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Inflation Hedges vs. Stores of Value

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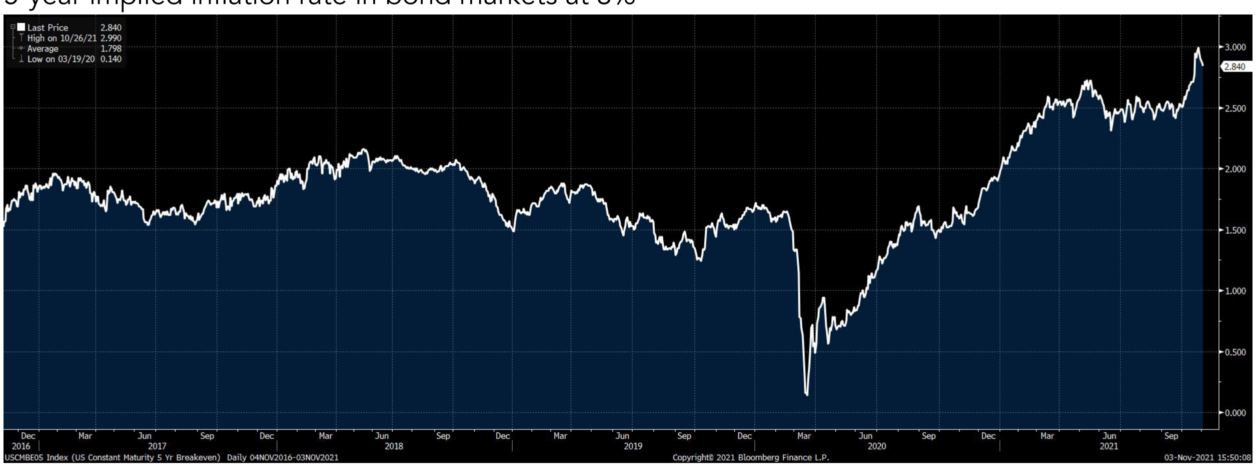
On October 22, 2021, inflation expectations reached a milestone as the TIPS breakeven rate[1] (a proxy for expected inflation) briefly rose above 3%. The breakeven rate currently shows that investors expect inflation to run about one percentage point higher than the Federal Reserve's 2% target over the next five years.

Chart 1 – Difference between 5-year US Treasury Bond and TIPS yields
5-year implied inflation rate in bond markets at 3%



Source: Bloomberg Professional Services

A 3% inflation rate would also be about two percentage points below recent year-over-year changes in the headline Consumer Price Index (CPI). That series has been heavily influenced by pandemic-induced shortages, in conjunction with strongly rebounding

[1] This indicator measures the yield difference between conventional five-year US Treasury bonds and US Treasury Inflation Protected Securities (TIPS) of the same maturity.

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demand fueled in part by federal economic stimulus. The extent to which current upward pressure on prices will prove transitory remains uncertain, but investors are increasingly asking how they should adapt their strategies to the possibility of a longer-lasting period of higher inflation.

It is essential to distinguish the two main approaches to protect your investments against inflation: (a) inflation hedges and (b) stores of value. The former will provide a temporary offset in an investment portfolio against an abrupt spike in inflation. The problem with all hedges is that an investor needs to be right about their timing. This rarely occurs. Stores of value generally provide longer-term results that match or exceed the rate of inflation. However, they may not work as effectively in the very near term.

Notwithstanding their reputation as a bulwark against inflation, stocks did not provide a near-term hedge when the United States last underwent a major surge in inflation in the 1970s. In 1974, the year-over-year increase in the Consumer Price Index reached double digits. Investors who held stocks from that point, as represented by the S&P 500, definitively caught up with inflation and overtook it only when Fed Chairman Paul Volcker's aggressive interest rate policy finally reined in inflation in the early 1980s.

