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# How Asia's Private Clients Can React to a New Era of Inflation and Future-Proof their Portfolios

The premise for the Hubbis Digital Dialogue event of April 21 was very simple. Asia's private clients need to be reacting and adapting their portfolios to help future-proof their investments in the face of the current bout of what now looks more likely to be persistent elevated inflation, most markedly in the major developed economies of the world. When inflation first reared its head after so many years in abeyance, there had been many divergent views, some arguing this was purely transitory and others warning that a new era of high inflation was emerging. But faced with more and more evidence and after the onset of the Ukraine crisis, these often very divergent views have moved somewhat closer today than perhaps four to six months ago. Even the inflation naysayers admit that US inflation will run at least 5.5% in 2022 and quite probably through 2023 as well, while those who are ushering in the 'new era' of inflation are upping their rhetoric to argue that this will soon wreak havoc on profits, financial stability and investments across the globe. And in the middle, there are still plenty of eminent economists and market watchers who argue that the clouds of a year or two of inflation will by late 2023 or by 2024 clear to reveal what is underneath - a low or no growth world ahead where inflation and rates will remain low for many years to come.

## SPEAKERS

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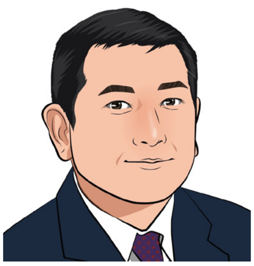

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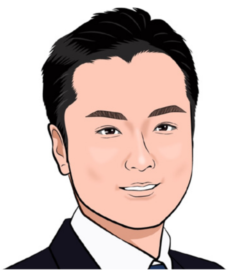

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## Setting the Scene

Whatever the view espoused, there is no doubt that private clients the world over need to adjust their portfolios in face of this temporary, or persistent, or expanding inflation. The wealth management experts we assembled debated how and how radically Asia's HNW and UHNW investors should adjust their holdings, perhaps to emphasise commodities, to shift from growth to value and cyclical stocks, from public to private assets, to structured products and more FX. They might be de-weighting the major Western economies and upgrading Asian and other EM assets that appear less hard hit by inflation. They could transition further from mainstream public market holdings to less liquid commercial real estate, and to more alternatives such as gold, or even cryptos and other digital assets. And what about weighting up in China, where inflation remains extremely muted and where the central bank stands out amongst the world's leading economies as having room to lower rather than raise rates?

## Inflation – short-term, or long-term and persistent? And where will the rocky road to normalisation lead us all?

"The inflation spike in 2021 was initially seen by many as a passing story, triggered by boosted demand for goods that were suddenly facing disrupted supply and transportation chains due to the onset of the Covid-19 crisis," a guest reminded the delegates. "But as the pandemic was to some extent abating in early 2021, we have then all seen the successive shocks in energy, agricultural, industrial metals' prices due to the war in Ukraine, as well as the possibility of renewed disruptions in global supply chains resulting from further lockdowns in major Chinese cities and ports."

All these elements have combined to postpone any rapid normalisation in inflation data and further increased the risk of some contamination in nominal wages, he extrapolated. "The inflation data numbers, for example headline US CPI, are now creating more of a perfect storm of shock and inflation. And frankly, when faced with this kind of situation, nobody knows quite where it will end, or if it will result in more difficult and permanent inflation. This means that the world might now be heading to more of a structural inflation phase, especially considering the apparent de-globalisation of the world economy."

