Interest rate turnaround and inflation

Hedge Funds, Liquid Alternatives, and Commodities could be profiteers - investors expect geographical shifts in asset allocation

Februar 2023

Executive summary

Rising interest rates and high inflation impact institutional investors' strategic asset allocation (SAA). However, effects vary depending on the respective alternative asset class. Representative data from our BAI Investor Survey 2022 and BAI Member Survey 2022 show that investors and asset managers see **Commodities as the alternative asset class benefiting most from the current environment.** In line with other tangible assets, they are technically interconnected to inflation. Also, in the current volatile environment with high downside risks but the constantly existing possibility of dynamic market recoveries, alternatives to long-only strategies are seen to offer good opportunities.

Therefore, **Hedge Funds and Liquid Alternatives are widely regarded as possible major profiteers of the interest rate turnaround and inflation.**

Current data also suggest a break in the negative trend regarding the importance of Hedge Funds and Liquid Alternatives in SAAs, although not yet far advanced. The experts' voices in interviews support the findings from data of Commodities, Hedge Funds, and Liquid Alternatives being relative profiteers. However, they derive distinctions between strategies and sub-strategies within the Hedge Fund sector. In this context, t**rend-following- and macro strategies were considered advantageous** in the inflationary environment.

The analysis of benchmarks for strategies and sub-strategies shows that Hedge Funds considerably outperformed the MSCI World in 2022, a year characterized by rising inflation, interest rate rises, and high volatility. Also, we could observe a significant variance between different Hedge Fund strategies and sub-strategies. For example, relying on momentum-driven market shifts with trend-following sub-strategies generated the highest performance among all sub-strategies. However, looking at the big picture, we can see in the data that Hedge Funds, especially trend-following sub-strategies, historically proved useful in times of market downturns and high volatility, which is not necessarily connected to an inflationary environment.

Furthermore, we show that the **current geopolitical context**, and risks linked to the macroeconomic environment, also impact Alternative Investments' **geographic asset allocations**. For example, according to the BAI Investor Survey 2022, most LPs expect **higher allocations in the USA**, and a majority sees **lower allocations in China**, for which we discuss reasons.

Introduction

As BAI Investor Survey data in the past years show, AI is becoming increasingly popular in institutional investors' portfolios. This development coincided with a historically unique monetary policy environment of „quantitative easing."

Central banks also had this leeway against the background of low inflation rates well below the targeted 2%. During this phase, the „cheap money" policy could be seen as a driving force behind the positive development of both liquid and illiquid asset classes. In particular, tangible assets such as real estate recorded enormous price increases. Monetary policy also led to the need for institutional investors to focus on alternative asset classes to achieve set return targets. According to the BAI Investor Survey 2021, the low interest rate environment is therefore named one of the central factors for the attractiveness of AI (44%). Other factors, such as an „attractive substitute to bonds" (25%), a „good risk-return ratio" (74%), and „portfolio diversification" (88%) as drivers of AI, are also related to monetary policy, as interest rates and inflation influence the absolute and relative performance of asset classes. By contrast, inflation hedging played only a minor role as a motivation for AI investments (17%).

However, it is becoming apparent that **the post-Covid world could be under a completely different monetary policy sign.** Ultra-expansionary monetary policy, increased consumer demand due to strong fiscal stimulus, the lifting of Covid restrictions, the catch-up of postponed consumption, supply bottlenecks, and commodity price increases led to rapidly rising consumer price inflation rates. In addition, the Russian invasion and ongoing war in Ukraine led to further commodity and energy price increases in an already highly tense environment. However, the consequences are still not foreseeable, and the exact impact on monetary policy remains unclear.

In any case, a change in monetary policy and inflation will influence alternative asset classes somehow. Therefore, the question of the possible impact on **institutional investors' SAAs is highly relevant, also from GPs' perspectives.**

Do the interest rate turnaround and inflation impact German institutional investors‘ SAAs?

