Inflation – Friend or Foe

Inflation, the oil for the economic engine

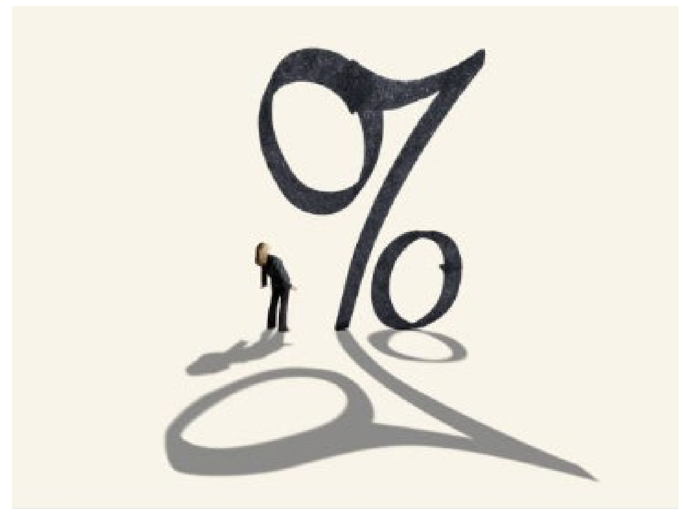
One of the main macroeconomic concerns today is inflation. For most of 2021, monetary authorities argued that inflation will be transitory and so, as a result, they felt that adjusting monetary policy was not required. However, in 2022, under the pressure of accelerating inflation on the back of higher commodity prices impacted by the war in Ukraine, monetary authorities were forced to adjust their policy and start raising interest rates.

Why are we and financial markets so worried about inflation? Inflation is like the motor oil in a car in that to drive smoothly the engine needs oil. However, too much or not enough oil creates problems and potentially prevents the engine from running. Interest rates as the 'price of money' are closely correlated with inflation and rise when inflation picks up to avoid declining or negative real interest rates (interest rates minus inflation).

Rising prices on the demand side reduce disposable incomes, hurt consumption, and creates demand for higher wages. As soon as interest rates start to rise, these effects are exacerbated, which puts further pressure on demand. Apart from being impacted by reduced demand, the supply side experiences pressure on margins by increasing input prices (commodity prices, material prices etc.) depending on how much of the higher prices can passthrough to the end consumer. Furthermore, wage increases, and rising interest rates put extra pressure on corporate earnings. A scenario of rising inflation and interest rates jeopardizes economic growth and can ultimately lead to a recession. Monetary authorities play a key role in managing this process primarily using interest rates to control demand and indirectly prices. However, since interest rates are a very blunt tool that only indirectly impacts inflation with a time lag, it is a very delicate strategy, comparable to steering a large oil tanker.

So where are we in the cycle?

Figure 1 shows the development of inflation in the US and UK since 1981. We see that inflation is not only closely correlated globally but is at its highest levels in decades. At 8.5% in the US, prices have not risen this quickly in 40 years. So clearly this is causing serious concern for monetary authorities and financial markets.