Nevertheless, he said that in the longer-term, his bank believes structural factors - such as demographics or technology - will continue to generate more deflationary, rather than inflationary, forces. "Ultimately,

*Expert Opinion*

**JEAN-LOUIS NAKAMURA, Chief Investment Officer, Asia Pacific & Chief Executive Officer, Hong Kong, Lombard Odier**

"The inflation spike in 2021 was initially seen as a transitory story, triggered by boosted demand in goods facing disrupted supply and transportation chains in the Covid-19 context. The successive shocks in energy, agricultural, industrial metals' prices due to the war in Ukraine, as well as the possibility of renewed disruptions in global supply chains resulting from lockdowns in major Chinese cities and ports postponed any rapid normalisation in inflation data and further increased the risk of some contamination in nominal wages. The succession of one-off shocks may then lead to the perception of a "structural inflation" story, especially under the light of the apparent 'de-globalisation' of the world economy. In the long-term, however, we believe structural factors (such as demographics or technology) will continue to generate more deflationary, rather than inflationary, forces and that ultimately, consumer inflation would stabilise at low levels in major economies. Investor's long-term inflation expectations, while on the rise over the last two months, remain well-anchored at just under 3%."

*The Hubbis Post-Event Survey*

### HOW CONCERNED ARE YOUR PRIVATE CLIENTS ABOUT THE IMPACT OF INFLATION ON THEIR PORTFOLIOS?

consumer inflation should stabilise at low levels in major economies. Accordingly, from our viewpoint, investors' long-term inflation expectations, while on the rise over the last few months, remain well-anchored at just under 3%. The view here is that the world is not embarking on a new era of high inflation, and we are positioning clients 's portfolios with that in mind.

## Dealing shorter-term with downside portfolios risk mitigation

He added that with a shorter-term perspective, inflation is likely to be at 5.5% to 6% in the US for the rest of 2022, so they have naturally had to implement or propose a lot of nearer-term inflation hedging in the client portfolios. "To achieve that, weighting up on commodities in recent times has provided a very good and efficient buffer and hedge versus inflation risk," he reported. "The way we treat commodities in our investment universe, in our asset allocation, in our risk optimisation, means that allocations to commodities have increased quite materially over the last few months. And more broadly, strong discipline and diversification remain very important across the entire portfolio."

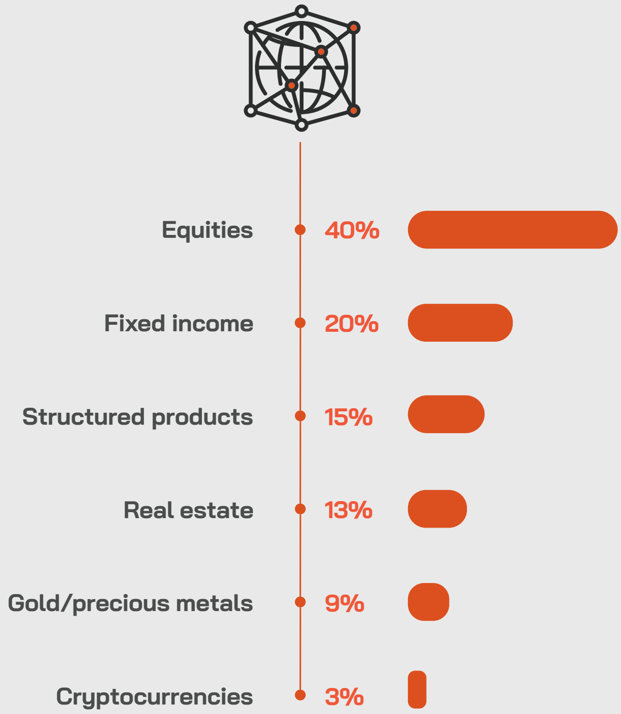
## The writing is on the wall, but is it in blue ink or red ink? Some think it is increasingly a deep red…

An expert offered his firm's take on the current environment. He pointed first to the analysis, noting that when he and colleagues consider the outlook for inflation, they first look in the near term at producer prices, which give a good indication of the likely direction of headline inflation, certainly over the ensuing six to 12 months. He noted, for example, that the most recent headline producer prices in the US jumped 1.4% in March alone, well above the consensus, and the core CPI rate was double the consensus for that month. He explained that energy and food prices were significant elements of these rises.

He remarked that the Ukraine was a one-off situation that had added to inflation momentum, but that margins were a key driver of producer prices, again, accounting for some 30% of core producer price inflation. He said the sustained surge in prices in some sectors, notably auto dealers as well as furniture, hardware, apparel, were to blame.

