Inflation Is Here to Stay

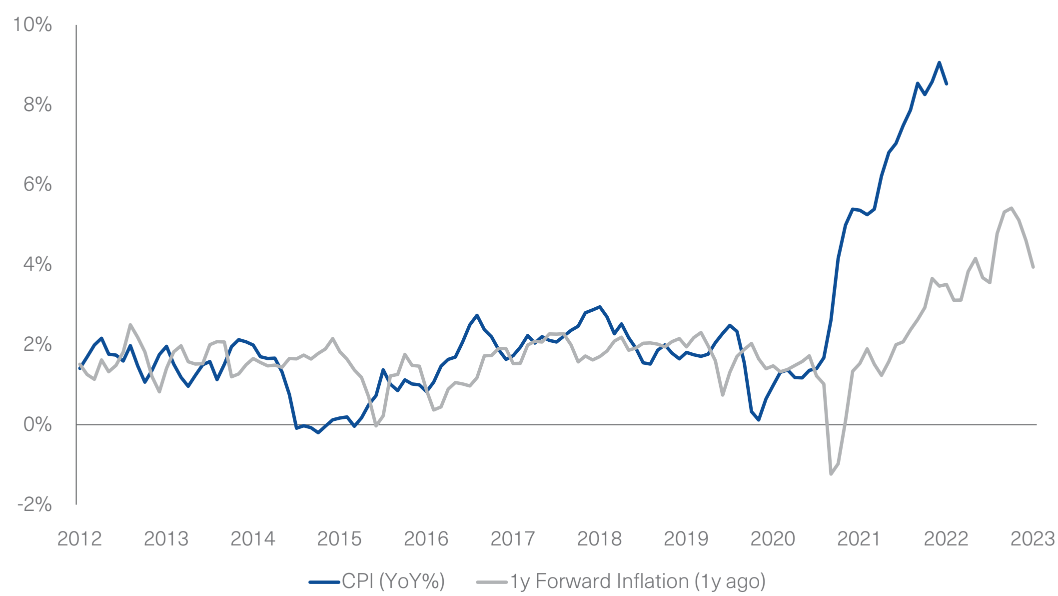
Fund in focus: Brompton Sustainable Real Asset Dividend ETF (BREA)

"I think we now understand better how little we understand about inflation"

- Jerome Powell (June 29, 2022)

To say inflation has been running hot might be an understatement without proper context. On August 10, 2022, the Bureau of Labor Statistics announced that the Consumer Price Index in the U.S. increased by 8.6% from the prior year through July. This was down only marginally from last month when the year-over-year inflation through June rate came in at 9.1%, which was a 40+ year high. The chart below shows that inflation began to take hold in early 2021 as vaccines were rolled out and the economy began to recover from the pandemic. While initially thought to be deflationary, the pandemic became a powerful inflationary force around the world as consumers, whose balance sheets were buoyed by government support, purchased goods at a record pace while supply, which was negatively impacted by pandemic shutdowns, could not keep up.