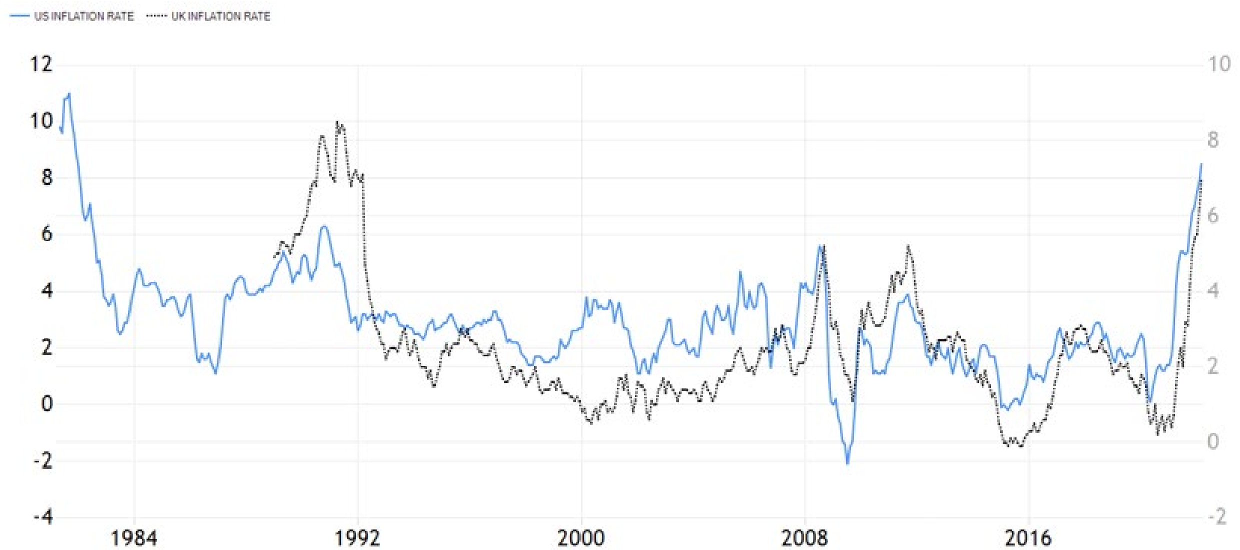


Figure 1: US & UK Inflation Rates[1]

If we look at long term interest rates, we can see that despite the rise in inflation, interest rates historically are still at a very low level. If we directly compare the US inflation rate with the Fed Funds rate (*Figure 3*), we can conclude that historically the interest rate instrument was used to directly respond to changes in inflation.

However, despite the current rally in prices, official rates are indeed still low and monetary authorities have been very slow to respond. Reasons for this include the flawed assumption that inflation would be transitory, the fact that monetary authorities are now using additional instruments (buying bonds) compared to the past and finally worries about disrupting the fragile economic recovery coming out of the global pandemic.

Figure 2: US & UK 10Y Government Bonds[2]

[1,2] Source: Trading Economics

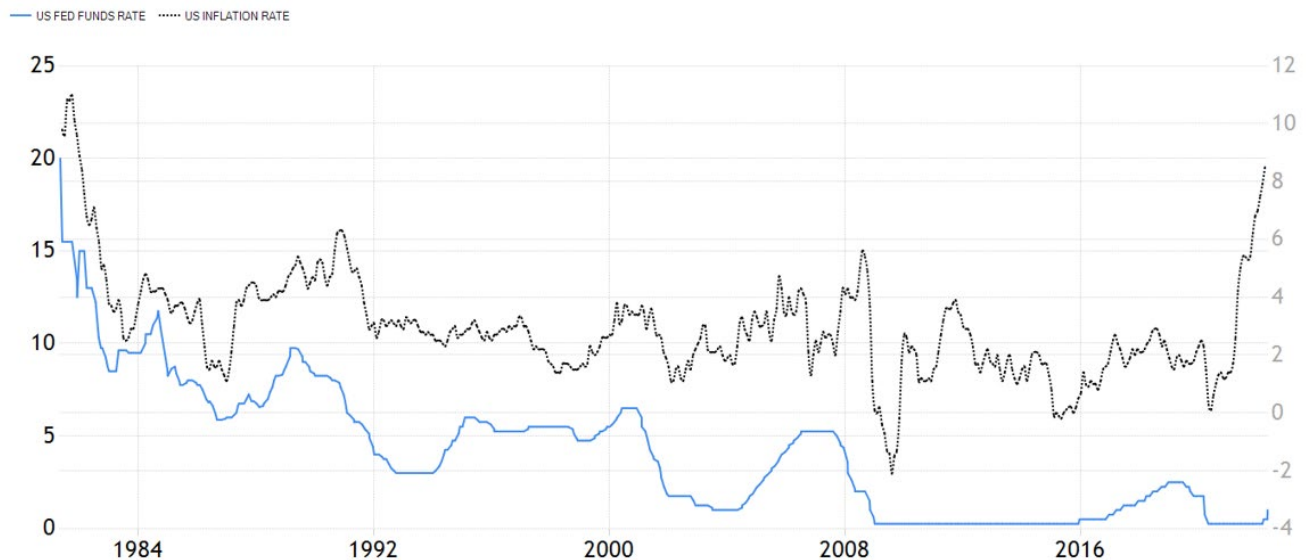


Figure 3: US Fed Fund Rate & US Inflation Rate[1]

Natural Resources and Real Assets

Financial markets are very nervous as price levels and valuations are historically high. The low level of interest rates has lifted valuations especially for growth assets to historic levels and with interest rate expectations rising markets have responded strongly. At the same time correlations among asset classes are rising, which is a problem for investors looking for stable uncorrelated returns in their investment portfolios. Add the war in Ukraine, which creates serious supply shocks in energy, food and fertilisers, and it is clear that we are entering into a period of increased risk and high uncertainty.

In general, but now in particular, investors should be looking for investment opportunities in asset classes that are less correlated with general capital markets. This means looking for investments that offer inflation protection, which will protect portfolios during the current environment. Institutional investors, such as insurance companies and pension plans, typically have liabilities that are long term linked to inflation.