"Our primary concern is that inflation expectations remain elevated, which we think will be reflected in sustained higher core consumer price inflation," he reported. "Ultimately, that's what central banks focus on. The near real time economic indicators continue to rebound following the plunge in Omicron, COVID cases, and that signalling that spending on discretionary services is rebounding. The sentiment is less optimistic because of all this, with confidence depressed. But in the US alone, households are sitting on around USD4.25 trillion in extra cash than they were before COVID, so we ex-

### IN THE CURRENT AND ANTICIPATED GLOBAL ECONOMIC AND FINANCIAL ENVIRONMENT, ROUGHLY WHAT PERCENTAGES SHOULD HNW/UHNW INVESTORS ALLOCATE TO THESE SEGMENTS?



pect them to spend a good chunk of that on travel and other services to catch up on missed experiences during the pandemic."

And what does that all add up to? "All in all, while core inflation in the US may moderate in the coming months, we think that core inflation is likely to remain elevated and we anticipate more entrenched inflation expectations and rising nominal wages," he surmised.

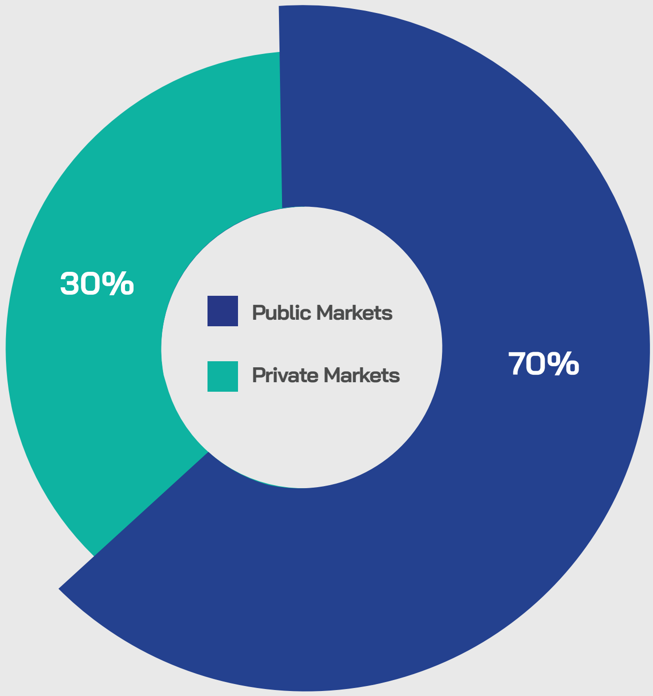
He noted that the ECB briefing a week before this event had focused on the upside risks to inflation having intensified, a view with which he and his team concur. He said that the ECB had also remarked on the war in Ukraine having increased the downside risk to growth, as well, and that this was weighing materially on sentiment throughout the Eurozone.

Turning his attention to Asia, he said the Russian invasion had seen energy prices surge and pushed other commodities and food prices had risen, although in China and Japan, CPI inflation did not look likely to breach their central bank targets, and therefore that neither were tightening policy, not looking likely to in the foreseeable future.

"If anything," he said, "the cost shock is likely to deliver more easing at the margin, with the growth recovery still fragile. The oil shock coupled with ongoing supply chain problems, may have tipped global trade over the edge. In short, it is a mixed picture across global markets but certainly when we look at the US and the Eurozone, those price pressures remain persistent."

He said watching and monitoring the central bank reactions and actions are becoming more critical to working out the movement of currencies. "Last week, for example, we saw the Reserve Bank of New Zealand hike rates by much more than the market had anticipated, with commentary there that they seem to be frontloading rate hikes instead of needing to implement a higher terminal rate. These types of nuances with respect to growth and inflation need watching carefully, as opportunities will always arise."

