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Inflation risks have started to come into focus

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Snapshot

- Since the global financial crisis that ended in early 2009, inflation has been low and inflation-sensitive assets have underperformed.
- However, expectations have recently picked up for inflation, and inflation-sensitive assets may therefore be poised to have stronger performance.
- We believe it's important to maintain a strategic allocation to inflation-sensitive assets rather than try to time inflation.
- This is not to say we are making an inflation call. Rather, we are highlighting our view that owning inflation-sensitive assets is a crucial part of diversified, strategic portfolio construction.

Considering the challenging environment for inflation-related assets in recent years—as evidenced by depressed inflation expectations, negative real yields, and the underperformance of inflation-linked versus nominal bonds—it's fair for investors to ask "Is inflation dead?". However, it is interesting to note that inflation risks have started to come into focus in recent quarters, and the outlook for inflation-sensitive assets may be improving. For example, mounting inflation pressures have been reflected in the U.S. consumer price index since the end of 2015 and in the producer-price index since the end of the following year. And while the U.S. labour market has endured a steady but painfully slow recovery since the global financial crisis ended in early 2009, it is now showing signs of substantial tightening; full or near-full employment could eventually put more upward pressure on prices, especially if wage and other employment costs finally start to accelerate. Meanwhile crude oil, as measured by Brent Crude Oil prices, has slumped recently they remain more than double their lows of 2016.

Exhibit 1: Trends creating upward pressure on inflation

Sources: ONS, Bloomberg, SEI. Data as of 31 October 2018 (Crude Oil), 30 September 2018 (Unemployment), 30 September 2018 (Wage Growth, Year-over-year change in the three month average).

In 2018, after a protracted period of generally lackluster performance of inflation-related assets, investors have been increasingly focused on inflation risks. This can be seen in Exhibit 2, which illustrates that inflation expectations have trended steadily higher since 2016—putting them above their long-term averages.

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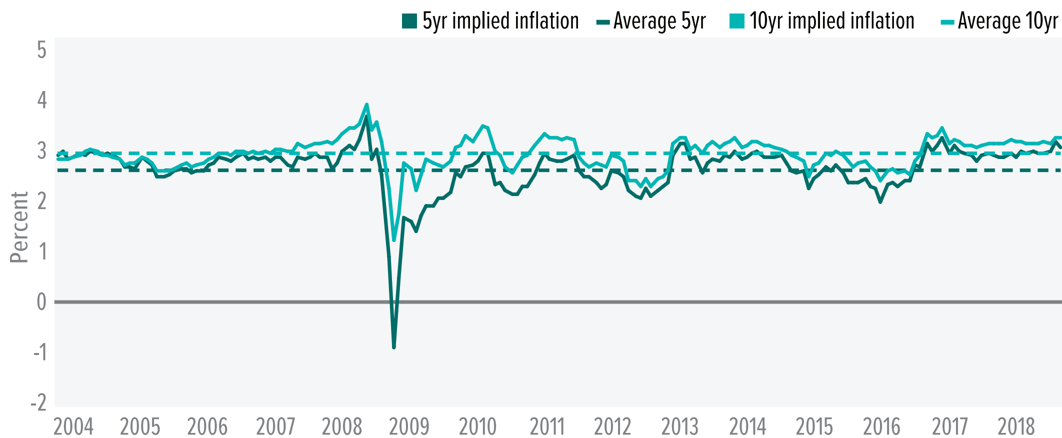
Exhibit 2: Recovery of inflation expectations



Sources: Bank of England, SEI. Data from Nov 2003 through October 2018 (15 years). Inflation expectations based on implied inflation spot curve as published by the Bank of England.

When it comes to building strategic portfolios, much of the investment industry appears to regard inflation-sensitive assets as a less critical component compared to traditional stocks and bonds. Yet at SEI, we believe that inflation-sensitive assets play a crucial role in strategic portfolio construction. But we do not believe that investors should try to time allocations to inflation-sensitive positions; it is impossible to accurately time major inflation-sensitive asset allocation shifts, just as it is for all other asset classes. While no one can predict shifting market expectations for anything, including inflation, we can try to prepare our portfolios for that eventuality. As such, there are indications that the inflation-sensitive assets in SEI portfolios could come into focus sooner rather than later.

A strategic allocation to inflation-sensitive assets should improve a portfolio's ability to weather whatever the markets may throw at it. This is not an inflation call or forecast—it is simply a reminder that the future is never certain, that most financial assets are negatively exposed to inflation, and that inflation risk (while missing in action the last several years) should not be presumed dead.

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