

# POSITIONING FOR HIGHER INFLATION

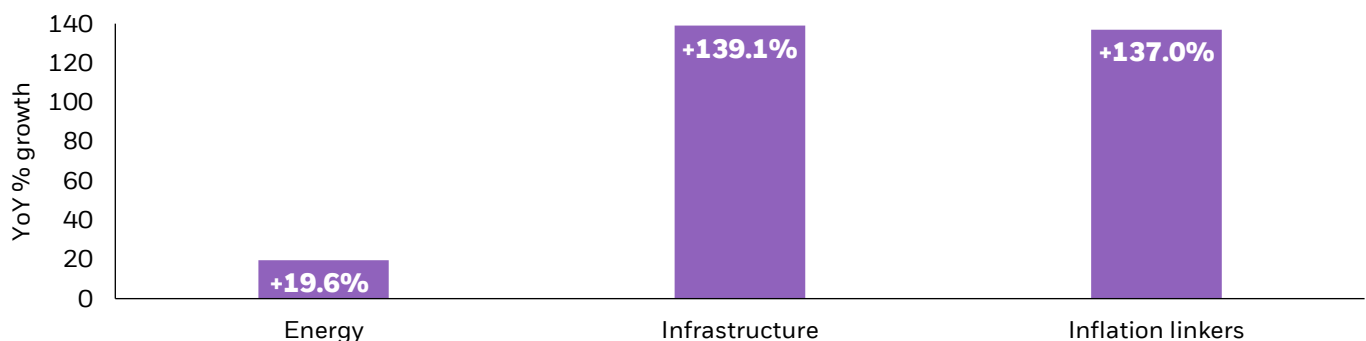
# BlackRock®

NOVEMBER 2021

- **Higher inflation has been a key focus for investors in 2021**, alongside its implications for central bank policy and markets.
- **We still see medium-term risks from price pressures** – eventually, we expect a higher inflation regime than pre-Covid – and advocate building multi-asset inflation protection into portfolios.
- **Below, we offer a ‘toolkit’ including inflation-linked and inflation-sensitive exposures**, with cross-asset implementation ideas across alpha-seeking and index products.

**Inflation has been top of mind throughout 2021, with investors focusing on the path of prices across the globe** as the restart has taken hold. Taking a step back from short-term inflationary headlines, we still see medium-term risks, and we expect inflation to eventually settle at a higher level than pre-pandemic. This has played out in investor flows, with increased buying across explicitly inflation-linked products as well as inflation-sensitive exposures. Inflows into inflation-linked bond ETPs, for example, are at \$41.0B YTD – more than double the \$17.3B added across 2020, which was itself a record breaking year.<sup>1</sup> Research by the BlackRock Portfolio Analysis and Solutions team highlights that, as of the end of 2020, asset managers across EMEA were not explicitly positioned for higher inflation, which could help to explain the uptick in inflation-related flows in 2021, alongside the rise in inflation expectations. As investors look at how to manage these risks, we advocate positioning portfolios for rising inflation through a multi-asset lens.

**Chart 1: Year-on-year growth, flows into global inflation-linked bond, energy and infrastructure ETPs**



Source: BlackRock and Markit, as at 04 November 2021. **Past flows into global ETPs are not a guide to current or future flows and should not be the sole factor of consideration when selecting a product.**

## Inflation into 2022

**We see elevated price pressures continuing into next year:** a stronger restart, supply chain constraints, and energy price pressures have seen a runup in inflation, leading markets to pull forward expectations for central bank tightening. Focus has been on the US, where leading indicators are pointing to sustained above-trend inflation, including average hourly earnings and survey-based inflation expectations. Yet while the debate continues around how long ‘transitory’ inflation could endure, rising inflation is not just a US story. Supply chain constraints have been particularly challenging for European markets, while the natural gas shortage has affected inflation more acutely in Europe than the US. 5y5y inflation swaps point to eurozone inflation above 2.1%, and UK inflation touching 4%.

