Rising interest rates, inflation, and asset allocation

M&G Multi Asset

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- We believe we are at a critical juncture where changes to the interest rate and inflation regime can determine the long-term characteristics of investors' portfolios.
- When determining return and correlation patterns across assets, it is just as important to assess the reasons why inflation and interest rates move as the levels they might reach.
- Considering a range of potential future interest rate and inflation scenarios is imbedded in the Multi Asset team's approach to portfolio construction.

The value and income from the funds' assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the funds will achieve their objectives, and you may get back less than you originally invested. Where any performance is mentioned, please note that past performance is not a guide to future performance.

Inflation and forecasting

A recent note from the M&G Public Fixed Income team ('Fixed income in a rising inflation environment', March 2021) succinctly outlined the cases for and against inflation emerging in the short and long term.

As that note made clear, plausible cases can be made for either viewpoint. What is important to keep in mind as investors is that, no matter how convincing a forecast may seem, markets will surprise us more often than not.

We only need to consider the consensus views exactly a year ago to highlight just how wrong that consensus can be. Anyone who had forecast a double-digit return from the US stock market in calendar year 2020 and fears of inflation by March 2021 would have raised eyebrows to say the least, just as concerns about *deflation* would today.

We must also consider that what seems 'obvious' is likely to be 'in the price.' A short-term cyclical pick-up in inflation, driven by base effects and supply bottlenecks does seem likely, but that observation is of little use if this belief is already widely held. It is surprises to the consensus view that tend to move asset prices.

It is therefore important then to make sure we do not 'put all our eggs in one basket' by adopting a forecast-led approach, but instead consider how the consensus might be surprised, and what compensation we are being offered for *the range* of possible outcomes that are out there. It is crucial not to simply focus on the topic that has driven asset prices in the past month. Are investors complacent about certain types of risk or are they panicking? Or is the outlook relatively balanced?

Asset allocation and rising rates

While we should be wary of *forecasting* the prospects for inflation and interest rates, we cannot ignore them. These forces are defining drivers of the returns characteristics of investors' portfolios.

We have discussed at length over the years how falling interest rates and inflation in large parts of the world have resulted in a strong investment background environment for many portfolios over the past 30 years.

Both growth assets, such as equities, and rate-sensitive assets, such as bonds, have generally delivered strong returns in aggregate while, for those that held both, near-term portfolio volatility was often smoothed by negative correlations in stressful periods.

It is no surprise then, that any signs of an end to this environment should raise serious concerns over what we should do with our money.

'Malign' or 'benign' rate increases?

In much of the recent narrative, policy rates, rates set in the market and inflation are often conflated.

However, for investors holding a portfolio of different asset types the interplay between these forces are extremely important. The reasons *why* rates are moving are critical to determining the ultimate implications for different asset classes.

UCITS HAVE NO GUARANTEED RETURNS, AND PAST PERFORMANCE IS NOT A GUIDE TO FUTURE PERFORMANCE

Inflation and growth

For most of the period since last summer, rising yields on long-dated government bonds have gone hand-in-hand with strong returns from many equity markets and sections of the corporate bond universe. At the same time, there was little move in near-term expectations for policy rates.

This can be regarded as a **'benign rising rate environment,'** where higher yields are associated with a more positive outlook for global economic growth. It may also have been associated with a simple improvement in investor risk perceptions as the panic of March 2020 abated.

We've seen such phases in the past, sometimes including periods in which policy rates were also rising, for example in the late 1990s, the early to mid-2000s and between the middle of 2016 and 2017. In these cases, improved expectations for profits growth or investors' greater willingness to tolerate volatility outweigh the rising rate effect and can bring gains in 'riskier' assets.

Importantly, in these phases, inflation is either less relevant as a factor driving higher rates (for example, when there is a simple shift in risk perceptions), or the inflation is seen as being associated with stronger growth. Even if *real* profits growth is weak, the ability for companies to keep pace with inflation can make them an appealing asset relative to cash and certain bonds.

Inflation, policy error, and discount rates

By contrast, a **'malign rising rate environment'** is one in which the higher interest rate effect swamps any improvement in growth beliefs.

Either policy makers are seeking to slow growth to stave off inflation threats or prevent asset bubbles, or investors simply seek higher compensation for risk in all assets.

In this situation, there can be correlated weakness across most major asset classes, as in the periods we have heard a lot about recently: 1994, the 'taper tantrum' in 2013, and in 2018.

In these environments, most assets suffer correlated declines. Far from rate-sensitive assets providing 'insurance,' as we have been used to for much of the last 30 years, they are in the eye of the storm.

