TAKING STOCK:

NEPC ASSET ALLOCATION ROUNDTABLE – THE INFLATION EDITION

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Asset allocation is integral to the success of any investment portfolio, and it is among the most important decisions an investor will make. In this discussion, we lift the curtain to offer you a behind-the-scenes glimpse of the issues and themes at the forefront of the meetings of the NEPC Asset Allocation Team.

THE PARTICIPANTS:

Jennifer Appel, CFA, Investment Director
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Aparajita Bubna, Managing Editor, facilitated this roundtable

What are your thoughts on the current economy?

Jenn: I heard someone say the other day that we are in the opposite situation that we were in during the Great Financial Crisis, where we had a significantly weak economic backdrop and then a fairly quick rebound in financial markets. I'd tend to agree with that comparison.

James: The question can be answered in different ways in different parts of the world. I think the U.S. economy, driven by consumption, is generally okay. But the economies in most other developed markets will face bigger challenges.

Phill: Unemployment is 3.5% and consumer spending is positive. Would anybody be concerned about the economy under these conditions at any other time? But obviously there is concern. That said, there are high-level data points that are still encouraging for a supportive economic environment.

Chris: That speaks to the fact that high-level data points always need to be taken with a grain of salt. We talk more about workforce participation than we do about unemployment because that's changed post pandemic. The whole world economy has changed as a result of the pandemic.

What are our views on inflation?

James: About to peak and roll over.

Jenn: Headline or core or both?

James: Headline already peaked and rolled over. Core is about to peak and roll over.

Rob: Yes, I would say we're near peak. I'm not sure how close…a month, two months, three months… but I think we're close.

James: There's a lot of confusion in some of the numbers that often get reported in the financial press. You can look at any month-over-month series across different inflationary stats and the biggest challenge is seeing those monthly stats no longer rise at a level of 40 or 50 basis points every month but move closer to 20 or 30 basis points.

That is one of the things that we're looking for in terms of actual evidence of inflation rolling over. When you look at the data right now, it's not there. When you look at monthly estimates of core PCE, you're still looking at 40 basis points a month. You annualize that monthly rate and that's 5%, which would indicate there's still more room to go before the Federal Reserve stops hiking rates.

Phill: In my mind, there is no way we see a return to a normalized inflation level if unemployment is below 4% and it's still unlikely if unemployment is below 4.5%. Do we see inflation meaningfully slow as we add 200,000 jobs a month? So, we're expanding the job market at the same point that we're hoping that inflation is going to magically turn over. Anyone that is looking at wages—workers or HR professionals—none of them think inflation is slowing.

Jack: I agree. Data from the most recent job report showed that most of the job adds went to lower earners. That could keep CPI elevated because you have more people working and earning more, and this is the same group that spends most of its income and saves less.

Chris: How do those statistics break apart people that are taking on extra jobs and extra work because of inflation and their need to make ends meet because they don't have savings? We just don't know.

What do you think is the most reliable inflation gauge? Where do you expect that gauge to be at the end of this year and at the end of 2023?

Phill: For this cycle, the most reliable gauge is the job market and the number of jobs we are adding every month. I expect we'll be adding jobs for the rest of the year and unemployment will probably stay below 4%. That means inflationary conditions are still running too high.

Jenn: I don't think there's a good comprehensive inflation metric. I've spent time looking at alternative metrics and there is one that I like to keep a tab on called the True Inflation Index. It's broader and pulls data from Zillow and other sources that don't have the same lag or same spending basket limitations that CPI has. That number is in the high-single digits now, and it's been at least a percent or two above where the CPI has been over the last year.

Chris: Yes, there's no real good measure. From a financial basis and because food and energy are volatile, we do talk a fair amount about core CPI, but I am very concerned about food and energy this winter. I think they're going to be hitting consumers in a material way.

Inflation also has a sentiment around it. If our economy is robust because it's a consumer driven economy and that consumer suddenly gets cautious because heating costs are four times what they were last winter, that is material.

Phill: Yes, and if I could amend my earlier answer, I would say the top two signals would be how the job market is faring and, to Chris's point, consumer expectations of inflation. The consumer confidence surveys don't seem to indicate that inflation is embedded in people's views and expectations, but if they are, then we have an even more serious inflation problem that is not being properly addressed by the Fed.

James: One thing I'll add, market break evens have not been a good inflation gauge in the short term. When you look at just the one-year forward break-even right now, it's 2.5%, and it's hard for many of us to sit here and believe that inflation's going to be 2.5% for the next 12 months. It's a bad idea to just look at market pricing of break evens to help figure out the direction of inflation. Instead, you have to look at some of these composite indicators that Jenn mentioned.

Phill: Let me ask this group what inflation will be for 2023?

Rob: 5%.

James: 3.5%.

Jack: Between 4% and 4.5%.

Jenn: In the 4.5% to 5% range.

James: Headline, we're saying headline inflation.

Phill: Yes, headline CPI. I say 4.9%.

Our top two economic indicators: the job market and consumer expectations of inflation.

Chris: I'm going to treat this like the Price is Right. Rob said 5%, so I'm going to say 5.1%!