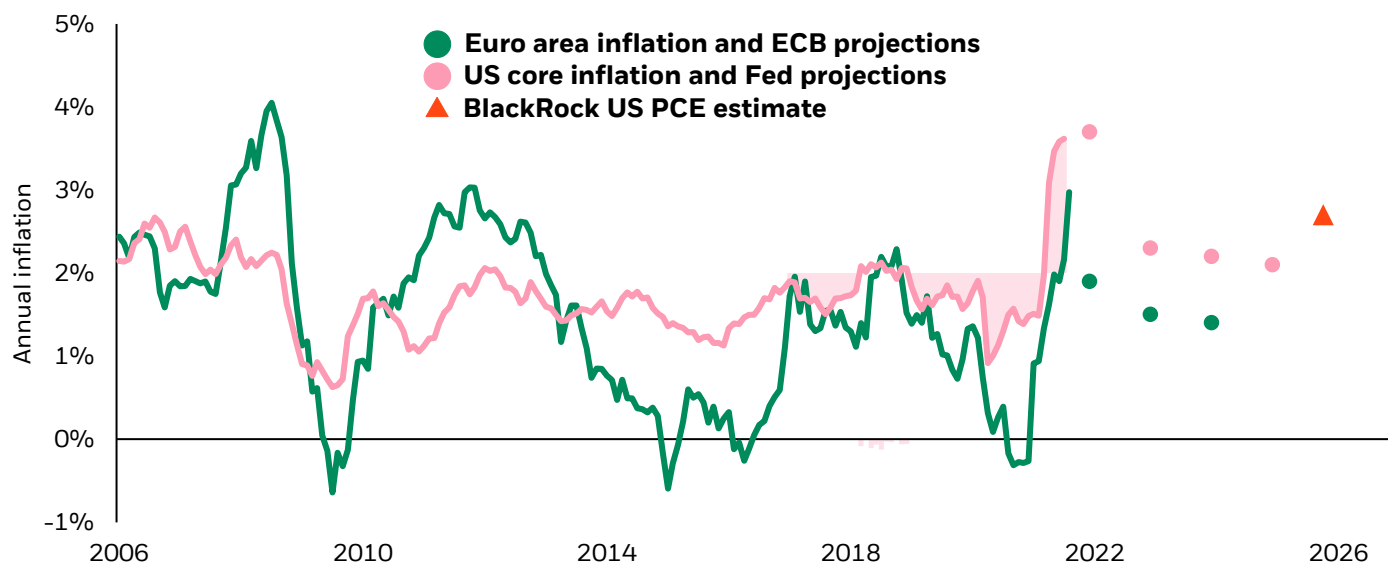
**What does this mean for monetary policy?** While the US Federal Reserve (Fed) has started to scale back monetary accommodation by tapering its bond-buying, we see market pricing of higher policy rates as overdone – in terms of both how soon and at what pace key developed market central banks may lift rates. Within our new nominal investment theme, we see policymakers continuing to tolerate inflation overshoots, with higher production costs and a rewiring of global supply chains, and unprecedented policy accommodation keeping price pressure elevated.

<sup>1</sup> Source: BlackRock and Markit, as at 04 November 2021. **Past flows into global ETPs are not a guide to current or future flows and should not be the sole factor of consideration when selecting a product.**

Figures are in US dollars, unless stated otherwise.

Higher debt levels may also impede central banks' capacity to lean against price pressures, alongside revised inflation mandates. This includes the Fed's new average inflation target framework – where the central bank aims for inflation to average 2% over time, meaning that overshoots can be tolerated to make up for past undershoots. In Europe, the adoption of a symmetrical target around 2% reflects a broader trend to relax constraints imposed by earlier frameworks to prevent looser policy.