**IN THE CURRENT AND ANTICIPATED GLOBAL ECONOMIC AND FINANCIAL ENVIRONMENT, ROUGHLY WHAT PERCENTAGES SHOULD HNW/UHNW CLIENTS ALLOCATE BROADLY TO MAINSTREAM PUBLIC ASSETS OR TO PRIVATE MARKETS?**




## A global juggling act between controlling inflation and not throttling growth

A guest said a particularly difficult challenge for many market watchers right now is in trying to understand the intersection between policy normalisation and growth risks, which vary across different economies.

Looking ahead, to 2023, he said the bank currently thinks the story might evolve from an inflation scare to a growth scare. "While it remains important for investors' portfolios to be equipped against short-term cyclical or supply-side induced inflation, with cyclical commodities or mining stocks as main hedges, what will matter for the next few months is to increase the resilience of portfolios against the expected windfall from the central banks' fight against excessive inflation," he observed. "Inflation cannot be tamed rapidly without some suppression in final demand, and that means a rising risk of a global recession."

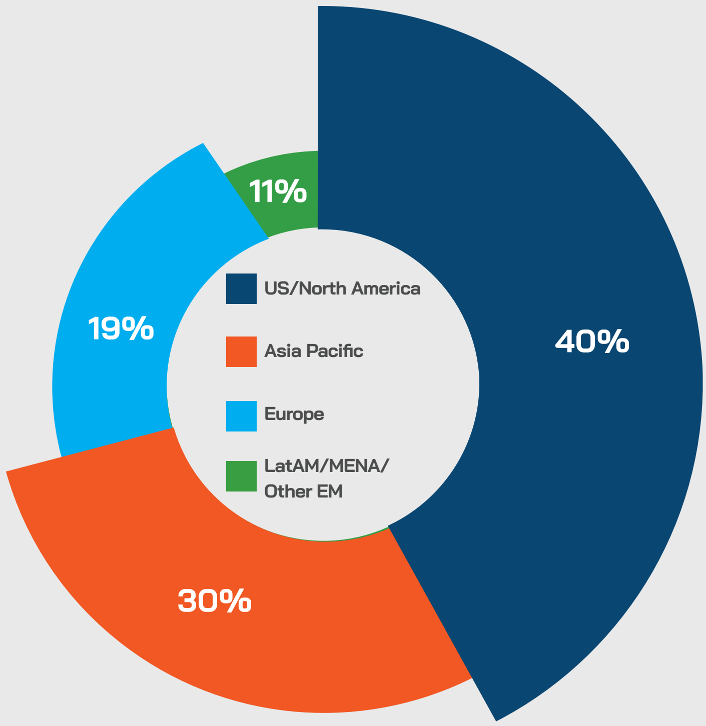
He offered more commentary on the potential growth scare. "Over the last three months, the world has moved to an expectation that the US Federal Reserve would be perhaps up to 250 basis points by the end of 2022 points by the end of 2022," he noted. "This change is huge and significant swing already and clearly the coming actions and guidance of the Fed are all likely to be higher and tighter. This will very probably lead to the US economy slowing down and potentially the fear of a recession will replace the fear of inflation. That could be before the end of 2022, or perhaps in 2023."

He said that while investors had shown a tendency to underestimate the pace at which the Fed could tighten monetary policy, but also at the other end of the spectrum they might overestimate the Fed's capacity to increase Fed rates without hurting the economy.

"We will need to watch very carefully to see exactly where and when US growth will start to feel the pain, perhaps it will be in the housing sector first, and then rest of the consumption sector. Accordingly, we are a bit more sceptical about the cyclical consumption sector, consumer discretionary, and we prefer consumer staples, for instance, as slightly more defensive and reciprocal sectors in the composition of equity portfolios."

All this, he said, means that investors should remain disciplined and diversified. They should slant their allocations towards assets such as gold, which is supported by lower real interest rates. "We like gold very much because it could act as a nice asset to having the transition between this period of very high inflation over solid growth, to maybe slightly lower inflation to much lower growth," he explained.