To get a general picture of the controversial issue of the influence of interest rates and inflation on institutional investors‘ SAAs, in July and August 2022 we conducted a representative survey among LPs and GPs on the topic. However, results paint a very uneven picture of whether the current inflation trend and the (expected) interest rate steps of the ECB are leading to shifts in the SAA of LPs between traditional asset classes and AI.

How GPs and LPs see the impact on SAA

Results show that a significant majority (about 2/3) of LPs do not plan to shift SAA between traditional asset classes and AI due to the expected inflation and the ECB‘s interest rate moves. For those investors who expect shifts, it‘s about evenly split whether they expect to invest more heavily in AI or traditional assets. The situation is clearly different on the asset manager side: More than 60% assume shifts between AI and traditional within SAA. The majority of those GPs who expect shifts see AI‘s importance increasing in SAAs (Figure 1).

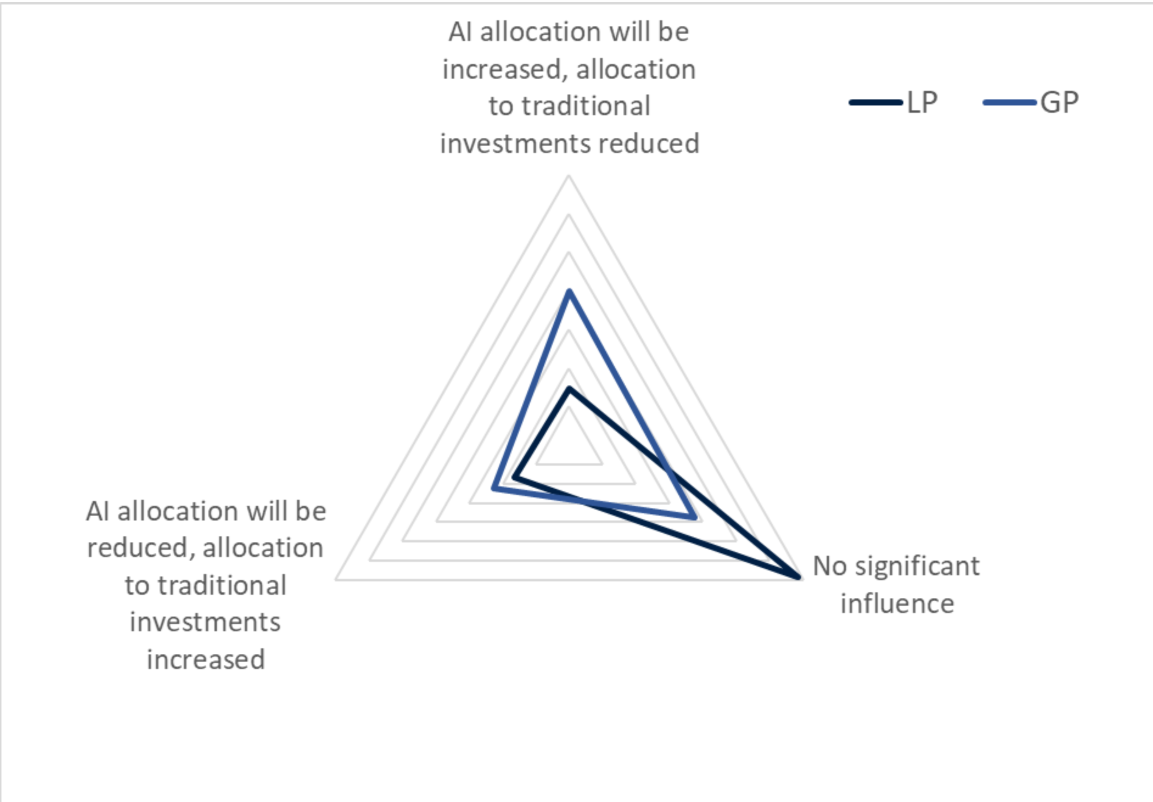

Figure 1: Do the current inflation trend and the (expected) interest rate steps of the ECB lead to shifts in SAA from traditional asset classes to AI?

