Family Office Horizons

The implications of inflation for family offices

20 September 2021

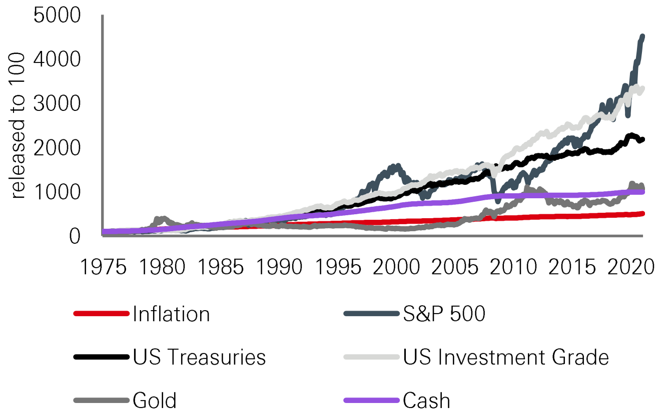
Family offices pay close attention to inflation dynamics. Passing on your wealth to the next generation becomes harder when rising inflation threatens to erode the value of investments over time. CPI typically understates families' living expenses and prices of luxury items. And families' borrowing costs could rise if central banks plan to react to higher inflation by hiking rates.

After years of benign inflation, the recent jump in global inflation metrics (with US CPI recently reaching a peak of 5.4%) puts the topic back on the agenda. So what is the inflation outlook and how should family offices adapt their strategy?

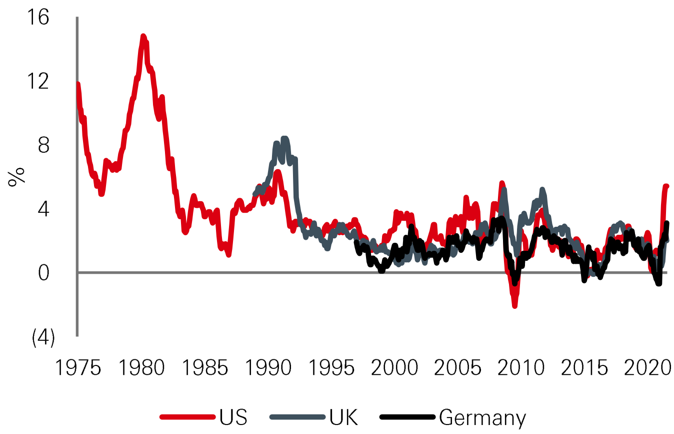
- The good news is that inflation pressures are largely related to the post-pandemic reopening, and that global competition, automation and technology should bring inflation back down from next year. In fact, the market's long term inflation expectations still are quite anchored, providing some comfort. There are risks to the upside, however: sustainability will come with a cost which is largely unknown, and de-globalisation could make supply chains less efficient
- The bad news, however, is that there is no silver bullet to preserve and grow your wealth in excess of inflation, and a multi-pronged strategy is thus needed. Holding cash will continue to come at a cost, as central banks will be slow to hike rates. And inflation-linked government bonds such as TIPS carry negative real yields so will underperform inflation. A better approach is to construct a diversified portfolio with a mix of real assets such as equities, gold and real estate as this should remain a good long term hedge
- Outside of the core portfolio, you can also align returns with specific drivers of inflation. For example, the upside inflation risks from de-globalisation and rising wages can be partially addressed by looking at our automation investment theme, or at quality companies with strong margin power. And strategies linked to carbon pricing, climate adaptation solutions or natural capital can address the risk of climate change boosting inflation
- Finally, portfolio leverage and business loans can be tailored to match the rate outlook, earn extra yield or lock in the low current levels
- In summary, the recent inflation spike is not a harbinger of a long term trend. But family offices nevertheless need to address the inflation topic, using a long term and multi-faceted approach

The inflation outlook: don't extrapolate the recent spike

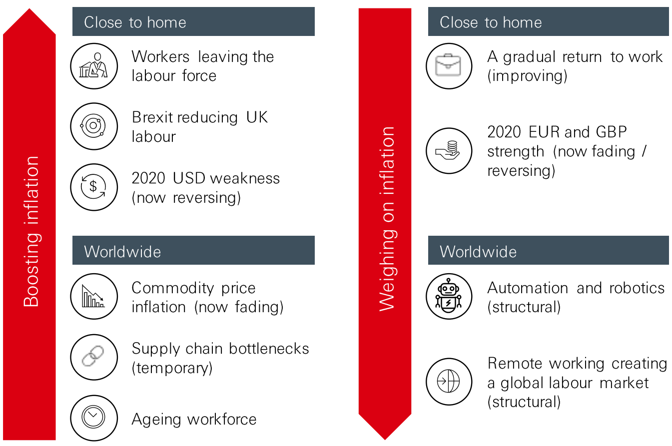
For several decades, inflation has not been a problem for investors, as most assets comfortably exceeded inflation