**IN THE CURRENT AND ANTICIPATED GLOBAL ECONOMIC AND FINANCIAL ENVIRONMENT, ROUGHLY WHAT PERCENTAGES OF THEIR TOTAL PORTFOLIOS SHOULD HNW/UHNW CLIENTS ALLOCATE WITHIN THE VARIOUS REGIONS AROUND THE WORLD?**




He also advised allocation more towards long-dated government bonds, which would then stand as better hedges than cyclical commodities. Cash, he added, while unfit in a structurally high inflation environment, could also play a role in this transition.

He also commented that in a time of anxiety DPM is appealing for clients. However, he cautioned that while private clients should also consider discretionary portfolios to help to manage this transition from a high growth/high inflation episode to a possible recessionary environment, those investors must understand what they are buying. "Processes playing a 'long-term value' game might suffer higher losses in the short-term, as they would chase after stocks whose valuation might be under persistent stress. In contrast, risk-mitigating strategies, excessively diversified in nominal assets over the last months, may provide better protection in a situation of falling global demand."

## Mismatches between reality and policy moves are opening the door to disruptions and opportunity

A guest pointed to the combination of many of the factors raised in the discussion had been point increasingly to mispricing at the front end of fixed income markets. "Given the starting point of historically low real and nominal interest rates, fairly limited spare capacity, healthy private sector balance sheets, elevated core inflation, and what we see as rising inflation expectations specifically for the US economy, the likely minimal impact of the commodity price shock on the growth outlook for the US as well has to be taken into account," he told delegates. "And all of that, taken together, means that central banks, especially in the US, remain materially behind the curve as they continue to pursue a fairly gradual approach to policy normalisation."

He said that it is easy to find central banks ratcheting up the rhetoric, almost daily, but that in general, in an environment of higher inflation, policy normalisation and liquidity withdrawal present risk signals to traditional asset classes.

"However, looking at the global macro situation, this type of environment provides a number of fairly attractive opportunities," he reported. "We can take advantage of what I think are several high conviction and non-consensus relative value trades, which are uncorrelated to traditional asset classes and can generate alpha in both bull and bear markets. For example, we see value in shorter dated developed market interest rates, fixed income relative value trades, tactical currency exposures and some selective EM fixed income themes."

*Expert Opinion*

**NOLI DE PALA, Chief Investment Officer, TriLake**

"There's great divergence in monetary policy around the world – expansionary and accommodating in Japan and China, a hawkish Fed, Europe getting to the point of hiking later this year, EMs a little ahead with their rate hikes. All well-meaning, well-thought-out in their respective jurisdictions of course, but in an interconnected world, we've all been lamenting the greater chance of policy error. Where this may first manifest itself would be the foreign exchange markets."

## In a world of such uncertainty, liquidity has plenty of appeals

"In anticipation of a changing world ahead, we made a board level decision a couple of years ago to keep liquidity as our number one priority," another expert reported. "Accordingly, we are extremely light on private equity and private debt. We are also well down on pure fixed income exposures, shifting instead to our income requirements to other things like real estate and structured products instead of fixed income. We are less scared of duration than we were early in 2022 but still not at all optimistic

*Expert Opinion*

**JEAN-LOUIS NAKAMURA, Chief Investment Officer, Asia Pacific & Chief Executive Officer, Hong Kong, Lombard Odier**

"While it was, and remains important for investors' portfolios to be equipped against short-term cyclical or supply-side induced inflation, with cyclical commodities or mining stocks as main hedges, what will matter for the next few months is to increase the resilience of portfolios against the expected windfall from the central banks' fight against "excessive" inflation. Inflation cannot be tamed rapidly without some suppression in final demand, at the growing risk of a global recession. Gold (supported by lower real rates), defensive stocks, but also ultimately long-dated government bonds would then stand as better hedges than cyclical commodities. Cash, while unfit in a structural high inflation environment, could also play a role in this transition."

about the prospects of the fixed income side. In short, we are re-jigging our tactical asset allocations to suit this current economic and fiscal regime."