Periods of uncertainty makes predicting market levels extremely difficult. It is therefore less relevant, and investors should be focusing on finding opportunities that will increase their true diversification. The only prediction that can be made with a higher probability is that the direction of inflation and interest rates in the medium term will be higher, which creates an increased recession risk.

Private equity, by design has a long-term investment horizon. But investing in companies exposes investors to most of the same economic exposures as liquid markets. For that reason, we believe that the focus of investors today should be on real assets, such as infrastructure and natural capital. The strong performance of real assets during inflationary times is rooted in the way these businesses operate.

Real assets provide an asset backing that over time provides a hedge against rising inflation. They are often connected with rising income streams that usually has some indexation ‘baked’ in, which provides income and further stability to investors. For example, the value of real estate buildings is largely tied to its replacement cost, which is linked to the cost of materials and labour. Also, real estate cash flow growth has historically raised at a higher rate than inflation. Similarly, forestry and infrastructure businesses often have strong pricing escalators tied to inflation.

Commodity prices are usually a leading indicator for rising demand. The housing market in many countries suffers from having a structure excess of demand

[1] Sources: Trading Economics

relative to supply, which leads to increasing house prices and building costs.

Forestry directly benefits from these developments as timber is a crucial building material for the construction sector. The pressure to switch to renewable energy is another positive factor. Many infrastructure investments in this area offer attractive long-term opportunities and often benefit from help in the form of governments offering index linked cash flow streams.

Finally, real assets also offer downside protection versus public equities since, as long-lived hard assets, they typically possess tangible and intrinsic value from their basic utility.

Where are we heading?

Even if prices ultimately taper off, it is clear that the Goldilocks period of stable low inflation and low interest rates is behind us. Capital markets are still adjusting to this new reality and investors will have to look for more diversification and monitor their exposures to inflation, recession risk, and credit risk. Real asset and infrastructure investments with indexed cash flows are an increasingly important investment opportunity and can offers strong protection against these risk factors.

Our world is changing rapidly. With changing demand patterns, there is a growing need for new technologies, even in very traditional sectors like agriculture, where emerging managers are responding more quickly than established counterparts in offering attractive investment opportunities with sound ESG implementation.

These long-term changes in macroeconomic trends are an important reason why Astarte believes that the crossroad of real asset and natural resource investments opportunities, in combination with emerging managers offers highly attractive and sustainable solutions, is the sweet spot for investors over the coming years.

About Us:

Astarte Capital Partners LLP is an asset manager focusing on sustainable real assets across Europe and North America, primarily in mid-market opportunities within the areas of infrastructure, energy transition, natural capital and real estate.

Astarte aims to provide access for institutional capital in specialist areas of real assets that are supported by the major macroeconomic themes, such as demographic shifts, resource efficiency, technology evolution and climate change mitigation.

The firm's main investment strategy is to act as strategic investor and anchor capital to emerging managers and thematic investment platforms that can demonstrate strong track record and growth potential in their specific asset class. Astarte brings decades of asset management and investment fund formation experience with a strategy of working closely with and institutionalizing operating teams.

Contact Us:

Website: www.astartecp.com; Email: info@astartecp.com; Address: Michelin House, 81 Fulham Road London SW3 6RD, United Kingdom

Important Notice:

This presentation (the "Presentation") is intended for professional investors only and is made available by Astarte Capital Partners LLP ("Astarte"). This material is intended to be for information purposes only and is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. It is not intended to provide and should not be relied on for accounting, legal or tax advice, or investment recommendations. Reliance should not be placed on the views and information in this document when taking individual investment and/or strategic decisions. Past performance is not a reliable indicator of future results. The value of an investment can go down as well as up and is not guaranteed. All investments involve risks including the risk of possible loss of principal. Information herein is believed to be reliable but Astarte does not warrant its completeness or accuracy. Some information quoted was obtained from external sources we consider to be reliable and is clearly referenced. No responsibility can be accepted for errors of fact obtained from third parties, and this data may change with market conditions. This does not exclude any duty or liability that Astarte has to its customers under any regulatory system. Regions/ sectors shown for illustrative purposes only and should not be viewed as a recommendation to buy/sell. The opinions in this material include some forecasted views. We believe we are basing our expectations and beliefs on reasonable assumptions within the bounds of what we currently know. However, there is no guarantee than any forecasts or opinions will be realised. These views and opinions may change. The content is issued by Astarte Capital Partners LLP, 81 Fulham Road, London, SW3 6RD. Registered No. OC399991 England. Authorized and regulated by the Financial Conduct Authority FRN 812389