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# Inflation Nation (Last of a Series)

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*"We are in a new era with the Fed. They have a new reaction function…[and] this is their first trip around the track with it."* – Anne Mathias, senior strategist, Vanguard.

Inflation, or the threat of it, presents challenges for both regulators and investors.

Higher inflation generally impacts fixed income assets negatively as increased rates erode bond values. Public equities, on the other hand, respond to the growth aspects of inflation positively. Last week's commentary from Natixis' chief US economist identified how well some commodities have fared in this environment.

Brian Nick, Nuveen's chief investment strategist, spoke recently to us on the investment implications of higher-than-expected inflation. "TIPS breakevens are pricing in higher inflation expectations in the short-term, with the breakeven curve still inverted. But longer-term nominal rates remain below their March peaks.

"The December 2023 eurodollar futures contract currently reflects almost three rate hikes between now and then. The implied fed funds target rate on that contract had fallen from a high of 1.275% to a low of 0.92%. If investors expect a more hawkish Fed, even in the absence of stronger growth (which "saved" stocks from a 1Q correction), equity valuations will come under pressure. Defensive stocks would outperform while high growth names suffer."

On the credit side, higher rates would likely benefit floating-rate instruments. As our high-yield bond friend Marty Fridson reported in a recent S&P LCD piece: "The adjustable rates of leveraged loans would be attractive and would siphon off investment capital from high-yield. Loans would be the winner there."

In that same article, another long-time credit investor added a cautionary note: "In variable rate structures, you would be partially protected from a rise in risk-free rates that would likely come if inflation were to present too much of a problem." But a rising risk-free rate world "would mean greater pressure to reduce duration, greater pressure on industries where capex is a material use of Ebitda, greater pressure on add-backs, and ultimately greater pressure on acquisition multiples. The model would seem to break in that scenario." You can't pay 12 times, he said, and still deliver returns in a 5% risk-free world.

Our content partner Creditflux also highlighted how inflation will benefit CLOs. "You're seeing quite a bit of demand for CLO debt up and down the capital structure," one portfolio manager noted. "Currently, the cost of capital for new issue CLOs is 10-15 basis points off the recent tights in 2018."

Another top investor agreed the credit outlook was constructive. "Inflation uncertainty will cause risk premiums to rise and we could see bouts of illiquidity in the market. So investors need to leave space in portfolios to take advantage of opportunities. Rather than go short credit, I would rather have dry powder."