## Investors might naturally head to the 'safety' of cash, but they need to achieve some yield and be ready to shift when opportunities arise

A banker observed that the generally negative view that clients have on risk assets means that they have a large amount of cash in their portfolios and that cash is not generating a return. "The key piece of advice that we have been giving is that clients need to employ that cash to give them some kind of return," he reported. "However, without risk taking, they might not actually make up for the negative effect of inflation. Nevertheless, it's better than sitting in cash with strongly negative returns so we think they should be looking to pick up assets with a limited amount of risk, they should be looking at the yield as something that they are taking now while they wait to then deploy that capital into whatever interesting opportunities come along further down the line."

## Real rates, the thrust to policy normalisation, FX dynamics and resultant opportunities

Without delving into too much detail, a guest commented that the US, the UK and Canada markets are actually already pricing in the expectation that the central banks will have to start cutting rates after a couple of years. However, the risk remains that core inflation remains elevated and that inflation expectations become persistently entrenched. "We actually feel that the policymakers may ultimately have to be far more aggressive in policy normalisation," he warned. "So, if we look at the very front end of the UK, we feel there is a mismatch, in other words that very little has been priced in taking into account actually some of the initial conditions which are unique to the UK, such as Brexit, which is having a material impact on labour supply and further adding to the inflationary woes there."

Turning his attention to currencies, he said relative rates are really reasserting themselves as drivers of currency performance. "If we look at, for example, the Scandinavian currencies and the Swedish Kroner in particular, versus the Euro, we've seen quite a marked shift in rhetoric from the central banks over the last 6 to 12 months," he observed. He explained that there were opportunities when a central bank, for example Sweden's Riksbank, abandons negative rates that should in turn lead to some normalisation of capital flows, in turn supporting the currency.

"We are essentially at the start of a phase when real rates are reasserting themselves in terms of

*Expert Opinion*

**RAHUL MATHUR, Investment Manager, Global Macro & Currency Fixed Income, GAM Investments**

"The recent surge in commodity prices, driven by geopolitical tensions, has reinforced the existing inflationary dynamic and underscored the extent of mispricing at the front-end of fixed income markets."

*Expert Opinion*

**RAHUL MATHUR, Investment Manager, Global Macro & Currency Fixed Income, GAM Investments**

"The risk that core inflation remains elevated and that inflation expectations become persistently entrenched suggests that policymakers may ultimately have to be far more aggressive in normalising monetary policy."

**NOLI DE PALA, Chief Investment Officer, TriLake**

"We've had to be a bit more creative especially for portfolios designed to generate current income. We've shifted some of the generation from traditional fixed-income securities to real estate, dividend payers/growers and even structured products."

FX dynamics," he added, offering examples such as the currencies of Mexico and Brazil that have risen this year as their central banks moved to raise rates ahead of the Fed.

Another expert on the panel agreed with these observations, commenting that there is indeed a significantly heightened danger of policy error from the central bankers of the world. "The FX markets could be ultimately where all of these policy moves, all well-meaning, of course, within their own jurisdictions, will land and create the havoc," he cautioned.

## Nowhere to hide amidst volatility and uncertainty, so Hong Kong clients are heading to structured products, FX and FRNs

Another guest remarked on the difficulty facing his clients in Hong Kong, with global volatility and a host of ongoing economic, fiscal, pandemic-related and geopolitical uncertainties. "There is nowhere to hide really," he stated. "The go-to move to cash in an inflationary environment is corrosive, so we have seen huge demand for interest rate linked type structured products this year. Secondly, with traditional listed assets struggling, clients are returning to the FX markets, especially as we all see the US Dollar trading stronger. We have seen a huge surge in volumes for FX options, for currency linked deposits type of products so far this year."

The third trend he had witnessed is a shift towards floating rate investments. "We have seen big flows from traditional fixed rate funds into floating rate funds, with money pouring in from switchers and new entrants."

*Expert Opinion*

**RAHUL MATHUR, Investment Manager, Global Macro & Currency Fixed Income, GAM Investments**

"The Global Rates strategy is well positioned to benefit from this environment with its continued focus on higher, short-term developed market interest rates, inflation protection, fixed income relative value trades, tactical currency exposures and selective EM fixed income themes."

