Special Coverage:

06/07/2022

Investing in times of high inflation

The material contained in this document is for general education information purposes only and is neither intended as, nor does it constitute, advice or a recommendation to buy or sell investments, as defined by the US Securities and Exchange Commission. For individualized tailored recommendations based on your needs or objectives, please contact your financial professional directly for more information.

Investments, annuity and insurance products

ARE NOT A BANK DEPOSIT OR OBLIGATION OF THE BANK OR ANY OF ITS AFFILIATES	ARE NOT FDIC INSURED	ARE NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY	ARE NOT GUARANTEED BY THE BANK OR ANY OF ITS AFFILIATES	MAY LOSE VALUE

HSBC

Special Coverage:

06/07/2022

Investing in times of high inflation

Neha Sahni
Global Market Strategist
Managing Editor, CIO Office
HSBC Global Private Banking and Wealth

Key takeaways

- As the world continues to grapple with high inflation, it is becoming clear that it's much more persistent than previously expected. This is not just challenging for consumers but also investors who are faced with extreme market volatility and altered investment return profiles.
- Investors therefore need differentiated investment strategies and asset mixes which they may not adopt in times of low rates and inflation. A traditional 60/40 portfolio just doesn't suffice.
- The investment strategies which can navigate the current challenging investment environment of high inflation, rising rates and greater volatility include quality companies paying durable dividends; commodity-like sectors such as Energy; a short duration exposure to manage the interest rate risk; and yield generating real assets like Real Estate.

Assets, sectors and styles that benefit in an inflationary environment

The latest data prints underscore that a) the inflation problem is broadening and becoming more entrenched; and b) even if inflation has peaked, it is more broad based and is likely to come down more gradually than previously anticipated; and potentially has a longer runway.

Accordingly, central banks are responding with tighter policies, and market volatility is rising. Investing in times of high inflation and therefore higher rates will be very different from low inflation and low rates that dominated the last few cycles. **We think that periods of extraordinary high inflation call for a pivot in investment strategy and asset allocation – in favour of those asset classes, sectors and investment styles – that benefit from it or are relatively resilient in an inflationary environment**.

1) *A focus on total return and income yielding strategies*

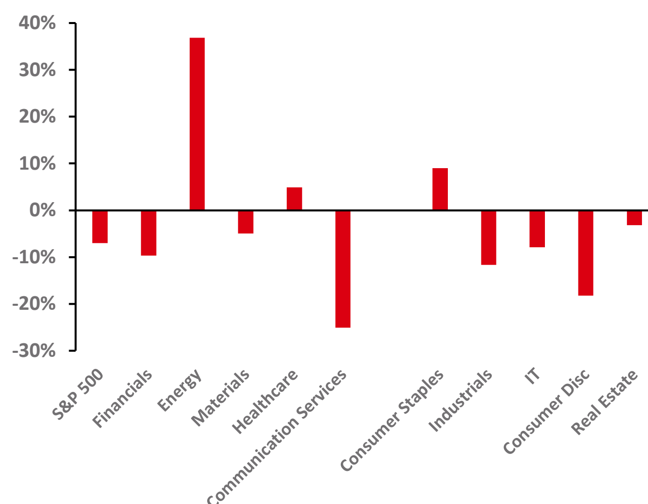
- Investors' returns are made up of **price appreciation** and **income** from an asset. The greater the proportion of return from the income element, the steadier the overall return profile for that asset is. This is because the income element (dividend pay-outs) is generally more predictable and has greater visibility than price appreciation. This is especially true of the times when the markets become more volatile and less directional. In the last decade or so, ultra-loose monetary policy led to asset price inflation, which meant that most of the investor returns came from price returns. Valuation multiples (Price/Earnings ratios) ballooned, just as the rising tide of liquidity lifted up all boats. But now, the macroeconomic picture is undergoing a regime shift.
- Persistently high inflation is forcing central banks to tighten policy in spite of slowing growth. This will drain out some of the extra liquidity and put equity and bond valuations under pressure (as seen in the first half of 2022). In the new regime, investors are likely to reap a lower proportion of their returns from "price appreciation" and need to refocus on the "income element", and hence the "total return profile" of an asset class. Therefore, in an inflationary environment, a focus on asset classes that produce relatively steady income is key.

