Market Bulletin

November 2016

Rising inflation: Options to help protect your portfolio

IN BRIEF

- Inflation rates are set to rise across the developed world. Rising inflation raises the bar for investment managers as clients require better returns just to stand still.
- Inflation-linked government bonds can play a role in retro-fitting portfolios for the inflation challenge ahead. But relying solely on inflation-linked bonds is unnecessary and unwarranted, given that there are other investment options available, such as sections of the equity market whose earnings tend to benefit from an inflationary environment.
- It is essential to consider the cause of inflation before reacting to it. The currency aspect of the UK's inflation experience opens up the option to buy foreign assets as a hedge against a further rise in inflation.
- Despite the coming increase, inflation will remain contained compared to previous inflationary periods, so it is important investors don't overreact and pay too much for inflation protection.

INFLATION IS COMING

With the newspaper headlines full of warnings about the coming rise in inflation, investors are justifiably asking if they should retool their portfolios for the year ahead. As **Exhibit 1** shows, inflation is set to rise across four of the largest economies in the world, with nowhere seeing a faster rise than in the United Kingdom. Although many of the factors driving inflation higher—such as stronger credit growth, lower unemployment and stabilising commodity prices—should be welcomed by investors, it's prudent to examine strategies to curtail any negative impact a higher inflation environment might have on returns.

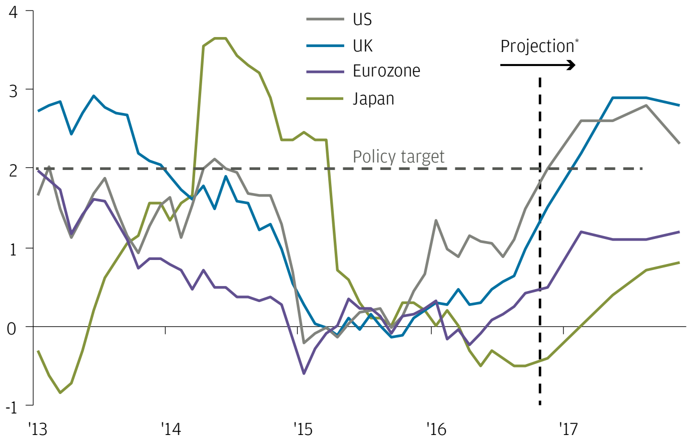
AUTHOR

Dr. David Stubbs
Global Market Strategist

Inflation is expected to rise significantly in 2017

EXHIBIT 1: INFLATION AND INFLATION FORECASTS

% change year on year



Source: Bank of Japan, European Central Bank, J.P. Morgan Economic Research, Office for National Statistics, Thomson Reuters Datastream, US Federal Reserve, J.P. Morgan Asset Management. *Inflation projections are J.P. Morgan Economic Research forecasts. Data as of 20 November 2016.

BONDS: THE VICTIM AND THE CURE?

Why does inflation matter to investors? Most investments are made in order to pay for goods and services in the future. Therefore, if the price of the things that investors wish to buy is rising, they will require a higher return from the assets they have chosen to invest in. This is most clearly the case in assets with predetermined cash flows that do not automatically take into account a rise in prices—in other words most of the bonds available to investors today. This is because the coupons from most bonds, and their principal value, will simply be worth less at the time they are received in the future if inflation has been higher than was predicted at the time the bond was bought.

If inflation is expected to be higher in the future than originally thought, then bond yields may well be required to rise in order to attract buyers and clear the market. Rising yields will mean a fall in bond prices and a corresponding loss in capital value to anyone holding those bonds. This loss of value can often be crystallised rapidly when expectations about the future rate of inflation change, as seen in November 2016 when forecasts of higher inflation contributed to significant losses for many fixed income investors.

Thankfully, within the fixed income universe there exists a ready-made solution: inflation-linked bonds. These securities pay a fixed coupon that is then supplemented by another payment equal to the prevailing inflation of the time. They therefore provide a very direct way to counter the impact of rising inflation...as long as the investor buys at the right price.

INFLATION BREAKEVENS AND VALUING INFLATION-LINKED BONDS

How do investors judge the right price? When thinking solely about the risk of inflation[1] it is possible to make a judgement on valuation by calculating the rate of inflation the bond market is currently expecting over the life a bond. This is simply the difference in yield between a regular bond and an inflation-linked bond of the same maturity. Right now the market is pricing in an inflation expectation of 2.9% at the five-year maturity and 3.1% at the 10-year maturity.

