Advisory Blog

Timely insights on the issues that matter most to advisors and their clients

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Floating-Rate Loans | Income | Inflation

EV Forward: Short-Duration Inflation Protection

By: EV Forward | June 29, 2022

Boston - We seek to deliver inflation protection with less interest-rate risk than is typically found with longer-duration, traditional inflation-protection strategies.

What we are seeing

Despite widely held expectations that inflation might have peaked, the May Consumer Price Index (CPI) indicated that U.S. inflation could likely go higher and be more broad-based than expected. The ongoing Russia-Ukraine war continues to pressure food and energy prices, while renewed COVID lockdowns in China threaten progress made in taming goods inflation and global supply chain constraints.

Consumers' longer-term outlook for inflation also spiked higher, which — combined with a tight labor market — could put further pressure on wages and push inflation higher.

In this inflation cycle, traditional inflation-protection income strategies have generally delivered sharply negative total returns along with the broader fixed income markets. By contrast, shorter-duration, inflation-focused strategies have performed positively.

What we are doing

The strategy was designed precisely for this environment — one inwhich inflation is high and the Federal Reserve has to raise interest rates quickly to try to contain it. We are still seeking to deliver inflation protection with less interest-rate risk than is typically found with traditional longer-duration, inflation-protection strategies. We believe this is best achieved by:

Focusing on shorter-duration, inflation-linked assets. These are 1) less negatively impacted by rising interest rates, 2) better correlated with the inflation consumers are experiencing, and 3) more likely to provide inflation protection if inflation continues to surprise by overshooting expectations.

Swapping interest rate risk for credit risk. Floating-rate securities, such as bank loans, can potentially enhance total returns and have attractive correlations with inflation. However, we are moderately decreasing this exposure and moving to a more neutral positioning across credit sectors, as the Fed has pivoted to tightening monetary policy more quickly and aggressively than anticipated.

What we are watching

We are keeping a close watch on high-frequency economic data that indicate the direction of the labor market and inflation, which will be key to future central bank policy.

Corporate earnings reports will start to be released in July. We will monitor these, focusing on:

- Top-line trends to show the adjustment between goods and services
- Companies' ability to maintain margins and pass through higher costs
- Corporate hiring plans to get a sense of intermediate-term labor market conditions
- Capital allocation decisions to learn how management teams are planning to use their balance sheets

We are looking at global central banks and their reaction functions, or how effective the banks' policy tools are proving to be. Consistently, we are tracking market "technicals" around global capital flows to gauge security supply and demand levels.

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Risk Considerations: *Loans are traded in a private, unregulated inter-dealer or inter-bank resale market and are generally subject to contractual restrictions that must be satisfied before a loan can be bought or sold. These restrictions may impede the strategy's ability to buy or sell loans (thus affecting their liquidity) and may negatively impact the transaction price. It may take longer than seven days for transactions in loans to settle. Due to the possibility of an extended loan settlement process, the strategy may hold cash, sell investments or temporarily borrow from banks or other lenders to meet short-term liquidity needs. Loans may be structured such that they are not securities under securities law, and in the event of fraud or misrepresentation by a borrower, lenders may not have the protection of the anti-fraud provisions of the federal securities laws. Loans are also subject to risks associated with other types of income like high-yield bonds described above. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. Changes in the value of investments entered for hedging purposes may not match those of the position being hedged.*

EV Forward

> We believe times like these underscore the value of active management — carefully assessing the fluctuations driven by all kinds of disruptions, and taking dynamic actions that best serve the long-term interests of our clients.