- However, it is not the best strategy to just chase high yielding stocks without understanding their true underlying fundamentals and historical return profiles. "Bond proxies" – defined as companies which offer steady but slow earnings growth and therefore stable dividends, may see their yield advantage eroded with high inflation and rising rates. On the other hand, very high dividend yields may be a sign of distress, as the company may not be able to sustain the current high levels of pay-out.
- High quality companies with high free cash flows; low debt burdens; high Returns on Equity; well-established, profitable business models, and a track record of not just returning cash to shareholders but also reinvesting for growth are better positioned to sustain a steady stream of dividends to their shareholders.

2) Investing in commodity-style equities

- In times of high inflation, stocks with exposure to commodities like basic materials, miners and energy, can act like shock absorbers to market gyrations in a well-diversified portfolio. Some of these companies are good at passing on high prices to the end customers, especially as economies continue to reopen around the world.
- Energy and Materials' companies tend to own physical assets and commodity based products. With higher inflation, the value of their products increases and they are poised to make super-sized returns. As their relative performance is positively correlated to commodity price inflation, they form a critical component of a diversified portfolio, especially in an environment where inflation remains a concern for longer. Some of these commodity style stocks are currently trading at very attractive valuations relative to their growth style peers.

Commodity proxy equities like Energy do well in an inflationary environment (YTD performance)



Source: Bloomberg, HSBC Global Private Banking, 26 June 2022. Past performance is not a reliable indicator of future performance.

3) Exposure to commodities and commodity currencies

- While having direct exposure to commodities is thought of as traditional inflation hedge, we think a differentiated approach is needed. We think oil is trading at elevated levels due to geo-political uncertainties and supply constraints emanating from the Russia-Ukraine war. As demand is starting to fall somewhat and global supply is roughly balanced with demand, we expect the oil price to ease to more normal levels. Gold has attractive diversification properties in the context of a multi-asset portfolio, but stronger Dollar and relatively higher real yields pose headwinds to the gold price. Once geo-political risks subside, we expect the safe-haven demand for gold to decline and other cyclical commodities like silver, other basic metals and soft commodities will be better performed due to their varied use cases in the real economy.
- Commodity currencies like CAD, AUD and NZD in the developed world, and MXN and ZAR in the emerging markets will also benefit both from the tailwind of high commodity prices and the allure of their attractive carry.

4) Exposure to Real Estate

- Real assets are desirable in an inflationary environment as they offer inflation protection over the long term. But selectivity is key as some areas offer better fundamentals than others. A differentiated approach with a focus on quality is required. One such investment avenue is rental-yield generating Real Estate, especially in the areas of urban logistics and warehousing facilities of commercial properties which are scarce in supply and have recently seen a demand boom due to reorganization of supply chains, re-stocking of inventories, etc.

- In many markets, particularly in Europe, rising inflation is captured by leases with annual inflation indexation. During periods of high inflation, this protects the landlord's rental income and capital values. Direct real estate exposure offers a long-term (partial) hedge against rising inflation, but has imperfect liquidity. Public traded REITs are more liquid but their performance is also a function of the overall performance of the stock market, and therefore typically not a great inflation hedge.

5) Shorter duration across all asset classes

- In times of high inflation and interest rate induced volatility, duration management is critical. In equities, companies that can grow free cash flow across any sector and the ones that pay durable dividends should outperform those companies where income is weighted to distant future (i.e. growth stocks). In Real Estate, it would mean opting for shorter leases (that can be renewed often in line with inflation) or leases that have an explicit inflation link rather than the long-term fixed ones.
- In fixed income, an environment of high inflation and rising rates calls for a preference for short duration bonds, to manage the interest rate risk. But heightened volatility also warrants a focus on quality given that the challenging economic environment can trigger credit spread widening. We think investors can find good carry opportunities in short-dated quality credits in Investment Grade and selective EM Hard Currency bonds which benefit from good local fundamentals.