Inflation has risen from very low levels, especially in the US. We do not think this is the start of a trend



Some of the causes of inflation are short term in nature, and global forces are generally deflationary



Sources: Bloomberg, HSBC Private Banking as at 15 September 2021. Past performance is not a reliable indicator of future performance.

Inflation has not been a major structural topic for investors in the US or Europe for many years until now. CPI has been so subdued that it has fallen short of central banks' targets. This pushed them to pursue a very accommodative monetary policy, which has pushed up asset prices (see left). Cash rates exceeded inflation from 1980 to the great financial crisis, but real rates are now negative. The takeaway: investors have been beating inflation easily, as long as they were invested.

Is this about to change, and should we worry about the recent inflation spike?

We have discussed the 6-12 month outlook for inflation at length in many other publications. As our infographic shows, short term and domestic factors are currently boosting inflation. There are clear bottlenecks in restauration for example, as the economic reopening boosts demand, creating labour shortages. In manufacturing, inventories are low, and there is a shortage of some inputs, boosting inflation there too. It is not clear when exactly supply will match demand in these areas and inflation may remain elevated for several months, but it would be very surprising if supply is still lagging demand 12 months from now.

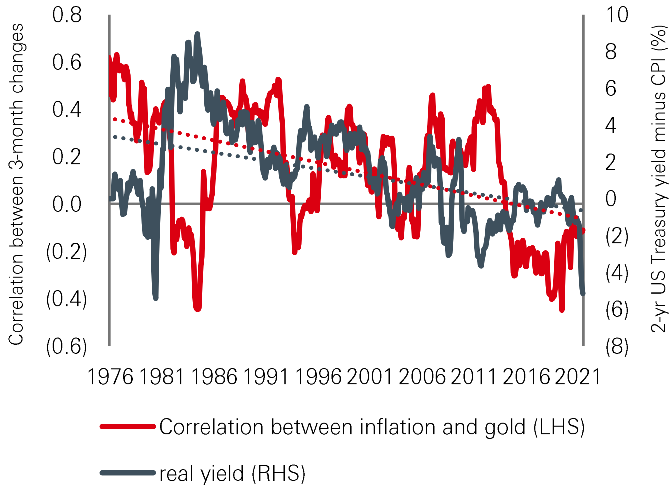
The longer term inflation outlook is still structurally low, in our view. The shift to an increasingly online economy means that workers face increased global competition, which should cap wage growth. Meanwhile advances in automation – accelerated by AI, 5G, robotics, fintech etc – should allow firms to manage their wage bills. Technological advances also allow consumers to compare prices before buying, reducing the scope for rapid price rises.

So our long term outlook for inflation is benign. We expect CPI inflation to come down from its current elevated level and average 2.3% in the US (close to market expectations), 1.9% in the UK and 2.1% in Hong Kong in the next 10 years.

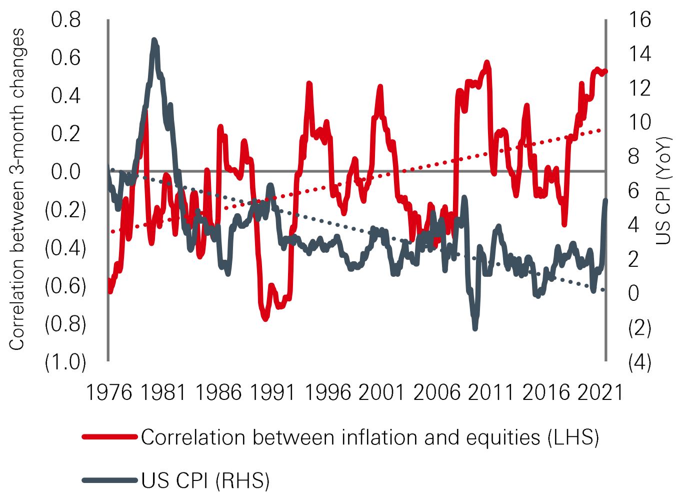
For family offices, it is prudent to position for somewhat higher inflation, compared to recent years. Central banks do not want inflation to remain below their target forever and the Fed will tolerate an inflation overshoot as long as inflation averages 2%. As for governments, they would welcome some inflation to help reduce the debt load. But while we are prudent, the recent spike should not be seen as a signal that inflation will run away, or that interest rates and bond yields will spike from here.

