

# HOW INFLATION PROOF IS YOUR PORTFOLIO?



John Wilson – Head of PIMCO Australia Pty Ltd.

*Rather than think about an investment portfolio as a range of asset classes, investors should think about their portfolios as a set of inflation hedges, each fulfilling an important role in hedging inflation outcomes.*

“While global growth prospects have softened since last year, inflation remains a concern in many countries. Pressure has been particularly evident in prices of food and a range of resource commodities. Oil prices have risen further in recent months, and base metals prices have also been at high levels. The main factor behind the continued strength in resource commodity prices seems to be the strength of Chinese demand, in combination with a relatively limited supply response to the higher prices to date.”

RBA Statement on Monetary Policy May 9, 2008

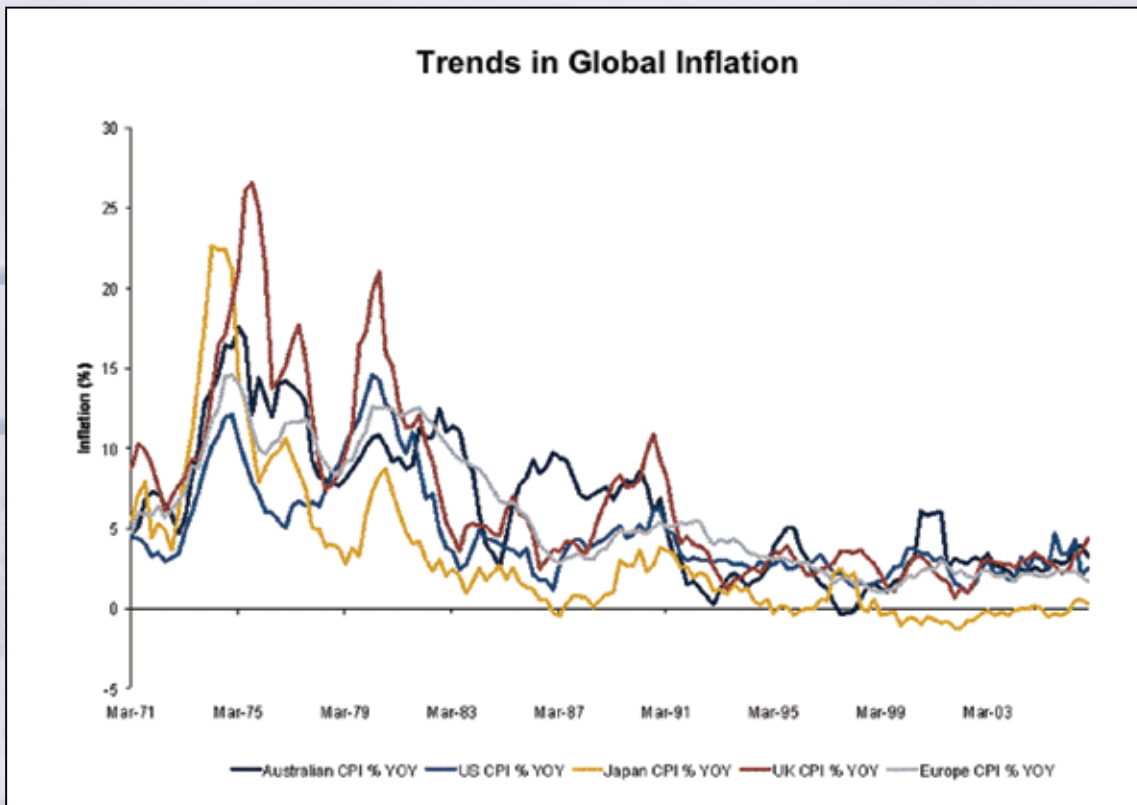
“...in light of the continued increases in the prices of energy and some other commodities and the elevated state of some indicators of inflation expectations, uncertainty about the inflation outlook remains high.

The substantial easing of monetary policy to date, combined with ongoing measures to foster market liquidity, should help to promote moderate growth over time. Although downside risks to growth remain, they appear to have diminished somewhat, and the upside risks to inflation and inflation expectations have increased”.

FOMC Minutes June 25th, 2008

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The last 15 years saw inflation targeting by central banks become the orthodoxy. So successfully did they discharge their responsibilities a whole generation of investors has sharply discounted the threat that inflation poses to their portfolios. Certainly, on the evidence of the following chart, central banks could claim victory. From the inflationary highs of the 1970's (remember the oil shock?) to recent times, inflation has been in persistent decline. A clear triumph for the central banks and their inflation targeting regimes? Perhaps yes, perhaps no.



Just how good were central banks, really? There is a theory that they were not as good as the data makes them look. The argument goes like this; central banks hadn't so much learnt what policy settings served to contain inflation but rather were carried along on a global wave of deflation emanating from political changes that had the affect of greatly expanding the global labour pool. Once that one off labour supply shock has been fully assimilated, then the usual laws of supply and demand will reassert themselves, with one important caveat; substantial wealth creation in emerging economies has created new sources of demand for basic commodities, suggesting higher inflation might be with us for some time.

