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Notes from the Road

Inflation, Private Assets and a Cautious Consensus

The beginning of the year always offers a chance to catch up with a broad range of clients who are in the mode of thinking about the big picture outlook: pension funds, insurers, consultants and sovereign wealth funds across Australia, Asia, Europe and North America. This note reflects on the key issues that clients have wanted to talk about in the early months of this year. Collectively, these topics give us a picture of what's on investors' minds.

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Details

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Despite having moved to the buyside, it's not easy to kick the habit of walking into a meeting with a 150-page slide deck, so in theory conversation can go anywhere, but inflation has been the near-universal top-of-agenda item in meetings. The discussions have not been about the near-term cyclical inflation outlook and (thankfully) not about where peak fed funds rates might end up—asset allocators want an assessment of the strategic inflation outlook five and 10 years out.

Agreement on the Arrival of a New Investment Regime

There's been remarkably little pushback on our view that investors face a new regime, with higher inflation driven by the triumvirate of deglobalization, demographics and ESG-related forces. If anything, a few clients have voiced the concern that we might be forecasting too benign an outlook, with 3% US inflation 10 years forward. The recent move down in break-even rates doesn't seem to have beguiled asset allocators into thinking the inflation problem is gone, so one can conclude that the consensus client view on inflation is higher than the "consensus" in market pricing. However, this doesn't mean people have adjusted their strategic asset allocation views to reflect this inflation outlook, because it's hard to do.

Higher inflation, lower nominal returns and less diversification all point to the prospect of lower real Sharpe ratios in the decade ahead than over the past 40 years. Given this backdrop, it isn't surprising that many client calls and meetings have revolved around what this means for the need for real assets, which assets are good inflation protectors in different inflation scenarios, and how asset-allocation dynamics must change given a higher inflation outlook.

Growing Private Exposure and the Illiquidity Premium Question

A key element of this debate—and an item at the top of many asset allocators to-do lists early in 2023—is how much to allocate to private-market exposure. The concerns vary by region. For US clients, debate is dominated by many pension plans' overweight to private assets—especially equity—in 2023 due simply to declines in public equities and bonds last year. Australian investors are less concerned about private equity. They focus more on the role of infrastructure and real estate in inflation protection, including how well they protect against inflation and how much infrastructure characteristics are changing and becoming longer duration. The universal question: "Is there still an illiquidity premium?"

Our take on this is that the illiquidity premium question should indeed be a core concern of asset owners. They face almost inevitably lower real Sharpe ratios compared to the past 40 years. The ways to ameliorate this outlook will require a combination of illiquidity risk, factor risk, active-management risk and leverage—all of these entail taking more risk. The more important question, in our view, is: What's the most efficient way to combine these risks, given an investor's individual concerns about dimensions such as time horizon, liquidity and the need to preserve purchasing power?

We conclude that private-asset exposure should continue to grow, assuming an investor has liabilities or targets ultimately set in real terms. These assets occupy an important position in the return/risk space investors are seeking to fill, and the supply of public equity and traditional credit has declined. Greater concern about liquidity, which we think is here to stay, will be an offsetting force.

The denominator effect from generally declining asset levels has left US plans overweight private assets, a situation that should really be looked through as a near-term issue. However, we realize it may be hard to put that consideration aside, so the public-to-private rotation will likely move more slowly over the next year. A case can be made that expectations for private equity have moved too far, so we've been suggesting a shift in marginal flows to private credit, infrastructure, real estate and farmland. Clients have been particularly open to private credit.

Conflicting Signals from Stock and Bond Markets

In many of our recent meetings and calls, clients inevitably want to switch perspective from strategic to tactical. Many of the questions revolve around the view that equity and bond markets seem to be sending very different signals. An inverted yield curve signals a growth slowdown and attractiveness in short duration fixed income. This is juxtaposed sharply with a lack of risk-asset selling and a lack of meaningful cuts in earnings forecasts. Many clients have expressed confusion on this situation, with the net result of a cautious tactical position on equities.

When put on the spot and asked to choose between “cash or the S&P500 one quarter forward,” I’ve answered cash—specifically short-duration bonds.

However, important features cushion the equity outlook over longer horizons, including investors’ unwillingness to buy overseas equities and the role of equities as a quasi real asset. Another support for equities versus sovereign bonds is sharply different supply and demand prospects: the outstanding amount of public equities outside of China is shrinking, while demand is set to remain robust over a strategic horizon. We’ve discussed the equity backdrop in more detail elsewhere. In contrast, the supply of sovereign bonds seems likely to rise, and we would argue that quantitative tightening, de-dollarization and inflation protection imply falling demand.

Factors Are Back: A Consistent Agenda Item

We’ve been struck by clients’ willingness to talk about factor allocations: one can conclude that factors are definitely back. The renewed interest might not be surprising after a strong 18-month period for factors, notably value, especially versus traditional asset classes. Clients have been asking about very different aspects of factors, though, including tactical views, a longer-term discussion about value versus growth, and the role of a broad set of long-short factors in strategic asset allocation.

We think value has a renewed role in a world of higher inflation. There’s still a caveat that the mean-reversion process isn’t as clearly linked to valuation anymore, given technological disruption. And there’s a question of how to measure value when the most corporate investment is in intangible assets. Nevertheless, there’s nearly a century-long link between inflation and value, suggesting that the value factor can be part of an inflation hedge.

We also don’t think investors should give up on growth. We’ve always rejected index providers’ view that value and growth are somehow definitionally opposite. High-growth companies have demonstrated the ability to deliver more persistent growth, and our view is that real interest rates won’t rise from here. Together, these arguments imply that one can indeed justify the current valuation of growth companies. The bigger issue, in our view, is identifying which specific companies can grow persistently, making a case for issuer selection within a growth universe.

Another question that has come up more than once isn’t a directional asset view but an issue of investment methodology: What’s the role of timing and how should one measure it? This question has become important in the context of reduced expected returns from passive asset-class beta, which lowers the bar for adding value from timing decisions and active management. Given the very nature of timing, it will always take longer to demonstrate skill at this approach than it would for security selection. However, we’ve laid out how to assess timing skill and use it as part of manager selection and strategic allocation.[1]

We’ll examine the topics discussed here in greater depth in our upcoming black book, *A Painful Epiphany: investing in a post pandemic post global world*. That research seeks to set out what we see as the key issues facing asset owners in the macro environment, the outlook for capital markets, strategic allocation and the future of the investment industry.

[1] Alpha, Beta and Inflation: An Outlook for Asset Owners

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