Somewhat confusingly, inflation-linked securities pay out based on the retail price index (RPI) measure of inflation, which has run around 0.6% higher than the consumer price index (CPI) since 1990. After subtracting that differential, it is still clear that the bond market is pricing in an average inflation rate that exceeds the Bank of England's 2% CPI target.

If you are convinced that we are entering a period where inflation will exceed the central bank's target then there is clearly some value left in inflation-linked bonds, but it doesn't appear a clear cut case. Therefore, although inflation-linked bonds can play a role in protecting against inflation, perhaps they should be augmented by other strategies.

OTHER INVESTOR CHOICES TO COMBAT INFLATION

Take a multi-asset approach to income generation

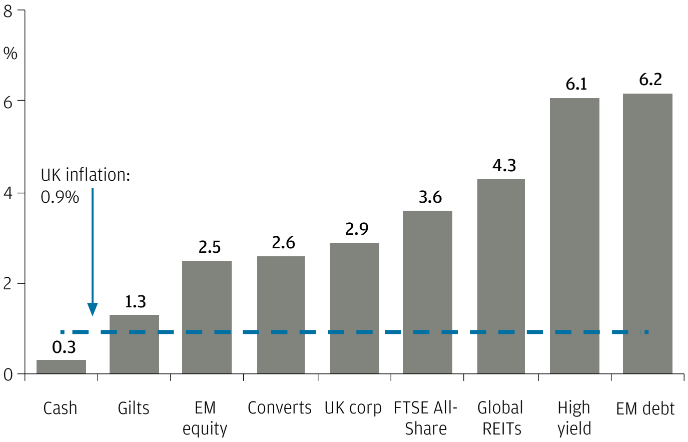
The low yield era of recent years has prompted many concerns among financial advisers about generating income for their clients. Despite the recent back-up in bond yields, they remain well below levels required to meet income needs, especially if inflation is going to raise the hurdle rate for most end clients. Our long standing principle for income seeking investors not only still holds, but is more essential than ever: take a multi-asset approach to income investing.

As **Exhibit 2** shows, there are several global asset classes that currently offer yields well in excess of those found in the UK fixed income market. Investors should consider utilising some, or all, of these global opportunities to enhance yield. Given the challenges in choosing the right balance between asset classes, not just now but on an ongoing basis, as well as the complex process needed to select the best securities within each asset class, a multi-asset income approach may be best achieved in a specialist fund that is designed and managed with income generation as its goal.

[1] Inflation is just one risk to an investor, and even the inflation component of the gilt valuation looks favourable, other risks may result in a loss to an inflation-linked bond holder. These include a rise in real yields, changes in the yield curve, and in some circumstances, default risk.

As inflation rises, utilising higher yielding asset classes will become ever more important

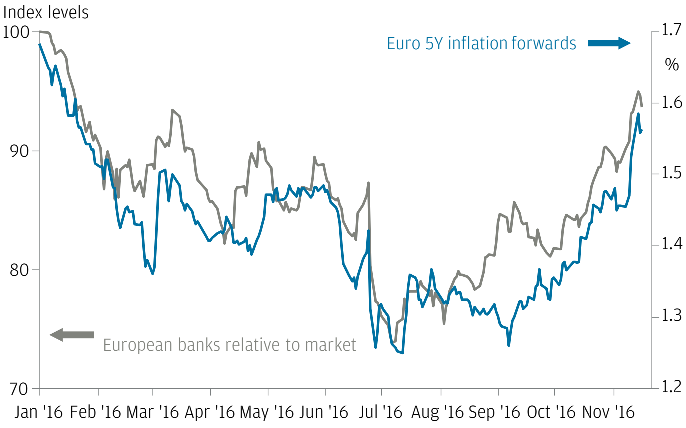
EXHIBIT 2: SOURCES OF INCOME



Source: Barclays, BofA/Merrill Lynch, FactSet, FTSE, Tullett Prebon, J.P. Morgan Asset Management. UK corporate: BofA/Merrill Lynch Sterling Corporate Index; EM (emerging market) debt: J.P. Morgan EMBI Global; High yield: BofA/Merrill Lynch Developed Markets High Yield Constrained; Global REITs: FTSE NAREIT Index; Converts (convertibles): Barclays Global Convertibles; EM equity; MSCI EM. Yields for the bond indices are yield to worst and dividend yields for the equity indices. Data as of 20 November 2016.

