unison
Investment Management

Priced to Perfection

Introduction

A confluence of positives has driven markets for the past decade: decreasing interest rates, lower volatility, increasing liquidity, growing equity prices, and tightening credit markets. These good times have populated an investment landscape of portfolios priced to perfection. Investors learned to buy on dips, increase leverage to offset lower returns, and take comfort that the Federal Reserve would keep rates low and federal funds accessible. Our longest-serving Chairman of the Fed, William McChesney Martin, would be wary of just how long the "punch bowl" has been left out for the markets.

In our present environment, we believe successful investing is tantamount to naive risk-taking. Wiser investment managers have remained mindful of rising inflation because of its immediate detrimental effect on real returns and the inevitable rise in borrowing rates that follow. This wisdom has yet to pay off throughout this past decade's bull run. However, the 10-year Treasury rate returns 1.6% per year, and the expected earning return on equity is at a near dot-com bubble low of 2.4% (i.e., PE ratio of the S&P 500 is 42.1). Even a small shock above the Fed's inflation expectation for 2021 of 2.4% may result in negative real returns across these two staple markets. This is what it means for a market to be priced to perfection. The economy has to grow at record levels to support current price levels of corporate equity and Treasuries.

To access pure protection against inflation, investors have to suffer a negative yield of the Treasury Inflation-Protected Securities (TIPS). A better solution which provides inflation protection, high yield, and a relatively low correlation to corporate equity and Treasuries may be real assets, notably, owner-occupied residential real estate equity (OOR).

1. https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/textview.aspx?data=yield
2. https://www.multpl.com/s-p-500-pe-ratio
3. https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20210317.htm

The Specter of Inflation

A decade of highly accommodative US fiscal and monetary policy, coupled with historically unprecedented per-capita public sector debt and near zero interest rates, has reawakened the specter of inflation. Investment managers currently tasked with protecting their portfolios in a rising inflation environment must operate without any real experience in such environments. Assets which perform well in a falling inflation environment (e.g., fixed income, equities, etc.) have performed spectacularly well. Such sustained performance has fostered an environment devoid of investable assets which may be expected to perform well when inflation rises. While one might expect ten-year TIPS to perform well in a rising inflation environment, priced-in inflation expectations have caused this security to yield a negative 66 basis points. Once inflation rises, the trades which performed well for the past decade will no longer work, and managers who might have provided personal experience about navigating such a reality will have long since retired.

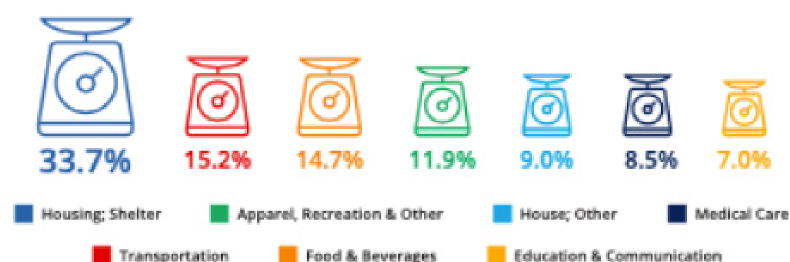
Putting the house in order

In preparation for rising inflation, investors may seek out new investment classes which generate sustainable returns and positive correlation to inflation. Owner-occupied residential real estate, which is considered a homeowners' primary residence, provides double-digit returns and positive correlation to inflation. This trillion dollar market consists of 100 million distinct, geographically, and economically diversified, owner-occupied investments. Unlike other asset classes whose positive correlation to inflation is incidental or academic, OOR correlates positively with inflation as it represents nearly half of the basket from which the Bureau of Labor Statistics calculates the Consumer Price Index (CPI).

Housing Represents 43% of CPI

CPI addresses a wide range of consumer goods. These goods can be summarized in a few overall expenditure “buckets” (See Figure 1 below). One can expect that OOR should closely track CPI given that housing is inflation’s biggest component across all expenditure buckets. Housing, in fact, represents 43% of the total index with the so-called Shelter Bucket alone - representing more than a third of the total index.

