Positioned for Inflation, Higher Rates, and Economic Uncertainty

New York Life Investments

At New York Life Investments, our years of experience, expertise, and insights can help investors balance their personal values with investment objectives.

Turmoil marked the first half of 2022 as inflation turned out to be much higher and more persistent than expected.

In response, the Federal Reserve and other developed-market central banks shifted to a policy of tightening. Lofty equity valuations sank as a result while the prospect of a possible recession applied additional pressure, causing U.S. stocks to drop about 20% and enter a bear market. In the fixed income arena, inflation and the shift away from more than a decade of accommodative monetary conditions also produced volatility.

The first half of 2022 also saw two other shocks, according to the team at Candriam. Both exacerbated economic uncertainties and produced effects that are likely to persist: the February invasion of Ukraine and China's Zero-Covid Policy. The invasion produced a jump in commodities prices, including a nearly 50% surge in oil. In China, large-scale shutdowns slowed economic growth, both in China and worldwide, and put kinks in supply chains. The confluence of these factors — a shift in monetary policy, rising prices, and constraints on production resulting from supply chain duress — has produced a global environment that may now be stagflationary.

Moreover, the outlook has become highly uncertain. Though oil and certain other commodities have come off their highs, it is not clear that inflation has peaked, according to our team at NYL Investors. If not, the Fed's commitment to fight inflation is likely to produce tighter financial conditions, which could affect demand and slow the economy, says the group. While the Fed is aiming for a "soft landing," the probability of a mistake is high. So, although unemployment remains low, the odds of a recession are not negligible.

Given the combination of high inflation and slower growth, investors may feel they have no place to hide. But remaining diversified is critical, and our Multi-Asset Solutions Team believes they should be positioned defensively while also protecting themselves against pricing pressures.

Equities

Although valuations have come down, Candriam notes that it is too early to take a "risk-on" position. Nevertheless, while economic uncertainty and a potential slowdown may incline investors toward traditional safe haven assets, being defensive in a today's high-inflation environment requires a different approach.

Our Multi-Asset Solutions Team favors continued exposure to equities, especially those that are defensive or value oriented. Earnings and stock prices in defensive sectors such as utilities, health care, and consumer staples should remain more resilient. We are also more inclined toward higher-quality names. For inflation protection, we favor exposures that perform well during periods of pricing pressures, including energy, infrastructure, and materials.

Looking globally, valuations appear more attractive in Europe than in the U.S. But in China, equities are even closer to a bottom, and they are receiving support in the form of monetary and fiscal policy, says Candriam.

Fixed Income

With the sell-off in the first half of 2022, the Global Fixed Income Team at MacKay Shields believes valuations are more attractive, and current yields have improved income opportunities substantially. But, in light of the need to be defensive in a slowing economy, bonds of higher credit quality are preferred. Floating-rate bonds also fit the bill, according to our Multi-Asset Solutions Team since their secured nature reduces their credit risk. Inflation also makes their floating rate especially attractive.

Generally, we prefer to be underweight duration until Fed hawkishness peaks, says the Multi-Asset Solutions Team, but some permanent exposure to core bonds is normal. To diversify against this risk, they recommend that investors consider infrastructure bonds. On the other hand, in anticipation of a likely economic slowdown and a decline in sovereign rates, the team at Candriam notes that they have shifted to a positive duration position on U.S. Treasuries.

The MacKay Shields Convertibles Team points out that convertibles have tended to perform well when rates rise. Convertibles lagged over the past two years and are now trading at attractive valuations. The Team believe the upside potential is now greater than the downside risk.

Emerging Markets

In light of rising interest rates and high commodities prices, certain emerging market economies may face challenges, according to the MacKay Shields Emerging Market Debt team. Emerging economies that have large amounts of external debt, are commodity importers, or have central banks that have been slow to react to inflation are likely to find the second of half of 2022 challenging.

On the other hand, corporate fundamentals in many emerging markets are more sound than those in developed markets, with net leverage ratios for investment-grade and high-yield issuers being lower. Thus, the Team believes a recent rise in yields in emerging market corporate bonds makes this asset class attractive. Carefully researched high-yield bonds may also offer appealing potential returns.

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Asset Class Risk:

Investments in common stocks and other equity securities are particularly subject to the risk of changes in investors' perceptions of the financial condition of an issuer, conditions affecting equity markets generally and political and/or economic events.

Bonds are subject to interest rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk which is the possibility that the bond issuer may fail to pay interest and principal in a timely manner.

Issuers of convertible securities may not be as financially strong as those issuing securities with higher credit ratings and are more vulnerable to changes in the economy. If an issuer stops making interest and/or principal payments, these securities may be worth less and the fund could lose its entire investment.

Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks. The risks of investing in emerging markets include the risks of illiquidity, increased price volatility, smaller market capitalizations, less government regulation, less extensive and less frequent accounting, financial and other reporting requirements, risk of loss resulting from problems in share registration and custody, substantial economic and political disruptions, and the nationalization of foreign deposits or assets.

Floating rate are generally considered to have speculative characteristics that involve default risk of principal and interest, collateral impairment, non-diversification, borrower industry concentration, and limited liquidity.

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