**Chart 2: Euro area and US inflation and central bank forecasts, 2006-2024**



**Forward looking estimates may not come to pass. Sources:** BlackRock Investment Institute, Bureau of Economic Analysis, Eurostat, Federal Reserve, European Central Bank. October 2021. Notes: The chart shows euro area headline inflation and U.S. personal consumption expenditure inflation. The dots show Federal Reserve and European Central Bank (ECB) projections. The Federal Reserve projections show Q4 annual inflation published in the FOMC Summary of Economic Projections over 2021 Q4-2023 Q4. The ECB projections show calendar-year average inflations rates over 2021-23. The triangle shows our estimate of average US personal consumption expenditures (PCE) – the Fed's preferred gauge of inflation – in five years' time. We derive this from our estimate of consumer price index in five years' time that currently stands at 3%. We assume a 0.3 percentage point wedge between PCE and CPI inflation based on the historical relationship and estimates of the factors that influence both.

## Positioning for inflation in fixed income

Inflation-linked bond ETPs offer a direct route to insulating portfolios for inflation, and investors have been leveraging the exposure for this reason since mid-2020. Short-duration TIPS have tended to be less sensitive than long-duration bonds during periods of rising rates. Shorter-maturity, interest-rate hedged or floating rate exposures can help investors limit nominal duration risk. Floating rate bonds, which move in line with interest rates, may be a useful way to eliminate rate volatility from fixed income allocations. Floating-rate bonds look well-positioned as we move into 2022, with the potential for a more volatile rate environment as central banks look to tighten financial conditions. Unconstrained fixed income funds are also designed to work in inflationary or rising interest rate environments, and may be positioned to benefit from both heightened inflation expectations and ensuing policy responses to manage price pressures.

## Positioning for inflation in equities

Inflation protection transcends asset class. Mentions of inflation on Q2 earnings calls were at the highest level in 10 years,<sup>2</sup> and this trend has continued into the Q3 season. At the same time, investors have been allocating to inflation-sensitive equity exposures: energy sector flows are at \$20.8B YTD – on track to be a record. Infrastructure ETPs – which can be used as an inflation hedge – are also on pace for a record year with \$7.7B added YTD – more than the annual flows to the exposure in 2019 and 2020 combined (\$6.8B).<sup>3</sup> Sectors with a high beta to inflation, such as US materials, can be used to position for the pickup in prices, while sectors like financials are well-positioned for an overall higher inflationary environment. Positioning for inflation may add exposure to increased volatility in equities, including small caps, energy, and the value factor. When considering allocations in the current environment, we also advocate building ballast in equities, through allocations to sectors which are positioned to pass on the rise in prices to consumers and limit the impact on company balance sheets.

<sup>2</sup> Source: FactSet, as at 17 September 2021.

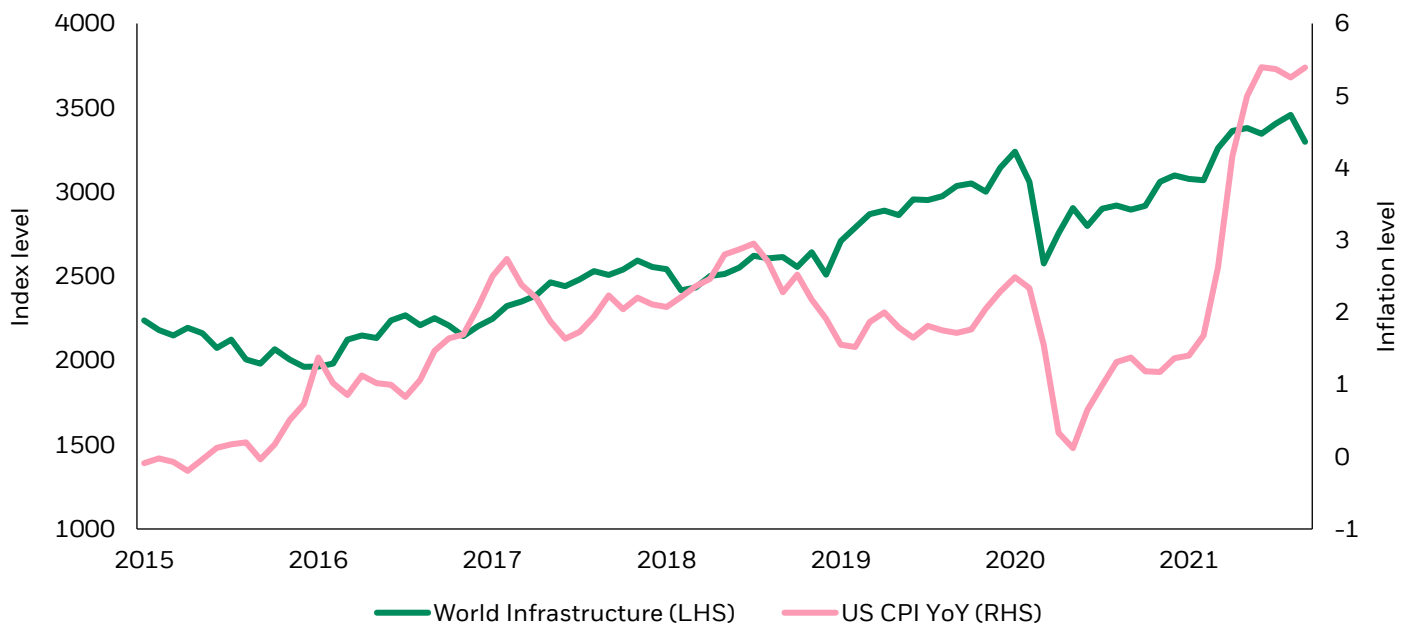
<sup>3</sup> Source: BlackRock and Markit, as at 04 November 2021. Figures are in US dollars, unless stated otherwise.

