Different world, different playbook – investing in an inflationary world

By Perpetual Private Insights
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The recent market volatility marks a turning point in economics and markets, a turning point big enough to change the way investors think about their portfolios, according to Kyle Lidbury, Head of Investment Research at Perpetual Private.

The volatility

The first few months of 2022 were difficult ones for investors with weak equity markets both in Australia and offshore and with unprofitable tech and growth stocks hit particularly hard. Underlying all this volatility was higher inflation (see below), the threat of higher interest rates and war between Ukraine and Russia. The exceptionally strong equity market performance of 2021 is in danger of becoming a distant memory.

The first trigger for all this volatility is the not-so-sudden re-emergence of inflation. As Kyle Lidbury notes in the video above, the most recent figures put US inflation at above 7% and so the US Fed has stopped talking about 'transitory inflation'. More importantly it has started to get more hawkish about raising rates.

Ukraine, Russia and global markets

It's impossible to predict the course of the Ukraine/Russia war.

Whatever happens, financial sanctions and disruptions to global trade are likely to further inflame inflation. Russia and Ukraine are major energy and food producers and disruptions to their output will push up costs on these essential goods – thus affecting consumers around the world. That could have a negative effect on growth.

This combination – rising inflation and a threat to growth – makes life difficult for Central Banks, who need to calibrate a strategy that keeps inflation under control without risking recession.

What goes up, what goes down?

With inflation on the surge and interest rates rising to slow it, the playbook for investors has changed and last year's flyers could be the next decade's roadkill. Here's a brief guide to who we think the winners and losers in a rising-rate world will be.

1. Active wins out

In a rising rate, higher-volatility world, security selection becomes more important. In equity markets, companies that can pass on input price rises to their customers will tend to do better than those in hyper-competitive segments where pushing up prices means pushing down sales. Finding those companies and paying the right price to own them is a job for an active manager, not an index-hugging algorithm.

2. A turn to value

Thanks to a decade of low-interest rates, growth stocks have comprehensively outperformed value stocks since the GFC. But the bounce back in value stocks has already started – and is likely to continue. Some analysis from our colleagues at Perpetual Investments explains why.

They compare the effect a 1% rise in the discount rate could have on BHP – a giant diversified miner – versus Afterpay, the darling of the high-growth, Buy-Now-Pay-Later stocks (the discount rate is the assumed interest rate analysts use to value the future earnings of a business). On this analysis, higher rates could cut BHP's valuation by 16%. But it would cut 36% off Afterpay.

"Higher rates have a two-fold impact on growth companies", explains Kyle Lidbury. "Firstly, their potential earnings get discounted more heavily. Secondly, funding all that growth via debt becomes a lot more expensive and that means lower profits. It's why the big losers from recent market volatility have been high-growth but unprofitable tech companies. And why the future looks brighter for companies with predictable cash flows – like banks. And those that benefit from higher commodity prices – like miners."

3. Portfolio shift

In the portfolios Perpetual Private manages for its financial advice clients, the big shifts are those summed up above – a further move towards value shares and a preference for using active managers to identify the companies likely to prosper in volatile times.

The third big move is an increasing allocation to alternative investments – ranging across private equity, infrastructure, sophisticated trading strategies and many more avenues. These alternative assets often rely on the skill of the manager rather than the underlying market moves to generate returns. Some also trade in private markets which make them less liquid but potentially more lucrative over the long-term.

"We've been building our alternatives expertise for 15 years," says Kyle Lidbury. "It gives us another avenue to find returns for our clients. And adds a really important extra level of diversification – which means more ways to manage risk.".

You can see more of the Perpetual Private Investment Team's thinking on 2022 markets here.