Three things, in particular, are interesting about the results:

- A significant difference in expectations among LPs and GPs, respectively.
- Ambiguous results on whether shifts in SAA between AI and traditional assets are expected.
- Differences in the sentiment of whether AI or traditional assets will benefit, in the case shifts are expected.

For observed differences in expectations between LPs and GPs, there are multiple potential explanations we can only hypothesize on. For example, asset managers could have higher awareness regarding the potential impact of the monetary policy turnaround and inflation than investors. However, their opinion could be driven from a theoretical point of view, and investors in practice might not yet be able to judge whether changes are necessary and, if so, in which direction. We are currently in a very dynamic environment, and LPs need a long-term perspective. Due to asset liability management, GPs usually have a shorter time horizon than LPs.

Also, the perception might be driven by structural differences, like the investor type and individual investment targets. Therefore, further individual assessment and dialog are necessary to understand the perceptions of LPs and GPs on potential impacts on SAAs.
Reasons for the other two results, ambiguity in the question of whether LPs and GPs expect changes in SAAs and if traditional assets or AI will gain importance, will be discussed in the following[1].

A) Expectations of inflations' time horizon as a reason if shifts in SAA are expected

Concerning the result mentioned above of significant differences in assessing whether current developments are expected to lead to shifts in SAAs, we argue the expectations regarding the time horizon of higher inflation and interest rate level play a crucial role.

In this context, it is crucial to differentiate between temporary and persistent inflation shocks.

Strategic asset allocations of institutional investors are fixed over long periods, which can vary individually depending on the type of investor. Still, a period of about three to five years can be assumed as a reasonable guideline, even if some investors have a longer time horizon. The strategy is oriented towards long-term success and does not pursue the objective of timing market fluctuations. If trying to time markets and profit from short-term swings does promise to generate excess returns is unclear. The tendency in the discourse is clearly to prefer a long-term view (Antoons 2018).

For this reason, **higher inflation and adjusted monetary policy only become relevant from an investor perspective when it is a long-lasting phenomenon.** Statements of investors at the BAI Alternative Investor Conference in May 2022 also pointed in the direction that hedging against unexpected jumps in inflation does not play a role in their SAAs.

Asset pricing is long-term, and inflation expectations and interest rate developments are more important than short-term peaks. If certain factors lead to price increases in goods prices, but it is already assumed that these factors will not persist, the price increases in the goods markets only have a limited influence on asset prices (Neville et al. 2021). Therefore, the first decisive question if there is a necessity for SAA adjustments is whether a longer-lasting price increase in goods prices and interest rates is anticipated and thus has to be priced in. Only in this case can it be assumed that a new market equilibrium with a changed monetary policy framework will be established. This new permanent market equilibrium would lead to adjusted asset prices and changed performances. In this case, institutional investors might be forced to adjust their SAAs.

Discourse on whether inflation is transitory

Whether the observed inflation is a temporary or persistent phenomenon is controversial. In particular, the ECB and Christine Lagarde argued for a long time that the higher inflation figures observed were a temporary phenomenon caused by the specific situation of the Covid-related supply chain problems. Also, a rapid flattening of the inflation figures was predicted, particularly due to base effects. Central to the question of whether inflation will be sustained or is a temporary phenomenon is to what extent rising prices lead to higher wages, which in turn cause higher prices – a so-called wage-price spiral.

A survey of experts by the Börsen-Zeitung shows a wide range of opinions on the subject: For the Euro area, one argument against such a wage-price spiral is that inflation here is mainly driven by energy and food prices, which only have a limited impact on other sectors. Moreover, an emerging weakening of the economy, also caused by the Russian war of aggression in Ukraine, could dampen demands for higher wages. On the other hand, there is the argumentation that inflation is not driven solely by energy prices and thus cannot be regarded as a short-term phenomenon, and ECB could have misjudged the situation. (Schrörs 2022).
Also, the opinion could prevail that factors which have kept inflation low for years – globalisation, the deflationary effect of technical progress, etc. – are gaining the upper hand again in relative terms and trumping exogenous factors that caused inflation shocks in the short term.