How good are the traditional inflation hedges?

Gold has been more closely linked to real yields than to inflation, but it is still a valuable diversifier



Equities like 'good inflation' – i.e. when inflation rises from a depressed to a more normal level



Real estate sensitivity to inflation

Real Estate CPI Elasticities

Property type	Income	Value
Retail	1.02	1.07
Industrial	0.70	0.91
Apartment	0.56	0.98
Office	0.18	0.74

Sources: Bloomberg, Massachusetts Institute of Technology study, HSBC Private Banking as at 15 September 2021. Past performance is not a reliable indicator of future performance.

Family offices typically look at DM and EM equities, gold, inflation linked securities and real estate to protect their portfolio against the risk of rising inflation. Recently, a very small proportion are also looking at cryptocurrencies as a potential inflation hedge in portfolios.

To test whether these are good strategies, the typical approach is to look at historical correlations of asset class performance vs inflation. For cryptocurrencies, that approach is not possible given the lack of a sufficiently long history. For other asset classes, historical averages can ignore the fact that **correlations change over time**, and it is important to know why they are changing.

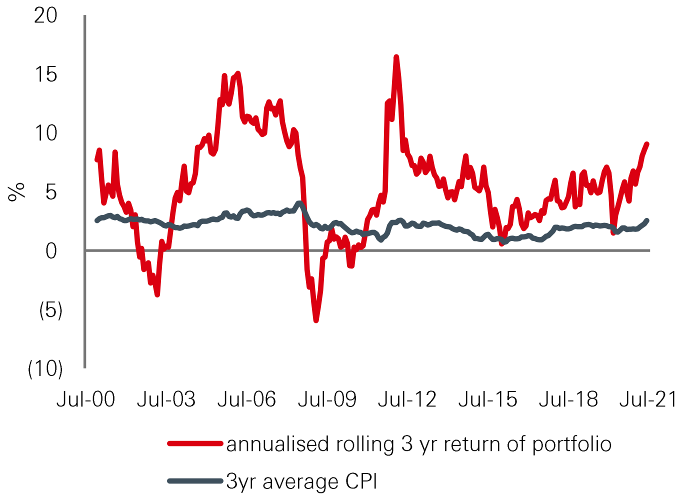
Gold's correlation with inflation, for example, has moved to negative territory, causing some to question gold's credentials as an inflation hedge. But inflation has been far below historical averages in recent years (until recently), and thus less of a driver of gold performance. Instead, gold has mainly been driven by falling real yields, resulting from quantitative easing and low structural growth. The end to QE should halt the fall in real yields, but they will still remain low due to the large debt pile (as this should weigh on growth and increase the impact of any rate hike). Other factors should take over as the main drivers of gold prices and we think **gold's correlation with inflation will progressively turn positive again.**

Meanwhile, the positive correlation between equity returns and inflation has further increased. In our view, this is due to the fact that inflation has been so low in recent years, so almost any rise is welcome. **When inflation rises from depressed to more normal levels, equities tend to benefit strongly.** EM equities tend to do well if the cause of higher inflation is commodity price appreciation (often linked to EM being a strong engine of global growth), as long as US monetary policy remains accommodative.

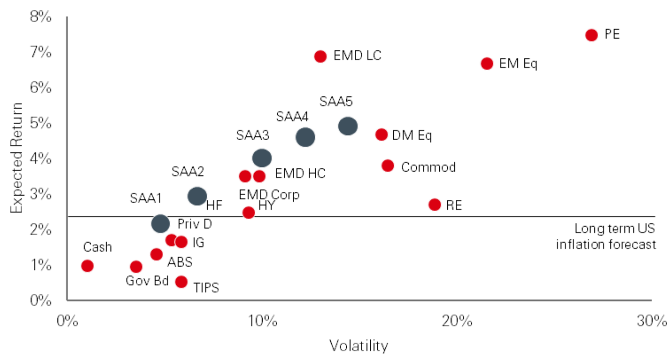
For **real estate**, academic studies suggest that values continue to be strongly related to inflation. As for rental yields, some leases are linked to inflation, while long fixed leases will offer little or no protection against inflation, unless indexed with price rises. Residential property is relatively closely linked to inflation due to the high share of owners' equivalent rent in CPI (32.7% in the US). Retail property returns generally show good correlations with inflation as well, but this is somewhat lower for commercial property. In any case, real estate's link to inflation only works in the long term, and many other drivers such as interest rates, supply and demand have an important impact. If inflation is linked to strong economic activity, real estate demand often increases with it, and higher construction costs often restrict supply.