At our client conference of 2006, Alan Greenspan, the former Governor of the U.S. Federal Reserve Board (and in a spirit of full disclosure, now a consultant to PIMCO), remarked that the fall of the Iron curtain in 1989 "was the most under researched event in economic history". Well it was big news all right but right up there in the pantheon of under researched economic events was the introduction of agrarian reform in 1978 by the Communist Party of China that set the foundation for the modern Chinese state. Regardless of which event wins the award for the absence of research coverage,

both events have affected global commerce and inflation in profound ways.

By IMF measures the global labour force has risen fourfold over the past two decades, reflecting the integration of China, India, and the former Eastern bloc into the global trading system. The end of European communism not only provided new markets for capitalism but more importantly supplied hundreds of millions of new, many highly qualified, workers for absorption by Western economies. Chinese economic modernisation provided the factory floor for the Western world.

The economic effects were twofold. First, wage inflation in the Western world was stymied as new sources of highly skilled labour (India, Eastern European labour) competed successfully in globalised markets and put a lid on labour prices for both skilled and knowledge workers. Second, Chinese scale in manufacturing drove down production costs, provided western economies consumption goods at ever lower prices and put a lid on unskilled labour prices. Unsurprisingly, corporate profits as a share of GDP drifted higher, while labours' share of the pie broadly stagnated. However labours' relative decline in income had been offset by the

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decline in the price of consumption goods, falling interest costs and the combined wealth effect of rising housing and asset values (well, until recently) thereby underpinning living standards absent wage rises. All in all, a serendipitous set of economic circumstances if you were a central banker.

Until now that is. The emergence of strongly expansionist economic policies and new wealth in the emerging world has put strong pressure on scarce resources, notably food and fuel. Longer term, inflation trends are likely to be bolstered by the empowerment of the Chinese workers (i.e. wage claims); the continuing emergence of the Indian middle class and growing affluence in emerging economies in general. In the developed world our central case is for slowing growth and continued rising inflation as higher commodity prices flow through to the end consumers.

If the great deflationary tailwind of globalisation is behind us and the emerging world provides new sources of inflation in the global economy, then inflation over the next 10 years is very likely to be higher than the last 10 (this is particularly true for a skills constrained, high immigration, and commodity fuelled economy like Australia).

If that is the case then what should be the investment response? You need some inflation hedges.

But just what?

Inflation hedges can be divided into four main buckets;

1. Leading inflation hedges;
2. Contemporaneous hedges;
3. Lagging inflation hedges; and
4. Hedges against the unexpected

### **Leading inflation hedges**

As their name suggests, leading inflation hedges are assets that tend to perform in advance of inflation becoming visible in the broader economy. Typically this is equities and some also argue property. On the basis of the spectacular falls in equities and property in the last 6 months you might also argue that once inflation is visible they do a truly terrible job of hedging out inflation risk! Notwithstanding that corporations (outside of finance and banking) are in pretty good shape, higher financing costs, slowing economies and higher inflation is a potent antidote to stock market performance.

A typical diversified asset portfolio tends to have a greater proportion of leading inflation hedges than

other hedges. This is a very polite way of saying that most funds are excessively reliant on the equity risk premium to achieve their long term CPI plus objectives. Essentially funds are willing to underwrite a large mismatch between the CPI plus target stated in their investment policy statement and the asset pool that supports that objective. Almost entirely this mismatch is explained by the belief that equities, over the long run, outperform inflation. That proposition holds if the average experience of investors over the last 10 years persists into the next 10 years; the CPI has averaged 3% per annum in the 10 years ending March 31, 2008 and Australian Equities have returned 11.8% per annum over the same period. A handy 8% real rate of return. But will the experience of the next 10 years more closely resemble the last ten or might it more closely resemble those of a US equity investor, from the mid 1960's to 1981, where the combined effect of the oil shock and inflation, crushed equity returns.

So for those periods where inflation is emerging and equities are being pummelled, what are needed are other forms of inflation hedging i.e.: principally fewer equities, which bring us to contemporaneous inflation hedges.

### **Contemporaneous hedges**

Examples of contemporaneous hedges include investing in Inflation Linked Bonds or CPI Swap contracts.

Inflation Linked Bonds are constructed to insulate the investor against rising inflation by explicitly imbedding a floating rate of inflation into the interest coupon that they pay, or by adjusting the capital value of the bond to reflect the prevailing inflation rate.

CPI Swaps provide investors with the price movement in the underlying inflation rate. It works as the exchange of a stream of inflation-indexed payments/coupons for a stream of nominal interest payments. The nominal payments may be based on either a fixed interest rate or a variable interest rate (e.g.; Bank Bills). It is an over the counter market, meaning you've got to go out and find someone to transact with as there is no exchange in these securities.