1 Full survey results will be published with the BAI investor Survey 2022.

Thus, the expectations regarding the time horizon of inflation and interest rate changes are crucial for the question of whether LPs and GPs expect shifts in SAA or not. However, the time horizon and strategy depend on the investor type, and differentiates between GPs ans LPs, as shown above. Therefore, the longer the time horizon relevant for SAAs, the less the need or impulse could be to adjust SAAs, which could explain part of the discrepancies in the responses. A more detailed analysis of the correlation could be made in subsequent publications with a more thorough evaluation of the survey results by investor type and through individual expert interviews with investors from various sectors.

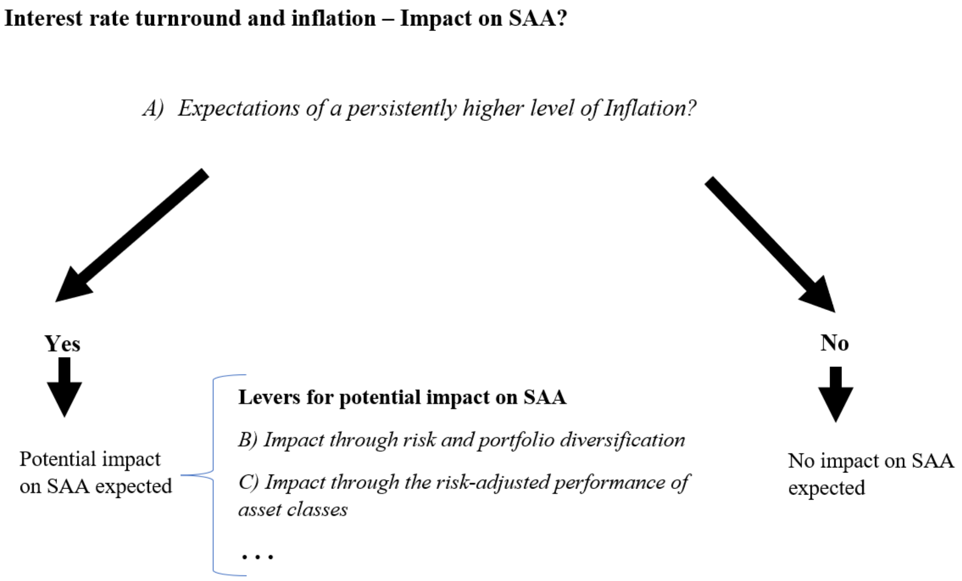

Figure 2: Factors relevant to the question of whether interest rate turnaround and inflation have an impact on SAAs

B) Impact on risk and portfolio diversification on AI – the stock-bond correlation

In case longer-lasting changes in the macroeconomic environment are assumed, and shifts in SAAs are expected, the question arises of which factors may influence the allocation between traditional assets and AI. Therefore, we look at two main characteristics responsible for asset allocation: **risk/diversification and performance.**

In the BAI Investor Survey 2021, the most important reason to invest in AI was „portfolio diversification," with 88%. Also, 74% of the respondents answered that a „good risk-return ratio" is a central factor for the investment in AI, and 25% of the respondents named it an „attractive substitute to bonds." Therefore, it is relevant to analyse the impact of the changing environment of monetary policy and inflation on the importance of AI for diversification through bond substitution.

The standard option for portfolio diversification is between stocks and bonds. Over the past 20 years, the performance of stocks and bonds has been negatively correlated – a negative stock-bond correlation (hereafter SBC). This negative SBC is crucial for investors to have risk diversification only using stocks and bonds.

