COHEN & STEERS

Getting Sensitive About Inflation

Allocating to Real Assets in a World of Rising Inflation Risks

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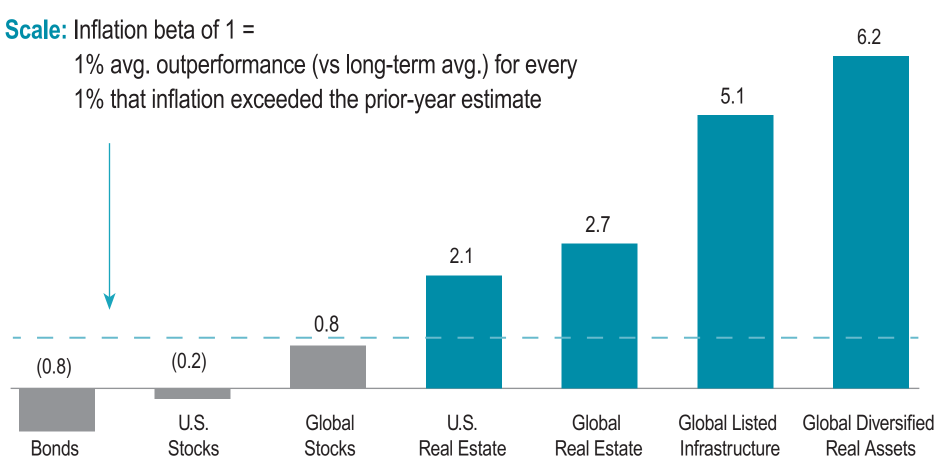
Amid a global wave of aggressive fiscal and monetary policies, many investors are considering how to position portfolios for inflation surprises—a scenario for which real assets have been historically well suited.

Are inflation expectations too low?
Though inflation may seem improbable in the near term, we see a growing probability of upside inflation surprises amid unprecedented government spending and central banks keen on driving inflation expectations higher.

Inflation often comes as a surprise
Past inflation tends to be a poor indicator of the future, highlighting the importance of a strategic allocation to assets that have historically outperformed in periods of unexpected inflation.

Real assets and inflation sensitivity
Real estate, infrastructure and other real assets have a history of attractive risk-adjusted returns, with varying strength of outperformance in periods of upside inflation surprises, particularly versus the performance of stocks and bonds.

Exhibit 1: Real assets are positively correlated with inflation surprises
Inflation beta since June 1991



At September 30, 2020. Source: Bloomberg, Thomson Reuters Datastream, Cohen & Steers.

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Are inflation expectations too low?

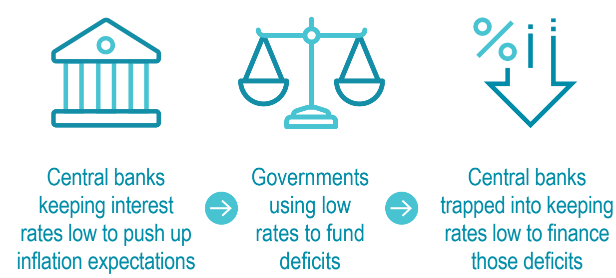
As the global economy climbs out of the 2020 recession, widespread unemployment and ample spare capacity suggest little risk of inflation in the near term. In fact, markets are betting that low inflation will be here for the foreseeable future, with so-called "breakeven inflation" rates in the Treasury markets pointing to sub-2% inflation in the U.S. through 2040.[1] However, at least some investors are taking note of the inflationary seeds being planted today, as seen in the increasing number of conversations with our institutional clients about long-term inflation risks.

The potential for higher inflation comes down primarily to a reinforcing cycle of low rates driving government spending, trapping central banks into keeping interest rates low to finance those debts.

Historic fiscal expansion

The fiscal response to the pandemic has been massive to date, and more help is likely on the way as policymakers seek to support employment and spending until a vaccine allows for a broader economic recovery. After witnessing the negative effects that austerity had on the post-financial-crisis recovery, many political leaders—including traditionally fiscal conservatives—have embraced higher deficits, seeking to drive stronger growth through vast public-sector spending.

Plans for unprecedented levels of fiscal spending over the next five years would, if implemented, add to already significant debt burdens. In the U.S., for example, total federal debt hit 135% of U.S. gross domestic product in the second quarter of 2020—and with additional fiscal relief measures in the works, debt could reach its highest level in the nation's history, including World War II. In the long run, more government spending is likely to drive stronger growth, allowing the economy to close its output gap more quickly, turning up the heat on inflation.



