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PEAK CAPITAL MANAGEMENT

Professional Investment Management

BLOG POST

Finding Market Leadership

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As we have mentioned in prior PCM reports, with the current market environment of possible persistently higher inflation and the Federal Reserve almost certainly on the path to higher interest rates, investors have begun to rotate their asset allocations.

Many of the high-flying growth names of the “stay-at-home” economy that thrived in 2020 are now under immense selling pressure. Just a few years ago, inflation was not the headline topic it is today, and chairman Powell was trying to shore up the economy rather than planning interest rate hikes. Treasury yields had hit all-time lows in the wake of COVID as investors flocked to safe-haven assets.

Fast forward to today, and the story is much different. Supply chain issues have pushed inflation to its highest level in four decades. Now the Federal Reserve is backed into a corner. There are indications that economic growth will likely slow in 2022 (although perhaps not contract). For example, the Treasury yield curve is flattening, which indicates that lenders are not well compensated for making longer-term loans. Likewise, the Purchasing Managers’ Index (PMI), which tracks overall business sentiment, has been declining. Furthermore, the International Monetary Fund (IMF) has reduced its global growth forecast.

The Federal Reserve, however, cannot ignore inflation, and is not likely to pivot with respect to monetary policy like it did in 2018. The central bank is tasked with maintaining price stability, which means slaying the inflation dragon. Higher rates will reduce the present value of financial assets. A rising rate environment is particularly challenging for companies with little to no pricing power or long-dated cash flows.

So, we are faced with the possibility of rising rates coupled with slower economic growth. Older investors will likely remember the stagflation economy from the late seventies and early eighties. The so-called “Fed put” might not be the backstop it has been since the global financial crisis. Investors should be mindful of how their portfolios are positioned, because it does seem different this time.

Equity Markets

If we do indeed enter a prolonged inflationary environment, companies with pricing power will likely outperform companies that don’t. A firm with pricing power can essentially pass higher costs on to consumers and sustain revenue through the business cycle. These companies tend to be more defensive in nature and maintain stable balance sheets.

Another feature of defensive companies is that many of them tend to pay dividends. A dividend is a short-duration cash flow that is typically paid on a quarterly basis. Furthermore, as these companies through higher costs to consumers, can generally increase their dividends over time. A rising cash flow can help offset the loss of purchasing power due to inflation.

Another sector of the equity market that could hedge inflation is real estate or, more specifically, REITs. By law, REITs must pass through their rental income to investors. In an inflationary environment, cash flow from REITs can rise as landlords increase rents.

In contrast, high growth companies that are valued based on the prospect of future cash flows and profitability are more susceptible to inflation risk. Earnings for these companies might not materialize for years (hence they are long in duration). Any meaningful rise in interest rates could put a dent in their present value. Furthermore, many high growth companies lack pricing power.

Fixed Income

Fixed income and inflation are like oil and water – they don’t mix well. For strategic portfolios, shortening duration can help. However, if yields are rising across the entire curve, principal losses are likely in the short run. One option for investors looking for an inflation hedge is TIPs, or Treasury inflation protected securities.

The coupon payments from a TIP will adjust with changes in the consumer price index. Essentially, a TIP owner has a variable cash flow pegged to inflation. If held to maturity, the investor will receive their principal back, plus a series of inflation-adjusted cash flows.

High-yield bonds could outperform investment grade bonds in an inflationary environment with rising interest rates, given their higher coupons and shorter duration. If an investor is willing to accept default risk, an allocation to high yield bonds could outperform traditional fixed income.

Commodities

There are several ways to invest in commodities, which historically have provided an inflation hedge. Investors can allocate to the energy sector, for example, and receive indirect exposure to energy related commodities. This approach typically provides dividend cash flow.

Another option is to buy and hold a commodity directly, such as gold. Precious metals, given their limited supply, have historically provided some protection against a loss of purchasing power.

Finally, commodities can be pooled together and actively traded through long and short positions. For investors wanting a strategic, long-term allocation to commodities, a pooled investment is likely the best option.