Flash Poll Series

INFLATION: How Institutional Investors Are Responding

A Survey By Clearwater Analytics, Q1 2022

Clearwater polled more than 100 institutional asset managers and owners representing more than $4 trillion in AUM to gain insight into changing strategies as a result of surging inflation levels. Our survey explored how investors are reacting now and what their expectations are three years out.

With inflation jumping to **7.5% on the Consumer Price Index (CPI) in 2021**, just like the average consumer, investors are concerned.

Two-thirds of survey respondents see inflation as non-transitory and indicated they expect it will have a material effect on the US economy.

As interest rates are entangled with inflation, we asked about rate expectations and found that **a large majority, but not all, expect a 100-200bps increase from current rates.** All these concerns are driving changes to portfolio allocation and risk. As you would expect, asset classes like real estate are in focus, while fixed income duration is being curtailed.

Investors Expect Higher Inflation to Persist

Our survey questions delved further into underlying expectations and investment strategy changes. When asked where they see CPI three years out, **40% of investors** surveyed believe it will **settle in at 3-4%**, significantly higher than the long-term level of **~2% in recent decades**. While 2021's CPI at **7.5%** is disconcerting for all of us, only **10% of investors** expect inflation to persist at high levels of **5% or more**. And **32% were hopeful that inflation would return to long-term levels of sub 3%** — we hope they are right!

Inflation is Driving Significant Strategy Changes

Expected changes in investment strategy showed that most are planning significant changes, but interestingly a third said they would stay the course. We asked respondents to indicate what asset classes they would favor, and the results highlighted **floating rate debt at 48%, real assets at 42%, and equities at 38%** as the top three. With record equity market levels, investors seem to be saying, "you can't live without them," given the alternatives. Asset classes less in favor but still cited in the survey included **commodities at 30% and Treasury Inflation-Protected Securities (TIPS) and cash at 25%.** We believe as many institutional investors shy away from the volatility of commodities, TIPS may offer inflation protection, but their nominal yields are low, and cash is safe — but not that safe when real yields are considered.

What About Risk?

So where are investors taking risk off the table? While equities are in play for many, as cited previously, **14%** said they plan to lighten up. Of course, **fixed income is in focus** with **a third saying they will reduce allocations**, and a **half indicating they would reduce duration as the Fed responds with rate hikes.** And related to rate hikes, we asked **where investors see the 10-year treasury rate in three years** and found that **80% expect a range of 2-4%,** while **10% said lower than 2%** and another **10% said higher than 5%**.

Diving Deeper into the Data

Investor Types Surveyed

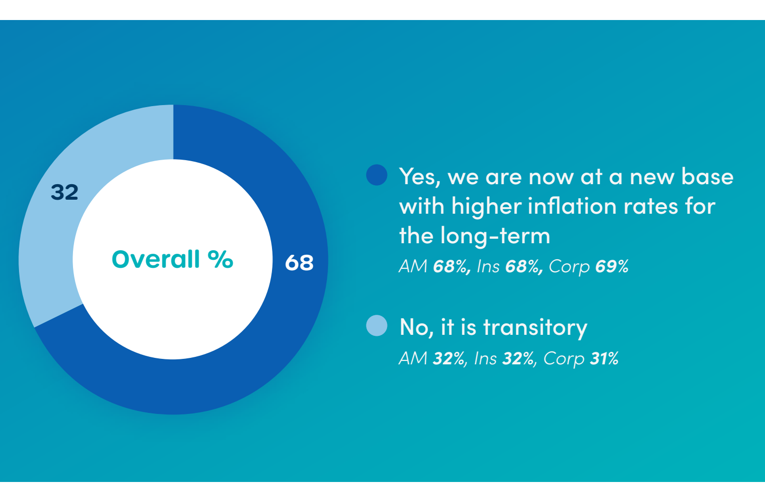
Clearwater works with all types of institutional investors including asset owners and asset managers. Of the poll respondents, about **30% each** were insurers and asset managers. **Corporations represented 13%**, and the remaining **11% are in other segments**, including governments.