## Positioning for inflation through alternatives

Exposure to alternative sources of return can help build inflation protection into portfolios, even through ETFs. Infrastructure, for example, is not only a tool for portfolio diversification that may offer income in a lower-for-longer environment, but can also serve as an inflation hedge. On the equity infrastructure side, companies tend to be lower-leveraged and offer a steady dividend yield. Timberland exposure may also provide an inflation hedge over the medium term, and can be used to position for the journey to net zero, alongside infrastructure, by allocating to areas that may benefit from the green transition.

Gold offers portfolio diversification properties the longer it is held in portfolios, with a sub 0.3 correlation to equities, which decreases the longer it is held. More broadly, commodity prices tend to move with headline inflation, particularly those commodities with a stronger energy focus. Finally, real estate can act as a hedge against unanticipated inflation with the added option of diversification vs. major equity indices, even with the equity beta of indexed real estate.

**Chart 3: World infrastructure vs. US inflation, 2015-2021**



Source: Bloomberg and BlackRock, as at 26 October 2021.

## BlackRock inflation toolkit

<b>FIXED INCOME</b>	<b>Inflation-linked bonds</b>	<b>TIP5</b> iShares \$ TIPS 0-5Y UCITS ETF	<b>ITPS</b> iShares \$ TIPS UCITS ETF	<b>IBCI</b> iShares € Inflation Linked Govt Bond UCITS ETF	<b>IGIL</b> iShares Global Inflation Linked Govt Bond UCITS ETF	
		<b>BGF Global Inflation-Linked Bond Fund</b>				
	<b>Floating rate bonds</b>	<b>FLOT</b> iShares \$ Floating Rate Bond UCITS ETF	<b>EFRN</b> iShares € Floating Rate Bond UCITS ETF			
	<b>Unconstrained fixed income</b>	<b>BSF BlackRock Fixed Income Credit Strategies Fund (FICS)</b>	<b>BSF BlackRock Fixed Income Strategies Fund (FISF)</b>	<b>BGF Fixed Income Global Opportunities Fund (FIGO)</b>	<b>BGF ESG Fixed Income Global Opportunities Fund</b>	
<b>EQUITIES</b>	<b>Inflation-sensitive sectors</b>	<b>WENS</b> iShares MSCI World Energy Sector UCITS ETF	<b>IUFS</b> iShares S&P 500 Financials Sector UCITS ETF	<b>IUMS</b> iShares S&P 500 Materials Sector UCITS ETF		
		<b>BGF World Energy Fund</b>	<b>BGF World Financials Fund</b>	<b>BGF World Mining Fund</b>	<b>BGF Natural Resources Growth and Income Fund</b>	
	<b>Size &amp; value</b>	<b>CSUSS</b> iShares MSCI USA Small Cap UCITS ETF	<b>IUVE</b> iShares MSCI USA Value Factor ESG UCITS ETF	<b>IEVL</b> iShares Edge MSCI Europe Value Factor UCITS ETF		
		<b>BGF US Small &amp; MidCap Opportunities Fund</b>	<b>BGF US Basic Value Fund</b>	<b>BGF European Value Fund</b>		
	<b>ALTERNATIVES</b>	<b>Real assets</b>	<b>INFR</b> iShares Global Infrastructure UCITS ETF	<b>CITY</b> iShares Smart City Infrastructure UCITS ETF	<b>IUSP</b> iShares US Property Yield UCITS ETF	<b>IWDP</b> iShares Developed Markets Property Yield UCITS ETF
			<b>BGF World Real Estate Securities Fund</b>	<b>BSF Global Real Asset Securities Fund</b>	<b>BGF Sustainable Global Infrastructure Fund</b>	
<b>Commodities</b>		<b>IGLN</b> iShares Physical Gold ETC	<b>WOOD</b> iShares MSCI USA Value Factor ESG UCITS ETF			
		<b>BGF World Gold Fund</b>				