Conclusion

- In inflationary times, "investing is the new saving", especially if one wishes to preserve the purchasing power of their savings and uphold the portfolio's value in real terms. This is because cash's purchasing power is eroded by inflation over the long run.
- We think there are several actionable investment strategies that can be adopted to navigate the current challenging investment environment of high inflation, rising rates and greater market volatility. In addition to those are mentioned above, it is important to stay diversified and invest for the long run. Such high inflationary environments do not last forever, but they certainly create dislocations and valuation recalibrations in the market which are normally great entry points for long-term investors.

Important information

The contents of this document may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose. All non-authorized reproduction or use of this document will be the responsibility of the user and may lead to legal proceedings. The material contained in this document is for general education information purposes only and is neither intended as, nor does it constitute, advice or a recommendation to buy or sell investments, as defined by the US Securities and Exchange Commission. For individualized tailored recommendations based on your needs or objectives, please contact your financial professional directly for more information.

Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors. We do not undertake any obligation to update the forward-looking statements contained herein, or to update the reasons why actual results could differ from those projected in the forward-looking statements. This document has no contractual value and is not by any means intended as a solicitation, nor a recommendation for the purchase or sale of any financial instrument in any jurisdiction in which such an offer is not lawful. The views and opinions expressed herein are those of HSBC Global Asset Management Global Investment Strategy Unit and HSBC Securities (USA) Inc. at the time of preparation, and are subject to change at any time. These views may not necessarily indicate current portfolios' composition. Individual portfolios managed by HSBC Global Asset Management primarily reflect individual clients' objectives, risk preferences, time horizon, and market liquidity.

The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested. Past performance contained in this document is not a reliable indicator of future performance while any forecasts, projections and simulations contained herein should not be relied upon as an indication of future results. Where overseas investments are held the rate of currency exchange may cause the value of such investments to go down as well as up. Investments in emerging markets are by their nature higher risk and potentially more volatile than those inherent in some established markets. Economies in Emerging Markets generally are heavily dependent upon international trade and, accordingly, have been and may continue to be affected adversely by trade barriers, exchange controls, managed adjustments in relative currency values and other protectionist measures imposed or negotiated by the countries with which they trade. These economies also have been and may continue to be affected adversely by economic conditions in the countries in which they trade. Mutual fund investments are subject to market risks, read all related documents carefully. **Please consider the investment objectives, risks, charges and expenses carefully before investing. The prospectus, which contains this and other information, can be obtained by calling an HSBC Securities (USA) Inc. Financial Consultant or call 888-525-5757. Read it carefully before you invest.** Bonds are subject generally to interest rate, credit, liquidity and market risks. Investors should consider the investment objectives, risks and charges and expenses associated with bonds before investing. Further information about a bond is available in the issuer's official statement. The official statement should be read carefully before investing.

Investment, annuities, and variable life insurance products are offered by HSBC Securities (USA) Inc. ("HSI"), member NYSE/FINRA/SIPC. In California, HSI conducts insurance business as HSBC Securities Insurance Services. License #: **OE67746**. HSI is an affiliate of HSBC Bank USA, N.A. Whole life, universal life, term life, and other types of insurance are offered by HSBC Insurance Agency (USA) Inc., a wholly owned subsidiary of HSBC Bank USA, N.A. Products and services may vary by state and are not available in all states. California license #: **OD36843**. **Investments, Annuity and Insurance Products: Are not a deposit or other obligation of the bank or any of its affiliates; Not FDIC insured or insured by any federal government agency of the United States; Not guaranteed by the bank or any of its affiliates; and subject to investment risk, including possible loss of principal invested.**

All decisions regarding the tax implications of your investment(s) should be made in consultation with your independent tax advisor.