The mechanism behind this is that in the event of positive growth news, stocks rise in value due to higher expected cash flows. But **this also entails the expectation of higher inflation.** This expectation of higher inflation reduces the value of the fixed nominal cash flow of bonds, which is why their prices fall. Negative growth news, on the other hand, lead to a flight to the safe haven of bonds and stocks loose relevance due to lower expected cash flows. In conclusion, stocks and bonds have different implications regarding growth news. **Expectations and news of higher inflation** can harm equities to the extent that the underlying companies cannot increase their cash flow proportionally with the inflation. Therefore, a self-reinforcing mechanism could be observed, driving the negative SBC.

Using data from 1972 to 2021, Brixton et al. (2022) also show empirically that stocks and bonds had opposite sensitivities to economic growth. However, they showed similar sensitivities to inflation environments – with positive Sharpe ratios in scenarios of inflation down and negative Sharpe ratios in cases of inflation up for both stocks and bonds.

But Brixton et al. (2022) and Markowicz (2022) prove that a negative SBC continuously exists only for about two decades. Using five years and ten-year rolling correlation between US equities and bonds, it is visible that the SBC was positive for most periods since 1900. To explain this phenomenon, Brixton et al. (2022) argue the relative importance of growth and inflation news is crucial for the sign of the SBC. **Bonds are stronger diversifiers in periods of dominant growth news, while they reduce the capability to diversify in periods of dominating inflation news.**

However, also other drivers can be discussed. For example, monetary policy changes could impact stocks and bonds in the same direction and push the SBC towards positive territory. But, abrupt changes in monetary policy are primarily reactions to inflation shocks, which makes them challenging to consider separately.

Markowicz (2022) argues not the absolute level of interest rate is crucial for changes in the SBC, but interest rate volatility. He empirically explains variation within the negative SBC since the early 2000s with interest rate volatility.

Also, the low interest rate used to be beneficial for both stocks and bonds but did not change the sign of the SBC. Possibly this was because the „low interest rate news“ was dominated by positive news about growth and not associated with the possibility of higher inflation. Expectations regarding inflation were continuously low until last year, which was a major driver for the negative SBC.

Markowicz (2022) gives empirical evidence for the theoretical claim of a major impact of inflation on SBC, showing that since 1926 the **equity bond correlation was positive 98% of the time the inflation exceeded 3% a year on a five-year basis.**

This result is in line with the considerations above of the potential impact of persistently higher inflation on SAAs. Moreover, since persistent inflation rates of more than 3% seem to be possible at present, these examinations are central from an investor‘s perspective because they influence the degree of diversification of a portfolio using stocks and bonds.

Currently, we can observe that stocks and bonds moved in the same direction in 2022, indicating the SBC became positive. We could observe a situation with losses for stock and bonds in two consecutive quarters, which is the case only for the second time in four decades (Man Institute 2022; Miller 2022; Solberg 2022). It remains to be seen if this is a longer-lasting phenomenon, forcing investors to react to balance the portfolio diversification.

Possible measures that investors could take are an increase in AI – in particular alternative assets with low correlation to traditional assets and a low extent of underlying macroeconomic factors with stocks and bonds in common. **From the spectrum of privat markets, infrastructure in particular shows a low correlation to public markets in the event of market downturns. Real estate can play a role too (Bunnenberg & Kaiser 2021). Also, commodities show low correlation with stocks and bonds** and liquid alternatives and hedge funds can play a crucial role too because they can be designed with low correlation to the stock market benchmark – ideally even being market neutral (Brixton et al. 2022).

Therefore, we argue:

Less diversification potential of stocks and bonds increases the necessity of a third pillar in SAAs even more – Alternative Investments.

C) Outlook: impact on the risk-adjusted performance of asset classes

Furthermore, as mentioned above, the second channel through which longer-lasting higher inflation and interest rate could impact SAAs is through uneven impact on the risk-adjusted performance of different asset classes, also within the spectrum of alternatives. An intuitive assumption that equity categories, as tangible assets, offer protection in an environment of higher interest rates and inflation, whereas debt categories are subject to more significant risks, is widespread.