Inflation Concerns Now and Expectations Three Years Out

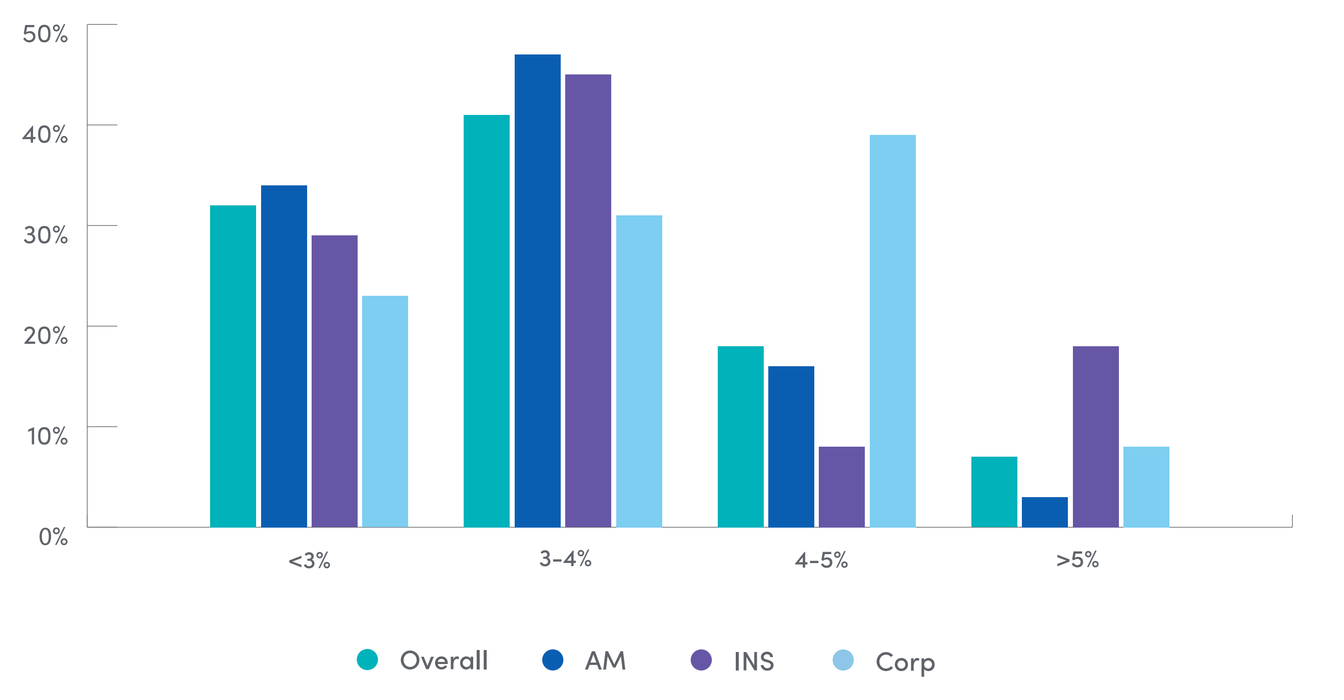
The investor types were consistent in their belief that inflation is not transitory, with only a third suggesting it is. Looking out three years, corporations showed the strongest sentiment that **CPI will settle in at 4-5%** compared to the **other segments, which expect it to be 4% or below**. Corporations also demonstrated the most concern, with **18% indicating an expected inflation rate of greater than 5%**, while the **other segments were 8% or less**. Corporations are clearly concerned about inflation, perhaps because they hold more prominent risks on the rest of their balance sheet or are not able to raise prices as quickly.

Detailed Survey Data

Do you think inflation is a material concern for the US economy?



What is your expectation for the inflation rate three years from now?