Another guest observed that in the past few rate hike cycles in the US, EM currencies performed well. "It is actually almost opposite to the traditional concept that EM currencies underperform when US rates rise," he noted.

## China watchers explain why world's second largest economy dances to a different tune

China is dancing to a different tune to G7 economies and central bankers. "China seems to the exception, as inflation pressure is still very minimal, the latest CPI number being 1.5%, and they are in a different rate cycle is also very different," a guest reported. "We see the fixed income products there are as safe haven assets compared to most of the other major fixed income in leading global markets. Chinese treasury bonds are in positive territory so far year to date and doing considerably better than most leading sovereign paper elsewhere."

He remarked that inflationary pressures in the rest of Asia are less acute, for example inflation is more muted in ASEAN countries

*Expert Opinion*

**JEAN-LOUIS NAKAMURA, Chief Investment Officer, Asia Pacific & Chief Executive Officer, Hong Kong, Lombard Odier**

"Discretionary portfolios could help to manage this transition from a high growth/high inflation episode to a possible recessionary environment. However, as always, investors must understand what they are buying. Processes playing a 'long-term value' game might suffer higher losses in the short-term, as they would chase after stocks whose valuation might be under persistent stress. In contrast, risk-mitigating strategies, excessively diversified in nominal assets over the last months, may provide better protection in a situation of falling global demand."

and the Indonesian equity market is up some 10% in 2021 because of this and other factors. Such as momentum related to commodity prices. "In terms of the markets that would be able to shield from the inflation pressure, China is one of them, and then the ASEAN markets seem to be another choice."

## Keep it local as tensions around the world remain elevated and play to the positives of diminishing pandemic restrictions

Another expert reported their expectation that geopolitical tensions will remain high, particularly between US and China, implying that enterprises that have a strong domestic focus would likely do better than those that are very global in nature. Focus on those with a strong local manufacturing process that depend less on globalisation," he said. "And another theme is the waning impact of the pandemic and pent-up demand for travel and leisure, aside perhaps from China and Hong Kong right now. So, we think that sectors like tourism, hygiene, health care, as well as entertainment, travel, consumer discretionary in the US and Europe particularly will do well."

## Action plans need to be clear and agile

A banker proposed four courses of action. First, he said cash needs to be managed to achieve a higher yield than from simple deposits, and hopefully also track rising rates, as well as being moveable if other opportunities arise.

*Expert Opinion*

**DAVID LAI, Partner & Co-CIO, Premia Partners**

"Long duration Chinese government bonds are a sweet spot in the global sovereign bond spectrum. Traders in US equities have generally been in agreement that they are in a late cycle bull market but have been keen to squeeze the last elements of return amidst what are relatively still ultra-low rates and yields. Their consolation to date had been that the central bank taper has only gradually withdrawn stimulus, and that policy tightening was still at least half a year away, or so they thought. Until the beginning of this year when the minutes from the December FOMC meeting came to light and led to the major wake-up call that this tightening would happen sooner, faster and more aggressively. The Chinese government has been working in the opposite direction, making long duration Chinese government bonds a very useful alternative as we brace for more challenging US equity and bond markets on the horizon, replete with lower returns and higher risks."

Secondly, investors should look to tactical opportunities arising in FX, and in this regard, it has been possible to construct investments where clients are taking relatively little risk with their capital, and yet can benefit in the event that a certain movement occurs in selected currencies.

Third, he pointed to opportunities to monetise the relatively higher implied volatilities that they see in the equity market through the use of options.

And lastly, he advised investors to target dividend paying equities, focusing on those companies that are really growing their dividends.

"The objective isn't necessarily to pick stocks that pay lots of dividends today, because that isn't necessarily positive in terms of the company's balance sheet, but those that have the right strategies, that are building their pay-outs through the quality of the business that they are building," he explained.

The conversation ended with a consensus amongst the panellists that inflation and its impact on central bank policy, on rates, growth, companies' profits and on investors' portfolios would remain a central focus for some considerable time to come. ■