As inflation expectations have risen in Europe, banks have outperformed

EXHIBIT 3: BANKS AND INFLATION EXPECTATIONS



Source: Bloomberg, J.P. Morgan Securities, J.P. Morgan Asset Management; data as of 20 November 2016.

Target inflation-linked securities within asset classes

Apart from investing in bonds with a direct inflation link, or investing across entire higher yielding asset classes as a group, investors can look within asset classes—especially equities—to help reduce the inflation risk in their portfolio. Traditional options include buying shares in firms that contribute to, or benefit from, an increase in inflation. The obvious candidates are natural resources stocks, such as energy and materials companies, where any increase in commodity prices that forces up the cost of related items in the shops would be expected to simultaneously boost their earnings.

Other pockets of inflation-linked earnings are also available in the equity market. Examples include renewable energy companies, whose earnings streams from government contracts include provisions to index payments to inflation. While these often small and specialised stocks could play a useful role in an investment portfolio, investors should keep in mind the usual considerations about liquidity and the volatility of smaller company shares. These assets may therefore be best accessed through a closed-ended investment trust structure.

Today's rising inflation forecasts come alongside easing concerns over outright deflation and the damage it, and ever-lower interest rates, would wreak on the financial system. It is not surprising then, as **Exhibit 3** shows, that banks have been outperforming the wider equity market in Europe as expectations of inflation have risen. Investors may consider financial firms as a respectable inflation hedge in this current environment.

CAUSE AND DURATION ARE KEY CONSIDERATIONS WHEN INVESTING TO BEAT INFLATION

The example of how the share prices of banks may be poised to respond well to a pickup in inflation expectations illustrates a wider point: the cause and expected duration of any inflation increase should be key considerations when retrofitting a portfolio.

At present, although the pickup in inflation is certainly widespread (as shown in **Exhibit 1**), the causes vary greatly. The outlier globally is the UK, where the dramatic declines in the currency are the primary cause for the expected rise in inflation next year. It could also be the reason why the inflation spike may be short lived. If sterling now stabilises, then by late next year the increases in import prices should drop out of the calculations. Of course, the opposite may occur. As Article 50 is triggered, the uncertainty and rhetoric around the Brexit negotiations with the European Union could well drive the currency down further. Hedging this outcome is rather simple: buy foreign assets. As **Exhibit 2** shows, there are many foreign asset classes that could help British investors offset the inflationary consequences of the drop in sterling.

Looking more generally at the inflation outlook both at home and abroad, it seems likely that this period of rising inflation will top out at levels that are still considered rather low compared with the experience of previous decades. With debt levels high, a new inflationary credit-fuelled surge in activity is unlikely. Although wage growth is starting to accelerate, low trade union membership, the competitive pressure of globalised supply chains and the availability of labour-replacing machines are likely to cap any wage gains that workers are able to secure from their employers.

In addition, although commodity prices have stabilised after significant falls from their 2011 peaks, a new supercycle seems unlikely to develop as supply capacity created in recent years will come online and help to prevent sustained price rises. In any case, the energy intensity of economic output in advanced countries continues to fall, neutralising the potential for rapid increases in energy prices to drive up inflation. Therefore, although it seems certain that inflation should be a greater concern in the coming years than it has been recently, in historical terms inflation will remain only a minor issue. This means investors should not over pay to protect against inflation risk at the expense of the other considerations that go into portfolio construction. Obvious hedges to inflation, such as inflation-linked bonds, may well become overly expensive in coming months as investor concerns rise.

INVESTMENT IMPLICATIONS

Inflation can be problematic for investors by raising the required returns they need to achieve their goals. Inflation can impact asset classes in a variety of ways and so investors should consider altering portfolios accordingly. Inflation-linked bonds are an obvious way to offset the risk of higher inflation, but diversifying income streams and considering foreign assets are ways to enhance incomes and control for the risk of any further currency-induced inflation that may lie ahead.

Compliance number: 0903c02a81b9bf07

LV–JPM34342 | 11/16