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How private markets can help navigate rising inflation expectations

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Many commentators expect the recent rise in inflation to be transitory, but a longer-term reflationary trend – or an increase in inflation expectations – cannot be ruled out. Against this backdrop, private-markets assets have a range of characteristics that could help investors hedge against – and even benefit from – any sustained return to inflation.

The return of inflation has presented investors with a challenge. The search for yield must now be coupled with a need to protect against inflationary trends. Several strategies under the private-markets umbrella look well-positioned to provide that hedge – and could even flourish if higher inflation persists. Moreover, the geographical spread of private-markets strategies can help investors diversify across economies at different phases in the inflationary cycle and varying responses by central banks. While some private-markets strategies are fixed rate with long duration, they may not necessarily underperform in an inflationary environment if actual inflation does not exceed market expectations for inflation.

Private markets are well-equipped for a range of inflationary environments

After the financial crisis of 2007-2008, the economy settled into a low-inflation, low-growth environment. But recently, monetary and fiscal stimulus as part of governments’ response to the Covid-19 pandemic has coincided with economies surging back to life. The release

Key takeaways

- Assets under the private-markets umbrella have various built-in hedges if the recent rise in inflation becomes a longer-term trend
- Inflation within the forecast 2%-3% range should be easily absorbed by many private-markets strategies as these levels are already built into pricing assumptions, and could even offer opportunities
- The structures in which private-markets strategies invest are often less impacted by inflation, and can even flourish in an inflationary environment
- A sector-specific focus on issuers and organisations with a track record of dealing with previous periods of inflation should serve investors well

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of pent-up savings has met with supply-side issues and a labour shortage, putting inflation firmly back onto the agenda. But will this environment last? There are two general views:

- The market consensus is that this inflation surge is transitory, and there is a fairly low risk of lasting inflation. In this view, the underlying causes of the latest inflation rebound should subside as the world's economies "reboot", people return to work and supply chain issues are resolved.
- The contrarian view is that the risk of medium-term inflation is underestimated by the markets. Inflation may surprise on the high side for longer, even if the actual year-over-year inflation numbers peak this year. Certain structural forces could keep inflation higher – including significant shifts in the monetary policy of major central banks, a changing labour force and ongoing deglobalisation.

Regardless of which view prevails, strategies across the private-markets universe may be well-equipped to deal with any fluctuations, and a general reflationary trend could provide opportunities for these asset classes. This paper takes a closer look at how various private markets can benefit from a range of inflationary environments.

An inflationary environment is generally good for credit and equity in the early stages, but if rate increases persist, default rates could rise as well. Infrastructure-like industries – which can frequently be accessed in the private markets – can often feature lower default risk. Moreover, one of the clear strengths of private debt is that usually it has preferential treatment in a default, and higher recovery rates, than public debt. It is worth noting, however, that we do not expect a big jump in defaults as many higher-risk businesses have used the historically low interest rates to "term out" their debt.

A closer look at how private-markets strategies can turn inflation into opportunity

The private-markets universe is vast, and each component has its own unique qualities that respond differently to inflation. Here's a closer look at several key areas:

- Private equity
- European private credit
- US private credit
- Asia private credit
- Trade finance
- Infrastructure debt
- Infrastructure equity

Private equity: underlying companies will be key

Inflation within the projected 2%-3% range (which is still low in a historic context) should have little impact on private equity (PE) strategies. Any increase in inflation would be expected to push financing costs upwards over time and likely lead to a fall in transaction multiples. As long as inflation remains within the forecast range, however, any impact on pricing may not be significant.

The threat of a return to inflation has already led to higher volatility in stock valuations. Should the reduction in transaction pricing outlined above come to pass, PE investments made at higher multiples at the outset would be affected by a contraction when exiting the position. Given that PE fund managers can actively manage their portfolio companies – extracting value through better management, mergers and acquisitions, and geographic and other expansion as well as the timing of exits – they have tools available to help mitigate any negative impact.