Going to monetary extremes

Ordinarily, we would expect higher deficits and debt levels to drive higher bond yields, as bond investors typically require a premium to account for the rising risk of default. That hasn't happened so far in 2020, partly because the aggressive approach to fiscal policy has been facilitated by equally aggressive central banks.

Many central banks are seeking to generate higher inflation expectations, and a quicker recovery will aid that effort. That means keeping interest rates lower for longer to run the economy "hot." These low interest rates may give governments added incentive to continue borrowing, long after a recovery is underway. Over time, we believe the combination of extreme fiscal and monetary easing could be tilting the risk of inflationary surprises toward the upside—perhaps sooner than investors expect.

> Instead of austerity and rising interest rates, governments today are talking about aggressive fiscal stimulus and low rates for years to come

(1) At September 30, 2020. Source: Bloomberg, Cohen & Steers. The breakeven inflation rate represents a measure of expected inflation derived from Treasury Constant Maturity Securities and Treasury Inflation-Indexed Constant Maturity Securities. The latest value implies what market participants expect inflation to be in the next 20 years, on average.

Inflation predictions are often wrong

Historically, predicting inflation with any degree of accuracy has been notoriously difficult. One possible explanation is that inflation expectations tend to be solidly rooted in the rearview mirror, influenced by recent experience.

An analysis of forward-year inflation expectations back to 1978 reveals that the outlook for the upcoming year had a 0.92 correlation with the trailing year's realized inflation rate. However, the accuracy of these forward-year expectations essentially amounted to a coin flip: realized inflation came within 100 basis points (to the upside or downside) only 49% of the time.[a]

The bottom line is that betting on the accuracy of one's inflation expectations, even over the near-term, is a risky proposition. Importantly, however, there are allocation options that offer inherent sensitivity to inflation, which, if implemented thoughtfully, may not require a sacrifice in long-term return potential.

0.92 correlation of forward expectations to past-year experience

49% accuracy of forward expectations within +/-100 basis points

Real assets and inflation sensitivity

Real assets have a history of helping portfolios during market conditions that tend to be challenging for both stocks and bonds, enhancing the diversification potential of traditional asset allocation mixes. One of these market scenarios has been the occurrence of unexpected inflation. This is particularly salient today, as we believe the risks of inflation may be as high as they have ever been from a portfolio perspective, with bond yields at historic lows and equity markets highly concentrated in high-duration large-cap growth stocks.

Whereas inflation surprises have historically had a mixed effect on stocks and bonds, real assets have demonstrated strong, positive correlations, indicating a tendency to deliver above-average returns when inflation exceeds consensus expectations. Investors who allocate to real asset strategies have the potential to benefit from distinct, inflation-linked economic drivers:

- **Real estate:** Higher inflation increases the expense of new construction due to higher costs for labor, land and materials, which is a positive for existing assets, as less supply supports higher occupancies and pricing power. Owners may also benefit from rising inflation through their ability to raise rents, increasing the value of their properties. At different points in a market cycle, pricing power can vary materially depending on the property sector and overall economic conditions. As we have seen during the pandemic, this can result in a wide difference in cash flow protection for different REIT sectors: data center, cell tower and self storage companies have generally maintained or increased rents, whereas retail and hotel operators have had to offer substantial concessions.
- **Infrastructure:** Cash flows and asset values may have direct or indirect links to inflation, such as rate escalators tied to inflation measures often seen in utilities and toll roads. Long-term economic growth may also drive higher throughput for these assets.

(a) 1/1/1978–9/30/2020. Source: Bloomberg, Cohen & Steers.

Data quoted represents past performance, which is no guarantee of future results. See Exhibit 1 for expected inflation calculation. See page 7 for additional disclosures.

- **Diversified real assets:** Multi-strategy portfolios include a mix of asset classes, such as real estate, infrastructure, commodities and natural resource equities. Natural resource producers generally benefit from higher raw material prices, potentially leading to higher profits. Commodities have the highest historical inflation sensitivity, frequently serving as direct inputs to inflation measures and responding to economic forces—such as supply constraints and changes in global demand—that often drive the prices of other goods.

The positive inflation association of these asset classes can be seen in Exhibit 1 (page 1), represented through an estimated "inflation beta." This measure assesses how each asset class has historically performed relative to its long-term inflation-adjusted average, depending on the degree to which realized inflation exceeded (or missed) the prior-year market estimate. The higher the inflation beta, the better the asset class has historically responded to periods of unexpected inflation.

For example, Exhibit 1 shows that U.S. REITs have historically outperformed their average return by 2.1% for every 1% of inflation surprise. A global diversified real assets blend—consisting for these purposes of equal parts global real estate, global infrastructure, global natural resource equities and commodities—outperformed by 6.2% in such periods. By contrast, stocks and bonds have either underperformed or have shown little response.