The advantage of both strategies is that they provide explicit inflation protection. In fact, if you are limited to a single inflation protection asset then the contemporaneous hedge ought to be preferred as it preserves real purchasing power. Effectively, an inflation linked bond ought to be regarded as the risk free asset of choice for a long term asset pool like a superannuation fund. After all, it solves the core

problem confronting a long term investor – that of the erosion of real purchasing power by inflation. The difficulty with both strategies is a lack of supply of suitable instruments and securities in Australia. One solution to the scarcity issue is to invest in a portfolio of global inflation linked bonds. There, the correlation of inflation between Australian inflation and the inflation of the major inflation linked bond issuing nations (the USA, UK, France and Sweden) is high; in fact over the various time periods we've looked at, the correlation of Australian inflation to global inflation has been 0.88; not perfect, but a good fit never the less to Australian inflation and an excellent contemporaneous hedge.

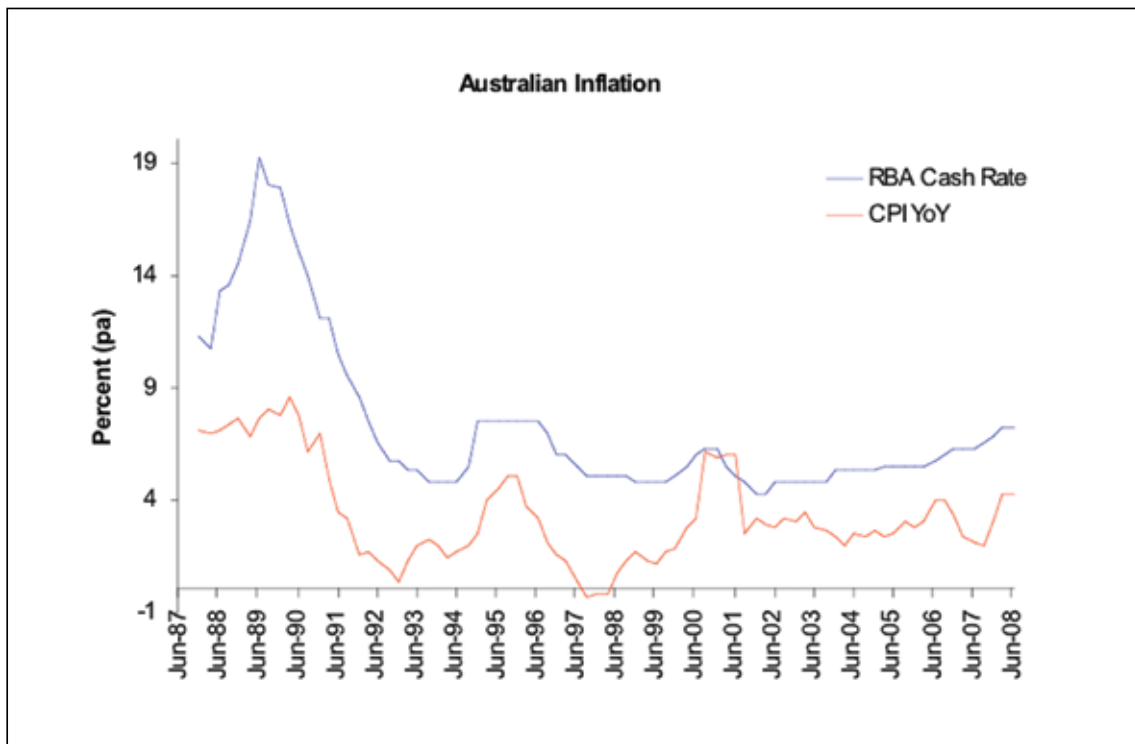
### Lagging Inflation Hedges.

Lagging hedges are centred in those assets that offer returns following bouts of inflation. For example as inflation drifts higher, central banks seek to curb demand by pushing short term interest rates up. Investors with investments in fixed interest securities like floating rate notes – where the yield is determined

by adding an interest margin over an index such as the Bank Bill Index, garner higher returns and gain a good lagged inflation hedge. In Australia, this strategy is particularly effective given the Reserve Bank, aside from one brief period, have maintained a real cash rate – that is, the cash rate has typically been in excess of the inflation rate. In fact, over the last ten years, the average inflation rate has been 2.9%, with a corresponding RBA cash rate of 5.4%. As a result, you are locking in real rates of return by owning cash. Add a margin for active management and in this environment of elevated cash rates, absolute return fixed interest looks a pretty compelling strategy for achieving high real rates of return and a good inflation hedge.

### Hedges against the unexpected.

Oh, and did I mention hedges against unexpected inflation? Well, that's commodities, but that's a story for another time.



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