NYU Stern School – http://people.stern.nyu.edu/adamodar/New_Home_Page/datafile/histretSP.html

When observing real returns, this impact is even more apparent. The chart to the left illustrates the inflation-adjusted performance of the S&P index and a balanced portfolio of 60% S&P and 40% US bonds averaged across calendar years ranked by annual US inflation. Interestingly, while shortening the lookback to 1928 excludes most of the largest inflationary declines thereby curtailing the distribution, a similar performance pattern emerges.

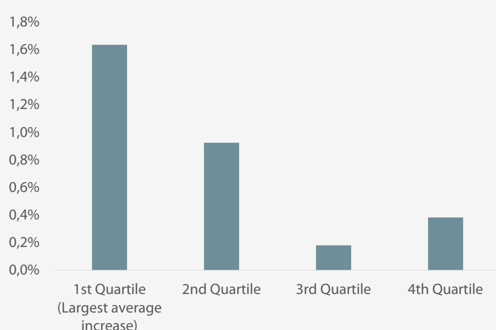
Historically, few investments have been able to provide an effective hedge against inflation. For those looking to mitigate potential downside equity risk should inflation begin to rise above currently subdued levels, finding an answer could become increasingly important.

THE MANAGED FUTURES SOLUTION

Managed futures strategies – or Commodity Trading Advisors ("CTAs") – have little history in inflationary environments as few were active the last time the price of goods and services was persistently increasing. The Barclay CTA Index includes aggregated manager performance from January 1980, but it is hard to place too much emphasis on the extraordinary results that were achieved in those early years as there were likely many other factors influencing returns other than interest rate expectations. However, the results should also not be ignored as the characteristics of these strategies make them potentially attractive solutions for those looking to benefit from a regime shift.

The chart below illustrates the average monthly performance of the Barclay CTA Index from inception ranked into quartiles by changes in the US Consumer Price Index. Notably, the index has generated the best results during those periods when the annual increase in CPI has been the highest.

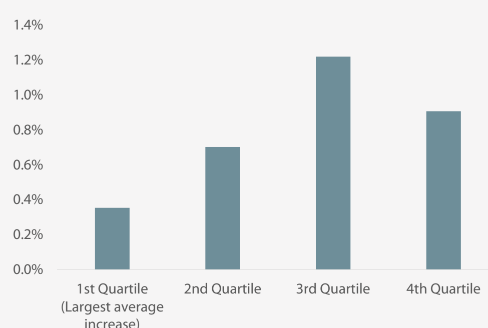
Average Monthly Return of the Barclay CTA Index Against Changes in US Consumer Price Index Since 1980



Source: Yale University – http://www.econ.yale.edu/~shiller/data.htm and Barclay Hedge

Meanwhile, over this same time frame, a long-only equity portfolio has exhibited similar characteristics relative to changes in the price index as in the prior hundred years.

Average Monthly Return of the S&P 500 Index Against Changes in the US Consumer Price Index Since 1980



Source: Yale University – http://www.econ.yale.edu/~shiller/data.htm

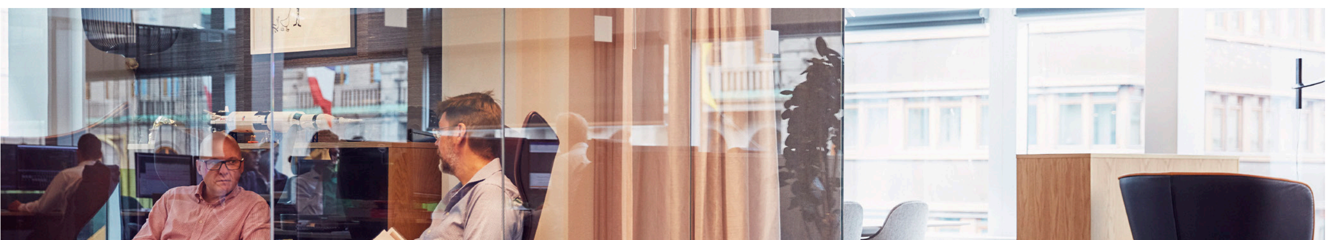
CTAs systematically analyze market activity and attempt to accurately predict how prices will move in the future. Some are agnostic to the fundamental factors that drive prices, while others incorporate this information into their forecasts. However, most have no explicit directional bias and can therefore as easily maintain short positions in stocks and bonds as long exposure. Inflation has been extraordinarily muted in recent history so any normalization would likely result in a relatively significant repricing of assets. CTAs aim to participate in – and capitalize upon – shifts in the macroeconomic landscape that influence prices from financials to commodities. As economic cycles tend to extend over a considerable period, many CTA strategies – such as trend-following – should be able to effectively capture the transition to higher inflation as it plays out.

Commodities may be a primary source of profit opportunity in this scenario as the diverse asset class includes markets that tend to move during shifts in the macroeconomic environment. Some have proposed long-only investments in precious metals and energies believing that prices will climb with inflation. However, gaining direct exposure to these assets can be relatively expensive and, in some cases, inefficient. Holding physical gold comes with a carry cost for storage and insurance premiums, and energies can only be accessed directly by even the largest institutional investors through derivatives like futures or swaps or indirectly through MLPs, ETFs or energy-related equities.

Meanwhile, investable commodity indices have historically disappointed many investors due to idiosyncrasies in the term structure of futures markets over time. When markets are in contango – the spot price is below the futures' price – there is a negative yield generated when rolling long positions from one expiry to the next. Further, the composition of those indices tends to remain static, while different commodity markets will experience different price pressure at different times.

Active management in commodities, however, has the potential to capitalize on the benefits that institutional investors desire while mitigating the risks and inefficiencies of holding passive long direct (or indirect) exposure. Most managed futures advisors include commodities in their asset allocation. Although they generally have not been a significant performance contributor since the end of the global financial crisis, the opportunities that should arise in an inflationary environment could be unlike any experienced during this period. In fact, given some production constraints on various commodities across the globe – from energy to agriculture – increasing demand could outpace any supply response for a prolonged period.

There is one other direct benefit of rising rates on managed futures strategies relating to the interest earned on unencumbered cash. Most managers generally only post between 10% and 25% of the capital they receive from investors in margin to achieve their volatility objectives. The residual is normally maintained in interest bearing accounts or short-term interest rate instruments to be used should there be demand for additional margin on their positions. As yields climb, so does the interest income that is generated.



CONCLUSION

One thing seems certain: the next decade of investing will be markedly different from the past 40 years. Building robust portfolios that can achieve investment objectives should an inflationary environment develop will require a different perspective than has been applied in recent generations, particularly in terms of forecasting returns for traditional and alternative assets. As alluded to previously, the models employed by most CTAs do not have an opinion on inflation or future macroeconomic trends, rather using price and fundamental data to systematically and objectively analyze market behavior. Notably, they have historically performed particularly well when there were significant shifts in market equilibrium.

Active management of risk across markets, including commodities, may be best suited to capitalize on the opportunities that inflation could bring. The ability to tactically allocate capital to stocks and bonds – and opportunistically build bearish bets – could potentially regain importance in achieving long-term investment goals. This is the case not only should inflation resurface. Unlike bonds, which are largely dependent on market regime, managed futures strategies have the potential to mitigate equity risk in many other macroeconomic scenarios, as well; the critical element is change.

CTAs have historically been valuable diversifiers in traditional investment portfolios given their relatively low historical correlation to equities but could again become the primary driver of return.

GET IN TOUCH WITH US

For more information, please contact our investor relations team at

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