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Changes in the rates of exchange between currencies may cause the value of investments to diminish or increase. Fluctuation may be particularly marked in the case of a higher volatility fund and the value of an investment may fall suddenly and substantially. Levels and basis of taxation may change from time to time.

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**Product Risks****iShares \$ TIPS 0-5 UCITS ETF**

Counterparty Risk, Credit Risk, Liquidity Risk

**iShares \$ TIPS UCITS ETF**

Concentration Risk, Counterparty Risk, Credit Risk, Liquidity Risk

**iShares € Inflation Linked Govt Bond UCITS ETF EUR (Acc)**

Concentration Risk, Counterparty Risk, Credit Risk, Liquidity Risk

**iShares Global Inflation Linked Govt Bond UCITS ETF USD (Acc)**

Counterparty Risk, Credit Risk, Liquidity Risk

**iShares \$ Floating Rate Bond UCITS ETF USD (Dist)**

Concentration Risk, Counterparty Risk, Liquidity Risk, Credit Bail in Risk

**iShares € Floating Rate Bond UCITS ETF EUR (Dist)**

Counterparty Risk, Credit Risk, Liquidity Risk

**iShares \$ High Yield Corp Bond UCITS ETF USD (Dist)**

Counterparty Risk, Credit Risk, Liquidity Risk, Non-Investment Grade Risk

**iShares S&P 500 Materials Sector UCITS ETF**

Concentration Risk, Counterparty Risk, Equity Risk

**iShares S&P 500 Financials Sector UCITS ETF USD (Acc)**

Concentration Risk, Counterparty Risk, Equity Risk

**iShares MSCI USA Small Cap UCITS ETF USD (Acc)**

Counterparty Risk, Equity Risk, Liquidity Risk, Smaller Companies Risk

**iShares MSCI USA Value Factor ESG UCITS ETF USD (Acc)**

Equity Risk, Environmental, Social and Governance (ESG) Risk

**iShares Edge MSCI Europe Value Factor UCITS ETF EUR (Acc)**

Counterparty Risk, Equity Risk, Factor Focus Risk, Index Methodology Risk

**iShares Global Infrastructure UCITS ETF USD (Dist)**

Concentration Risk, Counterparty Risk, Equity Risk, Investments in Infrastructure Securities Risk

**iShares Smart City Infrastructure UCITS ETF USD (Acc)**

Concentration Risk, Counterparty Risk, Emerging Markets Risk, Equity Risk, Environmental, Social and Governance (ESG) Risk, Liquidity Risk, Smaller Companies Risk

**iShares US Property Yield UCITS ETF USD (Dist)**

Concentration Risk, Counterparty Risk, Equity Risk, Investments in Property Securities Risk