10-Year Treasury Yield Expectations

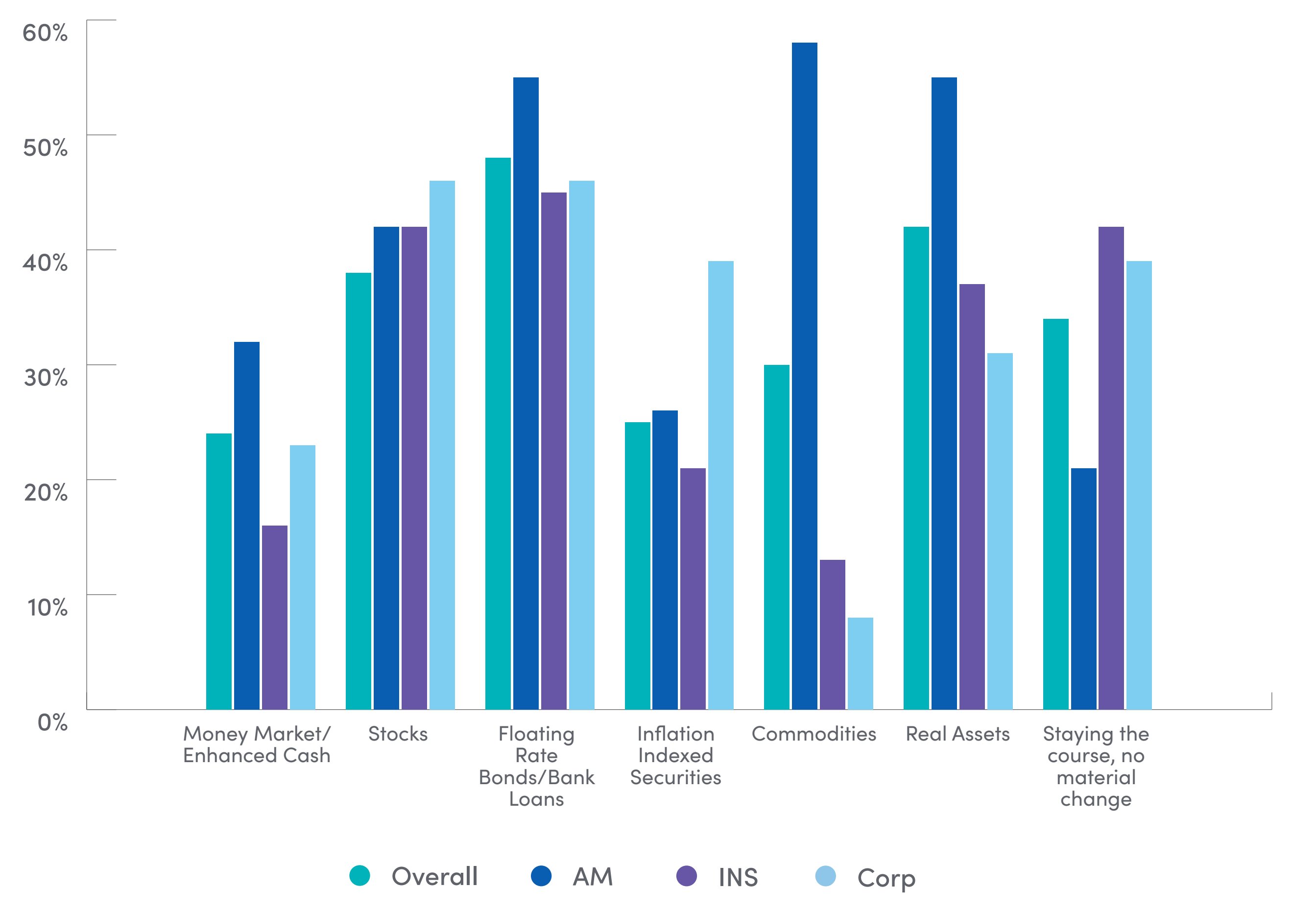
Inflation and rates are partners in crime. Survey respondents overall showed bias toward a 10-year treasury yield at 4-5% three years out, but more corporate respondents saw the rate range at 3-4%. This is an interesting result given their elevated inflation concerns; Perhaps they don't believe the Fed can tamp down inflation.

What is your expectation for the 10-Year Treasury Yield three years from now?

Asset Classes Favored Due to Inflation

When it came to asset class sectors investors are favoring, we saw a theme. Asset managers planned to make more aggressive changes than the asset owners, with only 20% of managers staying the course compared to 40% of asset owners. The most notable asset classes favored by the managers were commodities at 58% compared to less than 15% of the owners. Real estate was similar at 55% for managers and mid-30s for owners. We assume managers tend to have broader capabilities and resources across these asset classes giving them more tools and leverage to make such moves. On the flip side, a third of managers favored cash while the owners were at approximately 20%. Perhaps managers are making an active decision to keep some dry powder for market corrections.

