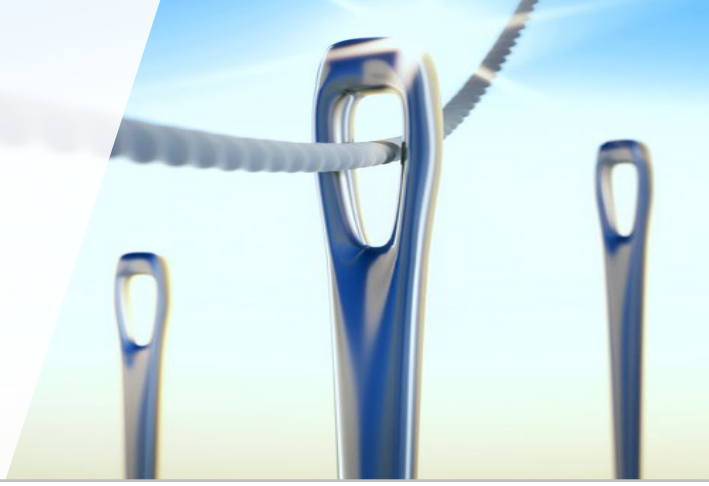
RPIA
Global Fixed Income Experts

Threading the Needle on Inflation

Q3 2021 Newsletter



Market participants have been debating the emergence of elevated inflation readings throughout the year, and for good reason. Inflation can have a broad impact on an economy, from driving consumer decisions to cutting corporate profit margins.

Rising inflation affects investors because it can cause central banks to raise interest rates quicker than they would otherwise like, while also reducing the value of future interest and principal payments we receive as bondholders.

Bond investors need to understand how central banks, particularly the Federal Reserve, think about inflation and how those thoughts might dictate policy action moving forward. We also want to understand what the market expects from the Fed and how other investors may respond to the central bank's decisions.

Threading the Needle

If the market believes the Fed will raise interest rates too soon, we will likely see a negative impact on bond prices in quite a volatile manner, as was the case with the Taper Tantrum that occurred in 2013. On the other hand, if the market thinks the Fed is reacting too slowly, concerns about the impact of inflation on the real economy could also negatively impact asset prices (but maybe in a less volatile manner).

The Fed must strike a delicate balance and adjust its view to changing economic data while communicating its plan effectively in order to implement it successfully. We are confident in the Fed's ability to strike a balance between growth and inflation and believe the Fed has learned lessons from history, so we do not expect Taper Tantrum 2.0 from this group.

Elevated Inflation Through Multiple Lenses

Looking over the data, we can see clear signs of elevated inflation. In the US, the core Consumer Price Index (CPI) hit 4.5% in June 2021, its highest level in nearly 30 years. We've seen that figure ease in July and August, falling to 4.3% and 4.0%. The Federal Reserve prefers to look at changes in the core Personal Consumption Expenditure Index (PCE) which has been a bit lower, but it also increased to 3.6% in July, hitting its own 30-year high.

Source: Bureau of Labor Statistics & Bureau of Economic Analysis.

Apart from the high-level data, our research team has seen and heard countless stories about cost inflation from corporate management teams. For example, the CEO of a home-building company noted that while the cost of lumber has come down from its recent peak, the cost of nearly every other commodity input in the home-building business has gone up in recent months. One of the largest delivery companies in the world recently highlighted that it is paying employees at one of its major hubs 16-25% more versus last year's hourly rate because the competition for talent is so intense.

Perhaps most importantly, global supply chains remain backed up. According to Bloomberg, the cost of transporting goods to the US from Asia on a 40-foot container has jumped from less than $2,000 just two years ago to more than $25,000 today. And it doesn't look like things are clearing up any time soon.

Monitoring Average Inflation and Policy Errors

Earlier, we mentioned that elevated inflation could lead to policy actions. However, in the current environment, inflation on its own may not be enough to force the Fed's hand in increasing rates. Inflation may be higher than we've seen in decades, but the Fed is choosing to balance those concerns against the arrival of Covid variants, questions about vaccine efficacy, recent geopolitical developments in China, and its commitment to full and inclusive employment.