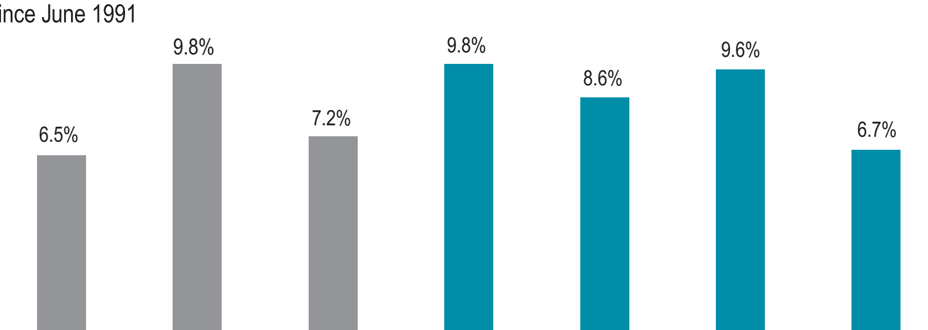
Where does gold fit in? Over the period shown in Exhibit 1, gold had an inflation beta of 2.4, confirming its reputation as an inflation-sensitive vehicle. Still, our research suggests gold is typically far more sensitive to moves in real interest rates and the U.S. dollar than to changes in inflation. And given its long history of high volatility, we believe gold is best deployed in combination with other real assets rather than as a standalone allocation for investors seeking specifically to enhance their portfolio's inflation sensitivity.

Attractive performance over full market cycles

Real assets' history of equity-like returns shows that their inflation sensitivity has not impeded their ability to deliver attractive returns over longer market cycles (Exhibit 2). Notably, the past three decades have

Exhibit 2: Real assets have delivered competitive returns

Annualized total returns since June 1991



	Bonds	U.S. Stocks	Global Stocks	U.S. Real Estate	Global Real Estate	Global Listed Infrastructure	Global Diversified Real Assets
Volatility	6.1%	14.5%	14.6%	18.7%	16.6%	14.2%	13.2%
Sharpe ratio	0.66	0.55	0.38	0.47	0.43	0.55	0.37

At September 30, 2020. Source: Source: Bloomberg, Cohen & Steers.

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been generally characterized by low inflation, indicating that high inflation has not been necessary for real assets to deliver attractive long-term returns. Furthermore, each of the real asset segments presented here exhibited higher or comparable Sharpe ratios compared with global stocks. Historically, this has meant that adding a real assets component to a diversified portfolio has helped to enhance inflation sensitivity without necessarily sacrificing potential returns—that is, provided it has been a held as a long-term allocation.

What's the tradeoff for adding inflation sensitivity?

Over much of the past decade, persistent disinflationary surprises have contributed to the underperformance of some of the most inflation-sensitive real assets, particularly natural resource equities and commodity futures. This is the other edge of the sword of inflation sensitivity: a greater likelihood of underperforming when inflation is unexpectedly low, especially when such surprises are enduring.

Looking to the next decade, with the prospect of upside inflation risks looming, we believe there is potential for stronger future returns across the commodity complex, an outlook further bolstered by the dis-investment that has occurred over the past five years, compared with the over-investment that took place following the financial crisis. Our analysis indicates that similar pressures, though to a lesser degree, are present in real estate and infrastructure, both of which are trading at below-average valuations relative to broad equity markets and comparable privately held assets.

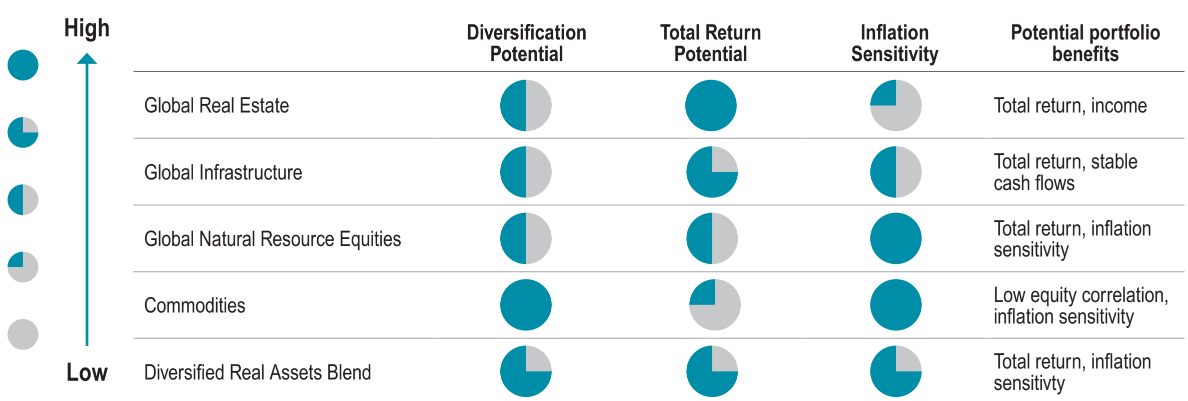
In our view, this suggests an opportunity for investors to enhance the inflation sensitivity of their portfolio while improving return potential as well. History tells us that mean reversion can be a powerful force. But turning it to one's advantage requires a long-term view. This is true for real assets as it is for any other long-term asset-allocation strategy.