Phill: If this is the average view of market participants and consumers, the Fed probably has some work to do to either rein in inflation quite aggressively or interest rates need to be higher.

James: But the bond markets are telling the Fed that inflation will be 2.5% for the next decade. If the market doesn't have this view of excessive inflation, then the Fed has to take that into consideration.

Phill: I think of this disconnect, more than anything else. Bond market is saying 2.5% for inflation and market participants are worrying it's going to be higher. This disconnect reflects all the volatility we're seeing in equity markets. Every inflation data point we get, whether that's inflation to the upside or inflation to the downside, markets are reacting dramatically, hoping to find what the longer-term path will be.

What are your expectations for a formal recession in the U.S. either this year or in 2023?

Rob: I don't know the definition of a recession anymore.

Chris: I mean a recession that everyone can point to. To Phill's point, one of the reasons that we might not officially be in a recession is the jobs market. I'm saying between the Fed, interest rates, mortgage rates and inflation…that sounds like conditions for a formal recession, but we are not seeing unemployment increasing and the economy truly retrenching yet.

James: The only real drag seems to be from residential investment. The consumer seems okay. I fail to see how this is a recession despite two negative real GDP quarters in the first half of 2022.

Chris: Yes, I'm not arguing for the current recession. I'm saying over the next two years, there is likely to be a real slowdown—not a technical one—and you're saying no.

James: Yes, that's what I'm saying. I don't see it getting significantly worse from here. It's more likely than not consumers take on more credit over the course of the next 18 months as they deal with higher prices because their overall balance sheets are healthier than they were pre-COVID. When you look at consumer credit versus GDP, it would seem to me there is room for increase there, which helps you muddle through higher inflation.

I could see a recession happening somewhere in 2024, at which point it becomes a bit of a political game because you're in an election year. Do you see the Fed start to pivot and cut rates in late 2023 to get ahead of that? My view is we don't see a recession unless we get an imported recession from the rest of Europe or the globe.

Phill: To add to James's comments, I don't see a recession happening unless we have something like 2.5 million jobs lost over the next 12 months; that pushes the unemployment rate closer to the 5% range which, historically, still doesn't feel very recession like. There needs to be a material uptick in job losses or some sort of external shock that causes mass layoffs and it's hard to see where that comes from.

Given the strong job market and that housing prices remain high in many areas despite the increase in mortgage rates, what are your views on the Fed? Also keep in mind that the Fed has said it believes the economy can take more aggressive rate hikes.

Phill: I'd say the Fed should be happy that we have the Bank of England because no matter what the Fed does, it's going to be viewed relatively better.

James: I would say the Fed was late to the game with their transitory inflation comments last year. Now, it is trying to be careful that it doesn't overreact by going too far. And we've heard from various Fed officials starting to temper the rhetoric on how far we go with interest rates. So, I would say it is being cautiously aggressive with this idea of tamping down inflation without destroying the economy.

Chris: The U.S. economy is resilient not because of the Fed but because it is a more dynamic economy compared to the rest of the world. So, the economy adjusts. Companies fail, new companies enter, people have job mobility like they've never had before…and that's very different than the problems you're seeing in Europe, Japan and even China right now.

For a recession to occur, there needs to be a material uptick in job losses.

Rob: I think the Fed seems overly committed to its 2% inflation target, especially looking out into the future. It feels overly punitive to the economy if the central bank sticks to a 2% target because of labor constraints, which feels more like a demographic issue rather than a cyclical one. So, if the Fed is trying to fight demographics, what are they actually trying to control?

Phill: Rob, when you say demographics, are you saying there's potentially a permanent imbalance in the labor force, that is, not enough workers for jobs?

Rob: Yes, because of COVID. It's not the great resignation. Workforce is younger…there's just not enough people to fill jobs. You can solve for that in other ways, for instance, the federal government can provide greater immigration incentives.

James: That's where you might see a shift, not in the Fed's mandate, but its targets: the mandate doesn't say 2% inflation, it says stable prices and full employment. Right now, to the Fed, stable prices mean 2% inflation. In a world where there's a structural labor problem, it might change its natural level of interest rates from 2.5% to 3.5%. When you do that, maybe that changes the Fed's inflation target to 3% from 2%. One of the reasons we still remain underweight equities from a current outlook perspective is because that next step of recognizing more permanence in higher levels of cash and inflation are not in the market discussion yet.

Phill: Either way, you end up with a higher level of interest rates. Where the Fed eases its long-term inflation target higher or the Fed raises interest rates methodically, by 50 basis points, 75 basis points each meeting over the next three-to-four months.
The Fed already has a sense of where it wants Fed Funds to be. My preference would be for the Fed to do it quickly. Let's get Fed Funds to 5% and then sit there for a while to see the impact on the job market, inflation and the economy.

James: Fed Funds expectations are already priced at 4.5% one year out. So, that speaks to the "Are we done yet?" point. The market is getting comfortable with the idea that we're going to stick at a higher level for most of the calendar year 2023. It's a question of what level that is? Is it 4.5% or above 5%? Right now, I'd say there's a 50-50 chance of it being either one.