The bigger question is whether increased inflation would spark a wider recessionary trend. This could impact the price of transactions as underwriting would become more challenging with the accompanying risk of reduced financing for deals. Also, if portfolio companies end up being held for longer as managers delay exits, this could hamper fund managers' ability to raise new funds. Both trends could result in a slower pace of private equity deployment. But this should not prove significant if inflation stays within the expected range.

- Sectors that could be hurt by higher inflation include industrials and manufacturing, which would suffer from higher input prices. But focusing on sector leaders could help minimise the impact of inflation on operational performance.
- Sectors that could benefit from higher inflation include tech and healthcare. Software companies, for instance, may be able to increase prices more easily. Similarly, sectors like education and emerging-market healthcare should benefit from strong secular tailwinds.

Whatever the sector, the business model of the underlying firm is key, and the ultimate hedge is to focus on well-run organisations whose managers have a demonstrable track record of successfully navigating previous periods of inflation and recession.

European private credit: variable-rate structure offers a hedge

Within private credit – ie, non-bank corporate lending, which is not accessible through public markets – any return to a more inflationary environment could represent an opportunity for asset managers who have picked strong companies without overstretched capital structures.

A private corporate debt investment also offers several hedges when compared with publicly traded corporate debt. It is typically structured around floating-rate notes, which means the interest rate is variable. As such, it offers protection against an environment of rising rates and inflation. Also, the duration of each investment is typically shorter than equivalents on the public markets, so managers can be more proactive in responding to inflation. And finally, absolute levels of return are typically higher, providing a further cushion.

At the micro level, interest expenses are typically hedged by the company/borrower at the outset of the deal, so any interest costs should remain manageable. A spike in wages and commodity prices could put some pressure on earnings in the short term, particularly for those companies that are already financially stretched. If inflation persists, companies with a strong market position should be able to pass rising costs to their customers. From that perspective, inflation could result in greater differentiation between strongly and weakly positioned companies.

Finally, the buy-and-hold nature of private credit assets makes them less volatile in terms of valuation. There would likely be fewer forced sellers in the private debt market than in public markets in the event of, for example, higher interest rates.

US private credit: focus on high-yield, shorter duration credit

We expect high-yield corporate loans involving US borrowers to behave broadly similarly to publicly traded equivalents in response to inflation.

The current bout of inflation has been largely driven by labour shortages and supply bottlenecks. While these issues should ease over the next year, we believe inflation is likely to persist beyond the current recovery period as the continuing availability of private capital will likely push most input and asset prices higher. These inflationary pressures are likely to be more pronounced in the US than in Europe, where they have been offset by greater fiscal stimulus.

With investment-grade credit, higher inflation and interest rates will ultimately lower prices for longer duration bonds. High-yield loans meanwhile will benefit from their shorter duration, but there is a risk that highly leveraged companies will face rising input costs that they could struggle to pass onto customers quickly enough. Shorter-duration investments would seem generally more attractive while inflation is high. Where longer-dated cash flows are necessary, sectors that can best control input costs – or high-margin businesses that are better able to absorb inflationary pressure – look well placed.

Asia private credit: ex-China economies could strengthen

China was the first country to reopen following the Covid-19 pandemic and surging costs of imported commodities have pushed up factory-gate inflation to its highest levels since 2008. China has had a deflationary influence on global consumer prices since the 1990s. But low margins – coupled with these rising costs and increased export demand – could lift prices just as inflation starts to pick up in the US and other reopening economies that have made progress in their vaccination programmes. This trend is further exacerbated by supply chain bottlenecks in other emerging markets, which we expect to drive inflation in the short term.

While the supply chain and trade trends could cause an increase in inflationary pressures in certain sectors, ex-China Asian economies such as India, Vietnam, Bangladesh and the Philippines are expected to benefit as companies transfer supply chains. This should further fuel economic growth in these countries as they develop the ecosystem underpinning the supply chains. As a result, within Asia, sectors at the heart of this evolution should be well-positioned. These include telecommunications, clean energy, logistics and packaging.

Businesses based around the trends that are likely to accompany economic growth in these countries – like urbanisation and adoption of technology – should also present opportunities within Asia. These include consumer goods, healthcare and pharmaceuticals.