To accomplish this, the Fed began embracing an Average Inflation Targeting (AIT) approach in August 2020. The idea is that since inflation has been below 2% for over a decade, it should be acceptable to have an elevated rate of inflation for a period without breaching the long-term average target rate of 2%. Since April, the Fed's Chair, Jerome Powell, has expressed his belief that the current pressures of inflation are likely transitory, not permanent, and he hasn't wavered from that view.

Generally, we believe the Fed (and other central banks) would be more concerned about having to fight off deflation or stagflation than inflation. The Fed also understands the need to avoid raising rates too quickly, given the potential damage on growth in an environment where growth expectations are already coming down.

Managing Inflation Risk in Our Strategies

First, we leverage our analysis of potential changes in expectations and the subsequent impact when developing our views on sectors, industries, and issuers. As a result, we can position our portfolios appropriately for a potential inflationary environment, or for a slowdown in inflation should that occur.

Our largest exposure by sector is to Financials, which includes many subsectors that would benefit from strong growth and rising (and steeper) interest rates. In particular, the global bank sector and the Business Development Companies (BDCs) should be beneficiaries if rates begin rising sooner, especially if the consumer and corporate balance sheets remain as healthy as they are now, which we expect to be the case.

Separately, we are underweighting the home-building sector given its sensitivity to interest rates and exposure to inflationary labour and cost pressures. Although, homebuilders have recently been able to pass on inflationary cost pressures to consumers through price increases, we believe that pricing pressure will increase as interest rates move higher. With price increases moderating in the short term, margin outlooks might be less attractive over the medium term.

Second, we aim to protect our portfolios against unexpected developments on the interest rate front or from a policy error (or miscalculation) by the Fed.

For example, in the RP Debt Opportunities strategy, we employ hedges designed to protect us if the Fed underestimates inflation readings and is forced to move up its timeline for raising rates. In the RP Select Opportunities strategy, we take short positions in high yield bonds that seem overvalued and could see a negative outcome if the cost of borrowing rises for the issuer.

Our traditional strategies continue to be and have historically been underweight rates risk (duration) relative to their benchmarks. Ultimately our credit work will continue to drive our security selection and exposure while we continue to mitigate broader macro risks, including inflation risk.

We are keeping a close eye on inflation developments and have taken steps to prepare for an unforeseen scenario, but our goal, as always, is to generate total returns in line with our targets.

Important Information

The information herein is presented by RP Investment Advisors LP ("RPIA") and is for informational purposes only. It does not provide financial, legal, accounting, tax, investment, or other advice and should not be acted or relied upon in that regard without seeking the appropriate professional advice. The information is drawn from sources believed to be reliable, but the accuracy or completeness of the information is not guaranteed, nor in providing it does RPIA assume any responsibility or liability whatsoever. The information provided may be subject to change and RPIA does not undertake any obligation to communicate revisions or updates to the information presented. Unless otherwise stated, the source for all information is RPIA. The information presented does not form the basis of any offer or solicitation for the purchase or sale of securities. Products and services of RPIA are only available in jurisdictions where they may be lawfully offered and to investors who qualify under applicable regulation. RP Debt Opportunities and RP Select Opportunities strategies are offered pursuant to available prospectus exemptions to eligible Canadian investors through units of RP Debt Opportunities Fund Trust and RP Select Opportunities Fund, respectively. RPIA managed strategies and funds carry the risk of financial loss. Performance is not guaranteed and past performance may not be repeated. "Forward-Looking" statements are based on assumptions made by RPIA regarding its opinion and investment strategies in certain market conditions and are subject to a number of mitigating factors. Economic and market conditions may change, which may materially impact actual future events and as a result RPIA's views, the success of RPIA's intended strategies as well as its actual course of conduct.