Constructing portfolios

Sustained periods of 'malign' rate increases can leave few places to hide for investors, and if these rate moves are associated with higher inflation (as they typically are) then even cash can be dangerous.

However, investors have come up with numerous rules of thumb to deal with such environments:

Different asset types

- Assets with **explicit inflation or rate protection,** such as inflation-linked or floating rate bonds.
- **Specific sectors** of equity or bond markets whose earnings have typically grown with inflation or rate increases, such as 'cyclical' stocks or the banking sector.
- **'Real assets'** such as property, infrastructure, or commodity-exposed assets.

All these assets can have a role to play but we must avoid lazily assuming that they will provide the protection investors need.

If an asset is expensive in its own right and other investors are overpaying for the protection it might offer, then they can disappoint even in inflationary scenarios.

The drivers of return are never one-dimensional. For example, inflation-linked Treasuries still lost money in the last month because bond market volatility manifested itself in rising *real* rates, even if inflation fears dominated commentary. Similarly, the inflation protection provided by commodities like gold is arguable, and we only need to look at recent phases of commodity price appreciation against a *deflationary* backdrop, to question simple rules of thumb.

Strategies

As well as individual asset classes, investors need to consider how different approaches to asset allocation and active management can behave in different scenarios.

Different approaches will result in differing balances between exposures that can 'protect' or 'grow' in particular scenarios.

As we have discussed frequently in recent months (for example in our 'M&G Multi Asset team outlook' in September 2020), the prevailing valuations of most major asset classes are currently far less attractive from a longer term perspective, while the tactical opportunities presented by the volatility in 2020 have largely unwound.

From this position, an ability to be flexible in terms of selection and to dynamically change portfolio characteristics to profit from short-term 'episodic' volatility could well be important in generating returns in the period ahead.

What our fund managers are doing

Dave Fishwick, co-manager of the M&G (Lux) Episode Macro Fund

"I've stressed the need to be highly tactical, and recent price action has only strengthened that belief. As tactical opportunities unwind, we need a portfolio that can preserve capital and give us a springboard to respond to opportunities. Ultimately, our view is that longer duration Treasuries can provide portfolio protection against growth shocks. However, while there has been much noise about rising interest rates, the market does seem complacent about the prospects of near-term rate moves. If the market were to be shocked in this regard – as it was in February – it could have a correlating impact across assets. Accordingly, we have sought to add portfolio protection against this scenario with a new short position in shorter-dated Treasuries."

Steven Andrew, manager of the M&G (Lux) Income Allocation Fund

"For a strategy seeking stable income delivery, Treasuries have a role to play as 'ballast' and potential insurance. However, rising rates would probably put pressure on these and many traditional sources of income. By focusing on those parts of the equity market, like banks, which can benefit from rising rates, we aim to provide an important counterpoint in constructing a balanced portfolio."

We are still positioned based on the belief that longer-dated Treasuries can provide protection in growth shocks, although after recent price action, very few investors seem concerned about growth and are far more worried about inflation. We are not saying one outcome is more likely than another but feel that we should try to be appropriately positioned for either."

Juan Nevado, co-manager of the M&G (Lux) Dynamic Allocation Fund

"Like Steve, we have been looking at our equity balance to ensure we have exposure to attractively valued regions and sectors which have the potential to benefit from cyclical expansion. We have recently added to our Asian and mining sector equity after some weakness."

"In addition, as the fundamentals of the US and the rest of the world's economies appear to be diverging, we have added protection by shorting short dated US Treasuries while increasing exposure to the US dollar."

For all funds mentioned, the main risks that could affect performance are set out below:

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund.

The fund can be exposed to different currencies. Movements in currency exchange rates may adversely affect the value of your investment.

Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.

For the M&G (Lux) Episode Macro Fund and the M&G (Lux) Dynamic Allocation Fund, the following risks could also affect performance:

The fund may use derivatives to profit from an expected rise or fall in the value of an asset. Should the asset's value vary in an unexpected way, the fund will incur a loss. The fund's use of derivatives may be extensive and exceed the value of its assets (leverage). This has the effect of magnifying the size of losses and gains, resulting in greater fluctuations in the value of the fund.

For the M&G (Lux) Episode Macro Fund:

The fund may be highly concentrated at times in a limited number of investments or areas of the market, which could result in large price rises and falls. The fund can be exposed to different currencies. Movements in currency exchange rates may adversely affect the value of your investment.

All these funds allow for the extensive use of derivatives.

Further risks associated with these funds can be found in the relevant fund's Key Investor Information Document (KIID).

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