Trade finance: short duration will help

Easy access to working capital is the lifeblood of free trade. The field of trade finance consists of financial instruments built around loans that provide the working capital to facilitate this trade. There is already a structural shortage of trade finance globally and a faster-growing economy will make the situation worse, while potentially improving the returns available for investors. Since trade-finance instruments typically have very short durations – around 90-180 days – the impact of rising rates would likely be minimal. Moreover, as liabilities run off, new deals can be financed at higher rates. This means there should be only a short delay between rates increasing and investors being able to secure higher offered returns.

If any inflation is part of a wider global reflationary trend, there will also be a resulting benefit to the fundamentals of the underlying credit risk, which should also increase the supply of trade finance deals available. The short spread duration also reduces volatility compared with longer-dated assets.

Infrastructure debt: strong regulation adds a layer of hedging

Infrastructure debt involves corporate-debt-based instruments that provide the bulk of funding for most infrastructure projects. These typically incorporate various safeguards that can provide further reassurance in times of inflation. Compared with other types of corporate debt, infrastructure is a relatively low-risk, investment-grade asset with a long duration that affords investors some certainty around meeting long-term liabilities. Furthermore, infrastructure is not exposed to the same market risks as other publicly traded corporate sectors, so it is less volatile.

Due to the nature of the projects being funded, the organisations behind the infrastructure deals are typically heavily regulated, which adds another layer of protection. Infrastructure projects often take place under a monopolistic or semi-monopolistic arrangement, and those regulators impose high barriers to entry.

Inflation expectations are one of the most important drivers of valuation for assets that have a strong correlation between inflation and EBITDA (earnings before interest, taxes, depreciation and amortisation). This describes a large part of the infrastructure universe, but the impact of inflation varies across infrastructure projects:

- For example, some projects are index-linked to maintain conservative structures. These should see little impact from inflation.
- Other deals are fixed rate, which could lead to some stress when the deals need to be refinanced at higher levels. However, this can be mitigated by amortising structures that both cut duration and reduce the amount of refinancing.
- Some fixed-rate deals finance assets that benefit from inflation, which allows them to de-lever more quickly than expected.

In a sustained high-inflation environment, there will be much more divergence between the best performers and the worst. Typically, the best performers should be those assets that have high margins, a relatively fixed cost base with sub-inflationary growth and the ability to achieve increases in tariffs. Digital infrastructure is a good example of this type of asset. Conversely, some infrastructure assets, such as ports, are heavily exposed to the deglobalisation trend.

Infrastructure equity: close correlation means higher inflation is an opportunity

Although the degree varies, investments into the equity of firms involved in infrastructure projects typically carry a high correlation with inflation. A portfolio can typically be split into the following broad categories, according to how inflation impacts them:

- **Real-return regulation.** This determines the real return on capex before overlaying additional compensation linked to inflation movements.
- **Nominal-return regulation.** This determines a nominal rate of return on capex. This is not directly linked to inflation, but typically will offer some protection against inflationary environments, for example by passing operational expenditure onto customers.
- **Volume-dependent.** This involves assets that are typically able to reflect inflation in their tariffs to customers in the short and medium term.
- **Tariff-regulation and long-term contracted**. These set long-term revenues at the outset. These are not always adjusted for inflation until the regulation is reviewed or the contract expires.

Of these categories, real-return regulation assets generally provide the best hedge against rising inflation. In fact, the positive correlation means that rising inflation represents an opportunity to increase returns on investments. For tariff-regulation and long-term contracted assets, the correlation is significantly lower, but still positive.

For debt generally, the underlying assets are typically fixed term, and often long term, so cashflows can offer a levered play on inflation.

Beyond inflation: look to private markets for yield and return potential

The long-term, buy-and-hold nature of many private-markets investments, and their ability to absorb or pass on increases in costs mean that, to an extent, these strategies can provide investors protection against inflation – both from a mark-to-market and fundamental perspective.

But private-markets strategies can offer more than that. They may hold opportunities for investors to find yield and access returns, whether through identifying the sectors and companies that are positioned to flourish during an inflationary environment, or through a structure that delivers a close correlation with inflation. For many, a return to inflation will not be feared. In the context of these strategies, it could even be welcomed.

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