**iShares Developed Markets Property Yield UCITS ETF USD (Dist)**

Concentration Risk, Counterparty Risk, Equity Risk, Investments in Property Securities Risk

**iShares Listed Private Equity UCITS ETF USD (Dist)**

Concentration Risk, Counterparty Risk, Derivatives Risk, Private Equity Securities Risk

**iShares Global Timber & Forestry UCITS ETF USD (Dist)**

Concentration Risk, Counterparty Risk, Equity Risk, Investments in the Timber and Forestry Industry Risk

**BGF ESG Fixed Income Global Opportunities Fund**

Asset Backed Securities / Mortgage Backed Securities, Counterparty Risk, Credit Risk, Currency Risk, Derivatives Risk, Liquidity Risk

**BGF European Value Fund**

Concentration Risk, Counterparty Risk, Equity Risk

**BGF Fixed Income Global Opportunities Fund**

Asset Backed Securities / Mortgage Backed Securities, Counterparty Risk, Credit Risk, Derivatives Risk, Liquidity Risk, Non-Investment Grade Risk

**BGF Global Inflation Linked Bond Fund**

Counterparty Risk, Credit Risk, Derivatives Risk, Non-Investment Grade Risk

**BGF Natural Resources Growth & Income Fund**

Concentration Risk, Counterparty Risk, Derivatives Risk, Equity Risk, Erosion to Capital, Liquidity Risk, Natural Resources

**BGF Sustainable Global Infrastructure Fund**

Specific sector risk, equity risk, infrastructure risk, ESG risk, counterparty risk

**BGF US Basic Value Fund**

Counterparty Risk, Equity Risk

**BGF US Small & MidCap Opportunities Fund**

Counterparty Risk, Equity Risk, Liquidity Risk, Smaller Company Investments

**BGF World Energy Fund**

Concentration Risk, Counterparty Risk, Equity Risk, Investments in Energy Securities

**BGF World Financials Fund**

Concentration Risk, Counterparty Risk, Equity Risk

**BGF World Gold Fund**

Concentration Risk, Counterparty Risk, Equity Risk, Investments in Mining Securities, Liquidity Risk

**BGF World Mining Fund**

Concentration Risk, Counterparty Risk, Equity Risk, Investments in Mining Securities, Liquidity Risk

**BGF World Real Estate Securities Fund**

Concentration Risk, Counterparty Risk, Equity Risk, Investment in Property Securities Risk

**BSF - Blackrock Fixed Income Strategies Fund**

Asset Backed Securities / Mortgage Backed Securities, Counterparty Risk, Credit Risk, Derivatives Risk, Liquidity Risk

**Blackrock Fixed Income Credit Strategies Fund**

Asset Backed Securities / Mortgage Backed Securities, Counterparty Risk, Credit Risk, Derivatives Risk, Liquidity Risk

**BSF Global Real Asset Securities Fund**

Concentration Risk, Counterparty Risk, Credit Risk, Equity Risk, Investment in Property Securities Risk, Investments in Infrastructure Securities, Risk to Capital Growth Through Derivative Use

**Description of Product Risks****Asset Backed Securities / Mortgage Backed Securities**

Asset backed securities and mortgage backed securities are subject to the same risks described for fixed income securities. These instruments may be subject to 'Liquidity Risk', have high levels of borrowing and may not fully reflect the value of underlying assets.

**Concentration Risk**

Investment risk is concentrated in specific sectors, countries, currencies or companies. This means the Fund is more sensitive to any localised economic, market, political or regulatory events.

**Counterparty Risk**

The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Share Class or Fund to financial loss.

**Credit Risk**

The issuer of a financial asset held within the Fund may not pay income or repay capital to the Fund when due.

**Credit Risk**

A main risk related to fixed income investing is credit risk. Credit risk refers to the possibility that the issuer of the bond will not be able to repay the principal and make interest payments.

**Credit Bail in Risk**

The issuer of a financial asset held within the Fund may not pay income or repay capital to the Fund when due. If a financial institution is unable to meet its financial obligations, its financial assets may be subject to a write down in value or converted (i.e. "bail-in") by relevant authorities to rescue the institution.