However, a closer look shows that the relationship between inflation & monetary policy, on the one hand, and the performance & attractiveness of asset classes, on the other hand, is much more complex in reality and depends on numerous individual factors. For instance, higher inflation can harm Real Estate Equity or Infrastructure Equity projects in cases where they cannot forward higher costs with higher rents or user fees. Also, a target conflict between market risk and inflation risk may exist, for example, if an energy infrastructure object has fixed contracts to sell produced electricity. On the other hand, Corporate Private Debt, Infrastructure Debt, and Real Estate Debt often have floating interest rate structures negotiated individually on every asset. Therefore, in the case of inflation-linked floater rates, they may offer inflation protection to some extent. So, a detailed analysis is necessary to identify asset characteristics through which inflation and interest rate levels influence individual assets. We will provide an overview of levers of inflation and interest rate on performance and relative attractiveness by asset class in upcoming publications.

Furthermore, in the context of scenario analyses, the influence of economic development in the interplay of interest rates and inflation needs to be addressed, and the impact on traditional assets has to be taken into account. We also conducted a representative survey among LPs and GPs regarding the expected impact by asset class. The findings from the representative survey and the theoretical analysis will be used to go into greater depth with expert interviews, through which we aim to better understand the expected impact on different asset classes in praxis.

References

Antoons, W 2018, *Market Timing: Opportunities and Risks*. Available from: https://caia.org/sites/default/files/market_timing_open.pdf.

Brixton, A, Brooks, J, Hecht, P, Ilmanen, A, Maloney, T & McQuinn, N 2022, *The Stock/Bond Correlation. Drivers and Implications*. Available from: https://www.aqr.com/Insights/Research/Alternative-Thinking/The-Stock-Bond-Correlation.

Man Institute 2022, T*ime changes all things – including factors; stock/bond correlations mean rates may still dictate returns; and the divergence across emerging markets*. Available from: https://www.man.com/maninstitute/views-from-the-floor-2022-august-16.

Bunnenberg, P & Kaiser, LE 2021, Der Diversifikationseffekt von Alternative Investments in Krisenzeiten. Tail Risk Mitigation im institutionellen Portfolio. Available from: https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/Der_Diversifikationseffekt_von_Alternative_Investments_in_Krisenzeiten.pdf.

Markowicz, S 2022, *Why is there a negative correlation between equities and bonds? We look at what drives the equity-bond correlation, why it changes over time and what it means amid the current uncertainty over interest rates and inflation.* Available from: https://www.schroders.com/en/hk/institutional-service/insights/thought-leadership/why-is-there-a-negative-correlation-between-equities-and-bonds/#:~:text=Earnings%20are%20positively%20related%20to,should%20have%20a%20negative%20correlation.

Miller, R 2022, *Why Are Stocks And Bonds Both Down?* Available from: https://www.forbes.com/sites/rmiller/2022/08/12/why-are-stocks-and-bonds-both-down/?sh=58932ab83a31.

Neville, H, Draaisma, T, Funnell, B, Harvey, CR & van Hemert, O 2021, *‚The Best Strategies for Inflationary Times‘*, SSRN Electronic Journal.

Schrörs, M 2022, ‚Das raten Top-Ökonomen der EZB‘, Börsen-Zeitung 08 June. Available from: https://www.boersen-zeitung.de/konjunktur-politik/das-raten-top-oekonomen-der-ezb-fc325cdc-e73f-11ec-b803-f53ae11f0290.

Authors

Florian Bucher

BAI, Consultant
Alternative Markets

+49(0)228-96987-15
bucher@bvai.de

Imprint:

Responsible:

Bundesverband Alternative Investments e.V. (BAI)
Poppelsdorfer Allee 106
D-53115 Bonn
Telefon: +49(0)228-96987-0
Fax: +49(0)228-96987-90