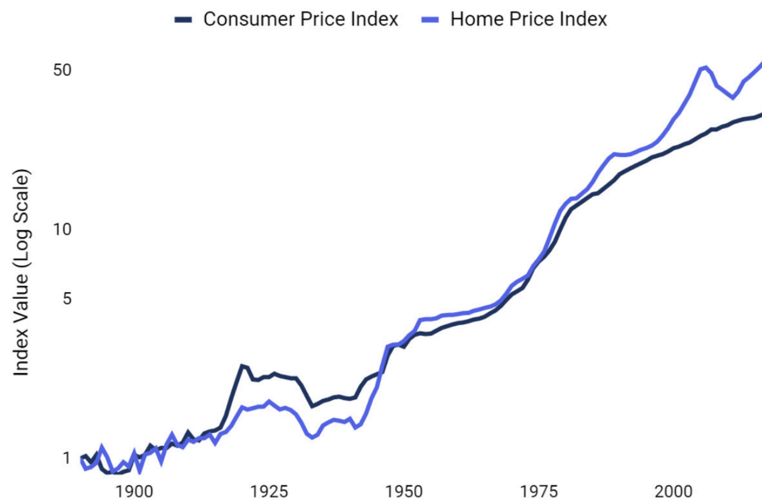
Figure 1. CPI Expenditure Category Relevance Weights (December 2016)



While OOR’s positive correlation with inflation appears obvious, one immediately encounters two problems in attempts to measure that correlation mathematically. First, institutional quality access, was only made available less than 10 years ago - signifying a new market with short historical data. In addition, inflation has not risen appreciably during the period in which access to OOR has been possible. In fact, inflation has not risen appreciably for the past four decades. In order to appreciate how OOR might perform when inflation rises, one must substitute a proxy with a more mature and reliable historical data set. Reliable, institutional-quality, nationally-recognized, same-house sale price indices (e.g. the Case-Shiller National House Price Index) have published results going back at least to 1970, and such indices can be reliably substituted as a proxy for OOR.

Over the past 40 years, inflation’s consistent downward bias obscures standard correlation mathematics. Assets which can be expected to have a positive response to rising inflation (e.g., TIPS, commodities, apartments, commercial real estate, etc.) demonstrate little meaningful correlation. Despite their supposed correlation to inflation, these asset classes are currently priced to perfection. TIPS, for example, are custom engineered to be correlated with inflation, yet have a correlation coefficient no greater than 30% as measured over the past 30 years. Despite the persistence of low inflation, US house prices demonstrate a correlation coefficient of 60% or almost twice as high as TIPS.

Perhaps, a more meaningful indicator of how OOR might perform versus inflation would be to examine more closely the decade between 1970 and 1980. In the 1970s, year-over-year CPI spiked twice, punctuated by a steep trough, and then the start of a decades-long decline. The chart below illustrates the relationship between US house prices and inflation during that period. Notice how during the decade between 1970 and 1980, US house prices tracked inflation up and down across both peaks and through the start of the long decline. House prices through both peaks and declines were a leading indicator for future changes in CPI. This makes sense because housing is such a high component of the index, and changes in housing take a number of months to feed appreciably into the CPI basket-based calculus.



In addition to the 1970s, US house prices closely tracked changes in inflation during the US Housing Crisis beginning in 2008. House prices, as measured nationally by the Case-Shiller Index, spiked sharply downward starting in 2007. As with the 1970-1980 experience, core inflation likewise spiked downward beginning one year later as the sudden revaluation of US housing fed into the CPI calculus. Likewise, when home prices began their sharp recovery in early 2010, core inflation spiked later in the year as reinflating house prices fed back in. It is reasonable, therefore, to expect that home prices will continue to track inflation when inflation rises.

Conclusion

Forty years of accommodative US fiscal and monetary policies have fostered an investment universe that has experienced an unprecedented historical run for the risk-on trade. The over-leveraged, undiversified portfolios which have eked out single-digit returns in the prevailing low inflation environment risk wholesale slaughter in an environment which is uniquely unprepared for rising inflation. Successful investment managers who continue on their current path risk underperforming at precisely the moment inflation erodes the buying power of the public they serve. In our view, this perfect storm calls for a solution such as OOR, which seeks to add positively-correlated inflation exposure to investor portfolios and aims to improve returns. OOR, as originated and offered by Unison, may achieve strong performance now and once inflation rises.

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