Key Questions

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How Can Bond Investors Protect Themselves Amid Rising Inflation?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

Staying relatively short and employing an actively managed approach can offset some of the pain.

Over the past several months, the debate within the Federal Reserve as to whether the pricing pressures we are experiencing are "transitory" (i.e., temporary) or "structural" (i.e., here to stay) has intensified. The examination between transitory vs. structural inflation has led some, including centrist Federal Reserve Bank of Atlanta President Raphael Bostic, to deem transitory a dirty word.

As we slowly move toward a post-COVID world, many questions emerge regarding the effects of unwinding a mountain of fiscal stimulus measures employed during the pandemic alongside the supply-side bottlenecks that have hampered the ability for goods to reach consumers. How these issues are resolved and what landscape we are presented with on the other side is an unknown. Meanwhile, bond investors are particularly sensitive to these issues and want to know what they can do to protect their portfolios from the specter of rising inflation.

Traditional fixed income assets (i.e., Treasury, corporate, and municipal bonds) are securities that offer investors a fixed return (coupon) through a known final maturity date. The coupon rate on a bond issued at par ($100) is known as the nominal return. The real return is this nominal return minus the inflation rate. In the event that inflation presents itself and is sustained, an erosion of that real fixed return can occur.

Consumer Price Index data released on October 14 revealed a trailing 12-month inflation rate of 5.4%, a 13-year high-water mark. If this rate of inflation is sustained, it would represent a true headwind to the real return of all asset classes with specific pressure on those instruments that possess a fixed nominal return. For context, the current average coupon rate of the Bloomberg US Corporate Bond Index is 3.58%, implying a negative real rate of 1.82%.

Inflationary pressures were relatively narrow as we entered this year. The price of lumber, gasoline, housing, and used cars have risen by double-digit figures, causing the Bureau of Labor Statistic's composite Consumer Price Index to soar. While supply-chain bottlenecks have widened across industries, implying a temporary shock, we are now witnessing a broader, more measured rise in the price of goods alongside steady wage growth for workers. These latter catalysts suggest a more structural framework for inflation to be persistent.

During the COVID-19 crisis, our team has advocated a greater level of participation on the short end of the yield curve. Reducing the maturity of fixed income allocations allows for a nimbler portfolio and affords investors greater flexibility regardless of whether inflationary pressures are transitory or structural.

Trimming the maturity profile of fixed income allocations also allows for swifter reinvestment as the rate environment normalizes. The rolling of maturities serves to smooth the impacts of inflation on allocations to fixed income over time. We are proponents of engaging in the active management of fixed income securities to take advantage of risk premium dislocations that can generate outperformance. Where appropriate, we also recommend investing in individual fixed income instruments that allow investors to identify the discreet cash flow and maturity schedule associated with those positions. This approach enables investors to avoid being subjected to a floating NAV associated with mutual funds and similar pooled vehicles.

What we know is that there will be a meaningful impact on the investment landscape as unprecedented global fiscal stimulus is gradually unwound, supply-side bottlenecks are resolved, and the system digests sustained wage growth. What we do not know is precisely how the interplay between these factors will impact longer-term inflationary conditions, whether they be transitory or structural.

In response, investors can position their fixed income portfolios to dampen the impact of real return degradation while allowing for swifter reinvestment opportunities. It's important investors consider options that mitigate the impact of inflation on fixed income portfolios. We also recommend an actively managed approach which we believe will continue serving investors well.

For more information, please contact your advisor.

About the Author

As a Senior Research Analyst with the Equity & Fixed Income Research team Michael utilizes proprietary corporate debt evaluation techniques to achieve strong risk adjusted compensation in client portfolios. He works to understand a client's priorities to ensure recommended investment and risk management strategies are appropriate for each unique circumstance.

Leveraging more than 14 years in the financial industry, Michael is responsible for evaluating the creditworthiness of individual investment grade corporate issuers.

Michael graduated Cum Laude with a Bachelor of Arts degree in Finance and Economics from Otterbein University and has completed his MBA degree from Ashland University.

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