Inflation Has Been Running Hotter Than Expectations



Source: Bloomberg as of August 12, 2022

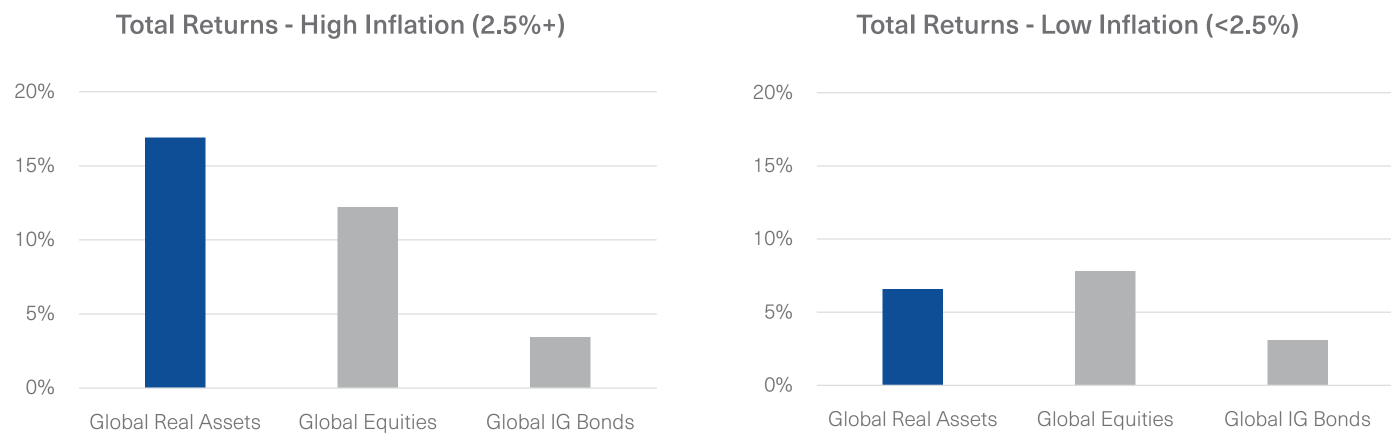
The chart above also includes 1-year forward inflation expectations implied by the market and shows that the market has consistently underestimated inflation since the beginning of the pandemic. We believe this is happening because the pandemic marked the beginning of a regime change toward supply-side inflation, which is structural as opposed to cyclical, and that market participants have been slow to update their models to reflect this change. While the pandemic has been one source of supply-side inflation that may become transitory as we continue to return to normal, and while inflation is very likely to moderate from the extreme rates we have seen lately, there are several sources of supply-side inflation that, because of their structural nature, are likely to persist for the foreseeable future:

- Russia's war in Ukraine and the related sanctions;
- The reversal of globalization trends, including trade wars, tariffs, and reduced immigration;
- A decade of underinvestment in many basic necessities, such as commodities, housing, and infrastructure;
- Demographics, particularly as the baby boomer generation gets older; and
- The cost of climate change and decarbonization.

As shown by the quote at the top of this article, even the Fed recently admitted that they don't fully understand the inflation we have been experiencing. To make matters worse, the Fed and other central banks are also mostly powerless when it comes to addressing these structural sources of supply-side inflation, as central banks cannot produce the things we need. Additionally, if higher interest rates push us into a recession, as many market participants believe, this would likely bring down inflation in the short term, but it could also lead to further underinvestment in supply and potentially drive inflation higher again in the medium to long term.

With inflation likely here to stay for the foreseeable future, investors should look for strategies that perform well in inflationary environments, such as real assets. Real assets can act as a powerful inflation hedge. These are long life, physical assets that often produce essential services and are characterized by high barriers to entry, low maintenance capital requirements, and strong pricing power. Real assets have historically outperformed during inflationary periods. As shown in the chart below, real assets have exhibited strong performance on both an absolute and relative basis during periods when inflation is above 2.5%. Given our view that inflation is here to stay, we believe that investors would be well served by adding a real assets investment in the current environment.

Real Assets Outperform During Periods of High Inflation[1]



Source: Bloomberg, Brompton as of August 23, 2022

Brompton's Approach

Brompton Sustainable Real Asset Dividend ETF (BREA) provides diversified exposure to global real asset companies including Utilities, Energy, Communication Services and Real Estate sectors. Many investment fund strategies currently on the market focus only on one main sector, such as Infrastructure, REITs (real estate), or Energy. Brompton believes that having a broader investment universe which combines all real asset sectors together, enhances the opportunity for capital appreciation while also providing "one-stop shopping" for investors. We prefer to invest in high dividend-yielding companies that are market leaders with strong balance sheets and have predicable free cash flow. We believe this strategy provides better risk-adjusted returns, particularly in an inflationary environment. In addition, diversified sector exposure mitigates investment risks in a volatile macro environment. We actively manage the Fund's sector weightings to strive to provide investors with optimal sector exposure depending on the state of the economy. We also use an actively managed call writing overlay to harvest volatility risk premium which enhances risk-adjusted returns.

[1] Based on average year-over-year total returns from 2005-04-30 - 2022-07-31 during periods when inflation is greater than 2.5%+ and periods when inflation is less than 2.5%. Global Real Assets represents S&P Real Assets Equity Total Return Index, Global Equities represents MSCI World Net Total Return USD Index, Global IG Bonds represents Bloomberg Global-Aggregate Total Return Index Value Unhedged USD.

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