Taking a lengthier historical perspective, Schroders research[2] found that, indeed, long-term investors have fared reasonably well by owning a diversified equity portfolio. For example, since 1892, US equities beat a bogey of CPI plus 5% in 73% of all 20-year rolling annual periods. As a practical matter, however, most investors will not want to wait for two decades to find out whether their strategies succeeded. Thus, identifying the investments most likely to produce satisfactory requires a finer-tuned approach than simply owning stocks as supposed protection against inflation.

Inflation Hedges

- **Oil and non-oil commodities** historically performed well at the beginning of inflationary periods. So did their related stocks. Since 1974, oil and gas stocks have performed best among the major sectors, based on a Schroder metric of

[2] Schroders, *Investment Perspectives: What are the inflation beating asset classes?* October 2021.

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return relative to inflation. Companies linked to agriculture, including producers of seeds and agricultural chemicals, have also done well according to this measure.

- **Treasury Inflation-Protected Securities** and other **CPI-linked bonds** also offer some short-term protection but have a poorer record of preserving value over the long run. TIPS' principal amount is specifically designed to rise along with CPI. As a result, their yields reflect expected inflation. One caveat is that inflationary expectations tend to be anchored to recent actual inflation. This implies that investors will not be fully compensated for unforeseen events that abruptly propel inflation higher.

Stores of Value

- The key to a more fully conceived higher-inflation strategy is targeting **stocks of companies with pricing power**. Investors who expect CPI to continue rising at a higher rate than in the years immediately preceding COVID-19 should avoid inflation's corporate victims. Those are businesses with little ability to pass on to customers the increases in their operating costs.

- Like the equity market, real estate is reputedly an inflation hedge, but once again investors must avoid painting with too broad a brush. The essential differentiator among **real estate investment trusts (REITs)** is whether management can raise rents frequently enough to keep pace with inflation. As a result, residential and industrial REITs, which derive their revenues from relatively short-term leases, stand out from other types in their performance relative to inflation.

- A similar issue affects the attractiveness of any particular **infrastructure** investment. The frequency with which fees are renegotiated will likely determine how well the instrument performs vis-à-vis inflation. Note that there is limited historical data for this asset class.

- In the fixed income category, **leveraged loans** show promise for staying ahead of inflation. They have historically earned a real, i.e., net of inflation, return

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almost three percentage points above the nearly 2% real return on cash, as reported by Schroders. The reported leverage loan returns take into account credit losses on the mostly below-investment-grade companies to which leveraged loans are extended.

- **Gold** more than held its own against inflation in the last big US inflationary surge, appreciating by 30.71% annually between 1969 and 1979. The yellow metal merits a place in an inflation-conscious investment strategy. Still, investors should be prepared to manage the position actively rather than buy and hold. The historical record shows the gold price is sensitive not just to inflation but also to the rising and falling risk of sovereign defaults (not specifically referring to the US).

Cryptocurrencies

Cryptocurrencies are touted as a safeguard against debasement of government-controlled fiat currencies. Until now, however, the most prominent of them, Bitcoin, has exhibited huge price swings unrelated to changes in inflation or inflationary expectations. Supporters contend that such volatility will disappear as Bitcoin becomes more widely accepted as a medium of exchange. However, whether that will happen remains an open question, as Bitcoin currently lacks the convenience of the best available payment systems. Furthermore, cryptocurrencies' wings may be clipped by increased governmental regulation.

Conclusions

Although many signs point to a moderation of inflationary pressures in 2022, we still have some reservations. In particular, the structural shortages in the housing market and the energy sector (while we are transitioning to clean energy sources) may have a more enduring impact on inflation than all the Covid-related transient components.

As the health crisis recedes, it is still premature to conclude if we are at the onset of an inflationary period. However, the time is right to examine the alternatives available to protect our client portfolios against high inflation. There are two types of approaches

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to combatting the erosion of investment value during inflationary periods: inflation hedges and stores of values. In the interest of building clients' wealth over the long run, we emphasize the latter.

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