BLOG POST

Asset Classes for Inflation

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As we have mentioned in previous PCM reports, the prospect of an inflationary environment is dominating the headlines. The narrative is that with the economy reopening from the COVID shutdown combined with a massive stimulus from the government will send overall prices higher. This in turn will force the Federal Reserve's hand and move shorter-term interest rates higher. Longer-term bond yields will also rise given the prospect of stronger economic growth.

The scenario described above may indeed materialize, although it is far from certain. At any rate, investors should be prepared for the possibility of a more inflationary environment over the next several years. There are certain investments described below that could provide attractive risk-adjusted performance, should we see an uptick in inflation.

Inflation Defined

Simply put, inflation is the loss of purchasing power for a given currency. For example, in an inflationary environment, a U.S. dollar will be worth less in terms of purchasing power in the future. As prices rise, it will take more dollars in the future to buy the same amount of goods today.

Inflation is typically gauged by the Consumer Price Index (CPI), which measures the price level of a basket of goods and services. The Federal Reserve in the past has tried to target an inflation rate of 2%. The reason for this target is to achieve a balance of economic growth against a loss of purchasing power. In theory, a modest level of inflation will encourage investment that will generate sufficient returns to more than offset the loss of purchasing power. If there is no inflation, investors will more likely save, which can stifle economic growth.

Inflation has various causes. When aggregate demand for goods and services exceeds production capacity, prices tend to rise. Likewise, an expansion of the money supply can find its way into production costs, which can result in higher prices as well.

A modest level of inflation is considered desirable. However, if inflation overheats, the results can be detrimental to the economy. Investments may no longer generate sufficient returns to offset the loss of purchasing power. However, there are certain investments that might weather the inflationary storm.

Inflation Sensitive Assets

There are options available across the three major asset classes – fixed income, commodities, and equities.

Fixed Income

Treasury Inflation Protected Securities, or TIPs, are bonds issued by the U.S. Treasury with coupon payments that periodically adjust based on increases in CPI. As overall prices increase, the interest collected on TIPs increases as well. These step-up payments offset the loss of purchasing power that exist with traditional Treasuries. To be sure, however, TIPs do carry duration risk. Prior to maturity, the price of TIPs will fluctuate based on changes in interest rates (like a traditional Treasury).

Another option within fixed income are floating rate bonds. These include leveraged loans with coupon payments that are referenced to a floating rate such as LIBOR. While the adjustable coupon can help in a rising rate environment, leveraged loans typically carry greater credit risk than investment-grade bonds.

Commodities

Historically, gold has been a store of value during inflationary periods. Past relationships show that when the value of the dollar declines, the value of gold tends to increase. However, there can be a significant opportunity cost to holding gold over the long-term, as it generates no earnings and pays no interest. However, a broad basket of commodities could provide attractive returns if inflation picks up significantly. If aggregate demand increases, the cost of raw materials should rise.

Equities

Historically, equities have provided a return in excess of inflation going back several decades. The long-run compound rate of return on the S&P 500 going back to the 1920s is roughly 9% compared to an average inflation rate of 3%. In other words, stocks have delivered an excess return over inflation of approximately 6%.

Moreover, dividends have grown at an average rate of 5% over the long-term, which may surpass the long-run rate of inflation. A broad basket of stocks that have historically grown their dividends (so called "dividend achievers") could help investors retain purchasing power in an inflationary environment.

Certain commodity sensitive sectors, such as basic materials and energy, could outperform the broader market if inflation becomes an issue. Specifically, precious metals and mining stocks might shine in a highly inflationary environment. Infrastructure exposure, which includes highly regulated utilities with price controls, could provide revenue streams that are largely shielded from inflation.

The bottom line is that there is no perfect inflation hedge. Investors must consider a range of investment opportunities as the sources of inflation are highly uncertain. The example given above could serve as the basis for a portfolio positioned to benefit from an inflationary environment.