How to beat inflation: stay invested and address upside risks

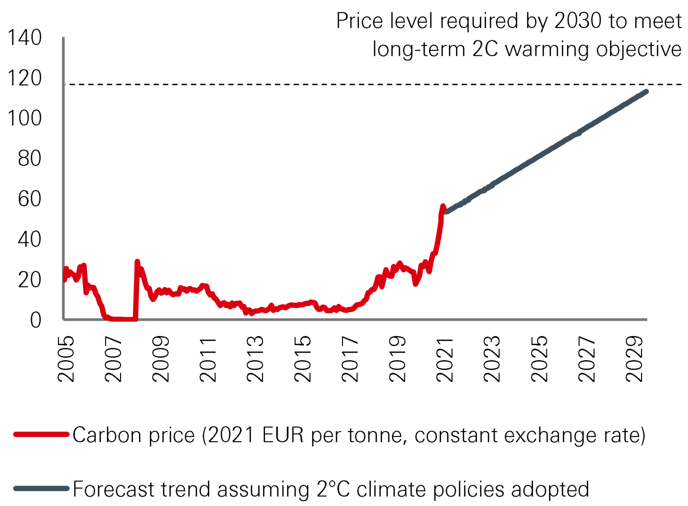
Historically, a diversified portfolio has outperformed inflation over almost any 3-year period



Our forecasts suggest that diversified portfolios should outperform inflation in the future too



Risks to the benign inflation scenario: will the rising cost of carbon raise the cost of goods and services?



Sources: Bloomberg, HSBC Asset Management, HSBC Private Banking as at 15 September 2021. Past performance is not a reliable indicator of future performance.

How can you beat inflation when one of the traditional inflation hedges – inflation linked securities – has such negative real rates? The best starting point is staying invested in a **well diversified portfolio that includes real assets** such as developed and EM equities, inflation-linked bonds, gold and real estate among other assets. Over medium-term and long term holding periods, a portfolio that reflects our strategic asset allocation (SAA) mix rarely underperforms inflation. The two exceptions are the credit crisis and the internet bubble, which were risk-off events, not inflation shocks. **Re-weighting a standard SAA** to include more real assets is possible if inflation is a family office's primary concern, but this may move the portfolio further away from the efficient frontier. Most family offices will be able to **take at least a 3-year view**, and this is important, as beating inflation over shorter term periods is not as obvious and can be erratic.

Looking ahead, diversified portfolios should continue to outperform inflation. Most asset class return forecasts are above our inflation forecast, with the notable exception of TIPS, as real rates are currently negative. Apart from the lowest risk portfolio, our SAAs for the four other risk profiles should also beat inflation. Companies' margins are currently near record levels, and inflation could pose a risk. Hence, we believe a **bias towards quality stocks** with strong margin power makes sense.

Where could inflation surprises come from?

The potential impact of climate change and sustainability on asset returns and inflation are hotly debated topics. Products and services generally do not yet incorporate their environmental cost, but this is bound to change, either through legislation or as companies will start to charge through rising carbon costs. Investors can adapt to this by looking at **strategies linked to EU carbon pricing** or by considering **natural capital strategies,** which may see more interest as investor interest in sustainability increases, and the regulatory focus intensifies. Climate change could also raise food prices, and investments in **climate adaptation solutions** (resilient crops, flood defences etc) should do well. Sustainable investments should address both climate mitigation and adaptation and rising carbon costs could boost investor interest in the **circular economy**.

Another risk is that of more durable wage inflation, if workers start to push back against the very low share of wages compared to GDP or governments see an increase of the minimum wage as a step towards a fairer society. If wage increases were to accelerate, companies will react by investing in **automation**, which is an investment theme of ours and should see good structural demand.

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