BLOG POST
Hedging History
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Milton Friedman famously stated, "Inflation is always and everywhere a monetary phenomenon" and this has remained a bedrock of economic theory for almost 60 years. That was then. In an era of Fiscal Stimulus, when over $5 trillion has been spent by the government in response to the pandemic, economic theory is being forced to evolve.

Inflation is on every investor's mind and the hedges that have been effective in the past to combat the silent assassin may not be effective in the current environment. Government transfer payments as a percentage of household income are at all-time highs according to WSJ data. As economies and businesses try to reopen, they are hindered by government policies making it more financially attractive to stay home rather than return to work. I have read of Domino's Pizza franchises paying $1,000 bonuses and $25/hour to get drivers to deliver pizzas.

Commodity price increases today would make the 1970's blush. The cost of shipping a container from overseas has risen from $3,500 in January to over $10,000 today for a furniture mart in Nebraska. The inflation print for April was influenced by massive gains in hotel and lodging (+7.6%) and airlines (+10.2%), as the percentage of vaccinated people increases and travel resumes. If the current trend continues, we are at risk of seeing a return to a dangerous psychology that was present in the 1970s -- buy before prices go up.

The Federal Reserve has historically used interest rates to tamp inflation, but that may not work considering today's causes of inflation. Higher interest rates are likely to lead to credit scarcity and higher cost of capital, but may do nothing to force prices lower. Even the recession that would be almost certainly created by higher interest rates may not bring prices down to the 2% threshold the Fed targets if transfer payments continue.

Gold has historically been seen as an effective hedge against inflation as it is an alternative currency to the dollar. Don't count on that in this environment. TIPS might reduce the pain of traditional Treasury bonds but may still generate disappointing results. Investors are going to have to find new, creative ways to mitigate the damaging effects of inflation on their portfolios and income streams.

Energy has historically been a strong inflation hedge in the past and should help protect portfolios today. When oil prices were in the $30s and storage facilities were at capacity much of the shale production was taken off-line, reducing supply. With prices now in the $60s that supply will start to come back online, but it will take a while to catch up with increasing demand. The world is consuming around 94.5 mb/d (million barrels per day) today, but this is expected to rise to 99 mb/d by the end of September, according to IEA forecasts. Energy stocks should fare well with strong pricing for E&P companies, pipelines, and oilfield services.

Industrial real estate is another sector that could provide shelter in an inflationary storm. Real assets tend to appreciate with inflation, and I expect demand for industrial land, particularly in areas with favorable regulatory policies, to see strong demand as manufacturing and supply chains are relocated closer to home. Warehousing is a very attractive space, especially as shipping costs are rising sharply.

There is a very interesting debate happening right now about the use of cryptocurrency as an inflation hedge. While there is no intrinsic value or industrial use with crypto as there is with gold or industrial metals, it is growing more mainstream on a daily basis. Those in the camp that the dollar's best days are behind it are turning to bitcoin and other cryptocurrencies as a hedge. I personally believe this is premature as a hedge as there is simply insufficient evidence that negative correlations exist between crypto and traditional currencies or between crypto and inflation. There are some interesting opportunities with companies like Square (SQ), Tesla (TSLA), and MicroStrategy (MSTR) who are industry leaders but also carry large amounts of cryptocurrency on their balance sheets.

The cause of inflation today is different than in the past and the strategies that prove effective to hedge the impact may be different as well. The velocity of money has not yet turned higher but seems likely given the excessive demand for services as the economy reopens. Governments are using fiscal policy to create social stability but ironically may be only compounding the inequality gap as asset inflation continues. Portfolios will need to be tactical and opportunistic to avoid getting steamrolled when yields begin to rise above consensus estimates.