Phill: Tying this back to the market outlook...if inflation's closer to 3.5% in 2023, it gives the Fed some room to maybe lower rates on the back half of the year. If inflation is somewhere above 5% in 2023 or close to 5%, that means the Fed has to move rates higher and the markets are going to rally or draw down over the course of the next three-to-four months as the inflation path becomes clearer.

James: Or four weeks, because everything happens on a quicker cycle now.

How do higher levels of inflation impact asset allocation?

Rob: Higher inflation for longer will push interest rates higher, with cash and fixed-income assets becoming relatively more attractive. This gets us thinking about how we balance equities and bonds in a portfolio. What's the optimal level? The mix of those in a portfolio in the last 10-15 years has been heavily in favor of equities because fixed-income returns were so low. Now, that balance is potentially shifting to more fixed income.

Chris: Broadly, fixed income looks more attractive relative to equities. But historically, there have been times like this. We need to check ourselves because in the early 2000s and early 2009, NEPC did very well by clients by recommending allocations to credit.
In hindsight, we would have had a better result just moving into equity. So, we have to question our priors regarding whether the market stress has reached a nadir. If it has, then you'd prefer to have a riskier investment like equity. But it's a difficult comparison between credit and equity, the two markets trade with different buyers and sellers and they can get disconnected.

James: I do think corporate bonds and bonds in general have a more attractive place in people's portfolios. They will provide more stability to investment returns over the course of the next three-to-five years while rates remain in this neighborhood.

Also, equities are likely to be marginally less attractive than they were because companies have to deal with higher financing costs. Companies now actually need a business, a product, cash flow and a resilient balance sheet.

As a result, active management might be even more important on the equity side to move away from market cap indexes that favored higher growth-related companies than those with more resilience.

Jenn: Speaking of active management, it will be an interesting test for some of the funds that have started in the last 15 years or so to see if they can continue to generate alpha in a time where there's no longer excess liquidity. So, that's just one point of caution with the active management story.

The other thing I'll mention is evaluating asset classes on the basis of Sharpe ratio, which has pitfalls as we all know, but moving more into fixed income over equities is fully supported by a higher Sharpe ratio.

Phill: This is really a paradigm shift in terms of investors' expectations. We've been so used to equities being the dominant provider of total returns. To some degree, it's warped our brains collectively as investors for the last 10-15 years. As a result, we have to untrain ourselves and we have to revise our thinking about what it means to build a portfolio's asset allocation.

Value equity starts to become more meaningful to a portfolio and higher interest rates support more investment-grade bonds. As interest rates keep rising, there's going to be more levers for investors to pull to be able to meet their return objectives and targets.

So, in some ways, the positive side of the market environment is we are resetting the system and giving people an opportunity to find a more customized path to reach their investment goals.

Jenn: It's like bursting the everything bubble.

What are your expectations for the midterm elections in November?

Phill: I think the best outcome for markets is (and this has been true for the last decade or so) having some form of a divided government. So, a divided Congress is probably a relative positive for markets.

Chris: That's what the polling and prediction markets are pricing in, the Republicans take over the House; the Senate is too close to call but neither party will control everything. So, that's very much a divided government as Phill outlined.

Phill: Consumer expectations today are lower than they were at the peak of the pandemic. If you have unhappy voters—whether that's because of inflation or other conditions—you are going to have a lot more volatility at the polls.

Chris: This does speak to our old globalization backlash theme. Post pandemic, every election around the world has tended to be the reverse of the current government in power.

How is the Russia-Ukraine war affecting our asset allocation strategy?

James: It's part of the reason why we are generally concerned about owning risk assets, but it's not the only one. It's also part of our reluctance to own European stocks.

Jenn: I agree. I'll also mention that it is having a meaningful inflationary impact globally on food and energy.

How is Europe faring relative to the U.S. in terms of economic growth and inflation?

Phill: Very poor.

Phill: When you look at Europe, it's doing a complete transplant of its energy infrastructure and there's no way that can be done without causing significant disruption to economic activity.

Jenn: Going back to some of Rob's comments on the labor market…that's going to be impactful in Europe because its demographic profile is even worse. It's a greater structural headwind there.

James: I think it's about economic independence. In the United States, we have energy, food, workers, consumers, and the global reserve currency. What does Europe have in comparison?

Rob: In some ways, parts of Europe look like an emerging market in terms of currency movements and the fiscal profile.

What's your best performing asset class for 2023?

Jack: Single-B U.S. corporate bonds.

James: That is great answer. I'll say U.S. value.

Jenn: I'm going to double down on my China bet. I'll take local China equity.

Phill: Short-term investment-grade bonds.

Chris: I'm going to take Jack's single-Bs.

Rob: Treasury STRIPS.

What is your most important recommendation for investors?

Chris: As an investor, the reason you set up policies and objectives when times are normal is so that when times are bad, like the current environment, you don't depart from the good governance you put in place.

Jack: If you haven't changed your strategic allocation in the last three years, you should talk to your NEPC consultant.

James: I have to echo what Jack said. The interest rate environment is so different that it warrants every investor re-examining their objectives. I think every investor would benefit from re-assessing their strategic objectives.

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