**Currency Risk**

The Fund invests in other currencies. Changes in exchange rates will therefore affect the value of the investment.

**Derivatives Risk**

Derivatives may be highly sensitive to changes in the value of the asset on which they are based and can increase the size of losses and gains, resulting in greater fluctuations in the value of the Fund. The impact to the Fund can be greater where derivatives are used in an extensive or complex way



**Equity Risk**

The value of equities and equity-related securities can be affected by daily stock market movements. Other influential factors include political, economic news, company earnings and significant corporate events.

**Emerging Markets Risk**

Emerging markets are generally more sensitive to economic and political conditions than developed markets. Other factors include greater 'Liquidity Risk', restrictions on investment or transfer of assets and failed/delayed delivery of securities or payments to the Fund.

**Environmental, Social and Governance (ESG) Risk**

The benchmark index only excludes companies engaging in certain activities inconsistent with ESG criteria if such activities exceed the thresholds determined by the index provider. Investors should therefore make a personal ethical assessment of the benchmark index's ESG screening prior to investing in the Fund. Such ESG screening may adversely affect the value of the Fund's investments compared to a fund without such screening.

**Erosion to Capital**

This Share Class may pay dividends or take charges from capital. While this may allow more income to be distributed, it may reduce the value of your holdings and impact the potential for long term capital growth.

**Factor Focus Risk**

Indices with a factor focus are less diversified than their parent index because they have predominant exposure to a single factor rather than the multiple factor exposure of most indices. Therefore they will be more exposed to factor related market movements. Investors should consider this fund as part of a broader investment strategy.

**Index Methodology Risk**

Although the Benchmark Index was created to select securities within the Parent Index for their recent price increases on the assumption that such increases will continue, there is no guarantee this objective will be achieved.

**Investments in Energy Securities**

Investments in energy securities are subject to environmental concerns, taxes, government regulation, price and supply changes.

**Investments in Infrastructure Securities Risk**

Investments in infrastructure securities are subject to environmental concerns, taxes, government regulation, price, supply and competition.

**Investments in Mining Securities**

Investments in mining securities are subject to sector-specific risks which include environmental concerns, government policy, supply concerns and taxation. The variation in returns from mining securities is typically above average compared to other equity securities.

**Investments in Property Securities Risk**

Investments in property securities can be affected by the general performance of stock markets and the property sector. In particular, changing interest rates can affect the value of properties in which a property company invests.

**Investments in the Timber and Forestry Industry Risk**

Investments in the timber and forestry industry are subject to environmental concerns, taxes, government regulation, price, supply and competition.

**Liquidity Risk**

Lower liquidity means there are insufficient buyers or sellers to allow the Fund to sell or buy investments readily.

**Liquidity Risk**

The Fund's investments may have low liquidity which often causes the value of these investments to be less predictable. In extreme cases, the Fund may not be able to realise the investment at the latest market price or at a price considered fair.

**Private Equity Securities Risk**

Private equity securities can be affected by daily stock market movements, political and economic news, company earnings and significant corporate events. Private equity companies may involve additional risks including higher levels of borrowing, unclear distribution of risk and losses within the private equity structure and constraints on buying and selling underlying investments quickly.

**Natural Resources**

Investments in natural resources securities are subject to environmental concerns, taxes, government regulation, price and supply fluctuations.

**Non-Investment Grade Risk**

Non-investment grade fixed income securities are more sensitive to changes in interest rates and present greater 'Credit Risk' than higher rated fixed income securities.

**Risk to Capital Growth Through Derivative Use**

The Fund may pursue investment strategies using derivatives in order to generate income which may have the effect of reducing capital and the potential for long-term capital growth as well as increasing any capital losses.

**Specific Sector Risk**

Investment risk is concentrated in specific sectors, countries, currencies or companies. This means the Fund is more sensitive to any localised economic, market, political, sustainability-related or regulatory events.

**Smaller Companies Risk**

Shares in smaller companies typically trade in less volume and experience greater price variations than larger companies.

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