Objective-based allocations to real assets

In our experience, investors considering an investment in real assets are often focused on balancing three main objectives: total returns, portfolio diversification and inflation sensitivity. The performance profiles of different types of real assets as shown in Exhibit 3 show the flexibility in various exposures and/or combinations that may make sense depending on specific portfolio objectives. Investors interested in greater levels of inflation beta may be more drawn toward a multi-strategy diversified real assets solution, whereas more total return-focused investors may be more interested in real estate or global listed infrastructure assets (Exhibit 3). Additionally, real assets tend to be effective portfolio diversifiers due to their distinct economic drivers.

Exhibit 3: Real asset characteristics

Qualitative criteria based on realized historical data since June 1991



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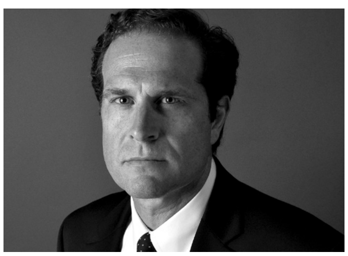
Conclusion

In the current environment, it is understandable that many investors have not been overly concerned about inflation. However, we believe the trend toward expansionary policies may drive increasing risk of upside inflation surprises. This does not necessarily mean a threat of runaway inflation, but it does suggest that current long-term inflation expectations may be too low.

It is a tall order for investors to assume they will be able to a) accurately anticipate when an inflation uptick may occur, and b) adjust their portfolios in time. Considering the historical unreliability of inflation forecasts, we believe it makes more sense to add an inflation-sensitive allocation before it is needed.

The power in real assets is that real estate, infrastructure and multi-strategy real assets solutions each offer long-term performance profiles that have delivered inflation sensitivity when needed, and attractive risk-adjusted returns over longer time horizons. To put it another way: why wait to be surprised before preparing portfolios for inflation?

About the Authors



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Index Definitions

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Bonds: ICE BofA U.S. 7-10 Year Treasury Index is composed of U.S. Treasury Notes with a 7–10 year maturity. **U.S. stocks:** The S&P 500 Index is an unmanaged index of 500 large-capitalization, publicly traded stocks representing a variety of industries. **Global stocks:** The MSCI World Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed markets. **U.S. real estate:** FTSE Nareit All Equity REIT Index is an unmanaged, market-capitalization-weighted index of all publicly traded U.S. REITs that invest predominantly in the equity ownership of real estate. **Global real estate:** FTSE Nareit Equity REIT Index through 12/31/1989 and FTSE EPRA/Nareit Developed Index thereafter. FTSE EPRA/NAREIT Developed Real Estate Index is an unmanaged market-weighted total return index which consists of many companies from developed markets who derive more than half of their revenue from property-related activities. **Global listed infrastructure:** 50/50 Blend of Datastream World Pipelines and Datastream World Gas, Water, & Multi-Utilities through December 2002; Dow Jones Brookfield Global Infrastructure Index thereafter. The Dow Jones Brookfield Global Infrastructure Index measures the stock performance of publicly listed infrastructure companies, intending to measure all sectors of the infrastructure market. **Global diversified real assets:** Consists of equal parts represented by global real estate, global listed infrastructure, global natural resource equities and commodities. **Global natural resource equities:** 50/50 Blend of Datastream World Oil & Gas and Datastream World Basic Materials through December 2002; S&P Global Natural Resources Index thereafter. The Datastream World Index Series encompasses global indexes of companies in their respective sectors (Gas, Water & Multi-Utilities; Materials; Oil & Gas; and Pipelines) compiled by Thomson Reuters Datastream. S&P Global Natural Resources Index includes 90 of the largest publicly traded companies in natural resources and commodities businesses that meet specific investability requirements, offering investors diversified, liquid and investable equity exposure across three primary commodity-related sectors: Agribusiness, Energy and Metals & Mining. **Commodities:** Bloomberg Commodity Total Return Index, formerly known as the Dow Jones-UBS Commodity Index, is a broadly diversified index composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metals Exchange.

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