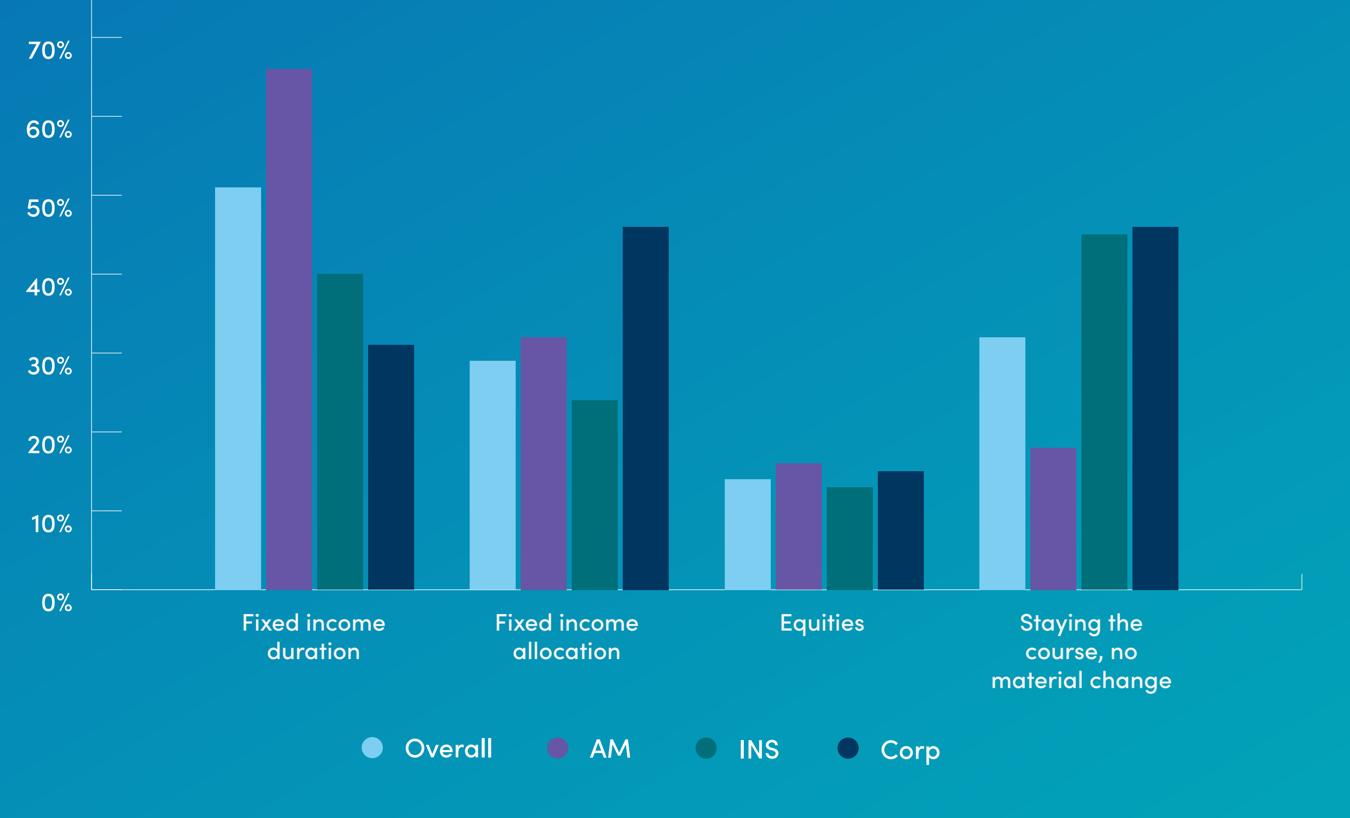
If inflation is a concern, what asset types will you favor?



Risk Reduction Due to Inflation

On the portfolio risk reduction side of the equation, again asset managers deviated more than the other segments. Two-thirds of asset managers plan to reduce fixed income duration compared to the other segments at 40% or less. Corporates showed concern for fixed income, with 46% planning to reduce, about double the others. In our experience, corporations have conservative portfolios, as they are needed to fund their business, rather than to make long-term market bets.

Where would you reduce your allocation?



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