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In focus

Where to find shelter from rising inflation

January 2021

The Covid-19 crisis has resulted in enormous fiscal and monetary stimulus while also destroying capacity in some sectors of the economy. This has led some investors to believe we are on the cusp of a rise in inflation. We analyse the impact of this potential scenario on seven asset classes and find that while some of them have desirable inflation-hedging properties, their ability to generate positive real (inflation-adjusted) returns varies over time. Whichever inflation scenario unfolds, traditional equity and bond investors face the greatest risks and cannot afford to be complacent.

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In the wake of Covid-19, investors have started debating whether long-dormant inflation risks will soon resurface. The fear is that the historic fiscal and monetary response to the pandemic, combined with the disruption it has inflicted on supply chains, could exert upward pressure on the overall rate of price increases for goods and services once economic activity normalises. This would bring an end to the era of low inflation that we have grown accustomed to over the past three and a half decades.

Markets are slowly waking up to this possibility. Inflation expectations, as measured by the yield difference between nominal and inflation-protected US Treasury bonds, have rebounded sharply from their pandemic lows. They are now just above their average of 2% seen for the past decade. But if inflation expectations rise even further, then markets could react unfavourably. For example, in the past, equities and bonds posted negative real (inflation-adjusted) returns more than half the time in periods of high and rising inflation. Clearly, there is a lot at stake and investors cannot afford to be complacent.

So where should investors look for effective inflation protection? To answer this question, we analyse the impact of inflation on seven asset classes: government bonds, equities, short-term bills, inflation-linked bonds, real estate investment trusts (REITs), commodities and gold. Our research finds that while some of these assets have desirable inflation-hedging properties, their ability to deliver positive real returns varies over time and arbitrarily selecting some of them may distort a portfolio's risk profile.

Given the range of risk tolerances for different investors, there is no optimal approach that would suit everyone. In general, a balance must be struck between a desire for inflation protection and a tolerance for volatility. Depending on an investor's asset mix and their assumptions about future market behaviour, it is possible, however, to incorporate inflation hedges into a portfolio without causing undue distortions to its prior risk profile.

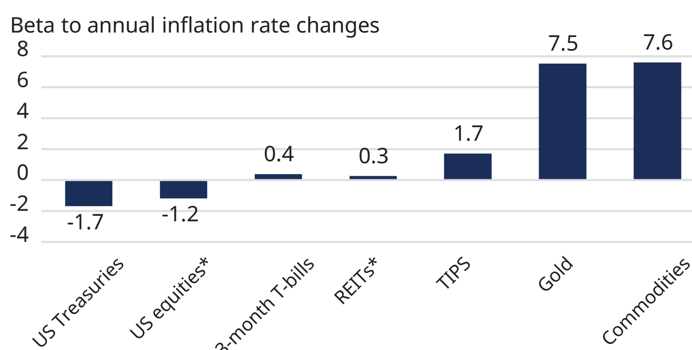
Our analysis is based on all available market data since March 1973. This period captures the end of the Bretton Woods era and the shift towards the fiat monetary system that remains in place today. To keep the scope of this paper manageable, we focus on US inflation, as measured by the consumer price index (CPI), although the insights we provide are still relevant for global investors.

Inflation sensitivity

The first step to evaluating any prospective inflation hedge is to assess its responsiveness to inflation. We measure this by calculating the sensitivity of an asset's total return to a change in the inflation rate over a one-year horizon, after controlling for the level of inflation. This is known as an asset's "inflation beta." All else equal, the higher an asset's inflation beta, the more its returns have tended to increase when inflation has risen.

Figure 1 illustrates how inflation sensitivity varies significantly by asset class (see appendix for the list of indices used). Bonds and equities, for example, tend to respond negatively to rising inflation. For every 1% increase in the inflation rate (e.g. a rise from 2% to 3% over one year), US Treasuries and equities fell by 1.7% and 1.2% respectively. In contrast, gold and commodities exhibited very positive betas, suggesting they have historically rallied when the rate of inflation increased.

Figure 1: Inflation sensitivity varies by asset class



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Source: Datastream Refinitiv and Schroders. Data from March 1973 to December 2020, except TIPS from March 1997. Notes: based on a multivariate regression of rolling annual total returns of each asset class on the change in the inflation rate over one year ($infl_{t+0}$ - $infl_{t-1}$) and the inflation rate at the start of the year (inflt-1). *Not statistically significant at the 5% level using robust standard errors.

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Some of these results are fairly intuitive, others less so. We delve deeper into the theory underlying their inflation-hedging properties below:

Nominal vs inflation-linked bonds

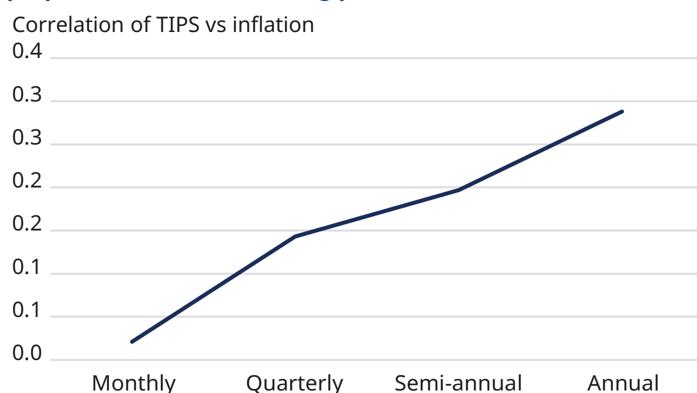
Bonds are an obvious casualty. Their fixed stream of interest payments become less valuable as the overall cost of goods and services accelerates, sending yields higher and bond prices lower to compensate. All else being equal, the longer a bond's maturity, the more vulnerable it is to increases in inflation.

Short-dated US Treasury Bills (T-Bills) perform considerably better because their returns have historically moved in tandem with overnight policy rates, which the US Federal Reserve adjusts to control inflation. However, as the Fed does not have perfect foresight, a lag in time often exists between increases in inflation and policy rates, meaning T-Bill returns can often languish behind inflation rate changes. Moreover, situations may arise whereby interest rates are held low to stimulate growth at the expense of high inflation. Both of these factors likely account for the inflation beta coefficient of less than one.

Inflation-linked bonds should offer more promising inflation-hedging potential as their interest payments and principal amounts are adjusted based on broad price changes. However, over holding periods less than their time to maturity, their returns can be quite volatile relative to inflation. This is because the price impact of movements in real yields can sometimes dominate their inflation-linked income.

For example, a 1% rise in the real yield on 10-year TIPS today would reduce their market value by around 7%, imposing a mark-to-market loss on existing owners. The lower relative liquidity associated with inflation-linked bonds can further exacerbate these short-term dynamics. As a consequence, the shorter the holding period, the weaker the correlation between TIPS and inflation (Figure 2). So while inflation-linked bonds have the potential to hedge inflation, this is clearly conditional on an investor's tolerance to ride out short-term market volatility.

Figure 2: Inflation-linked bonds exhibit weak inflation-hedging properties over short holding periods



Past performance is not a guide to future performance and may not be repeated.

Source: Datastream Refinitiv and Schroders. Data from March 1997 to December 2020.

Commodities & gold

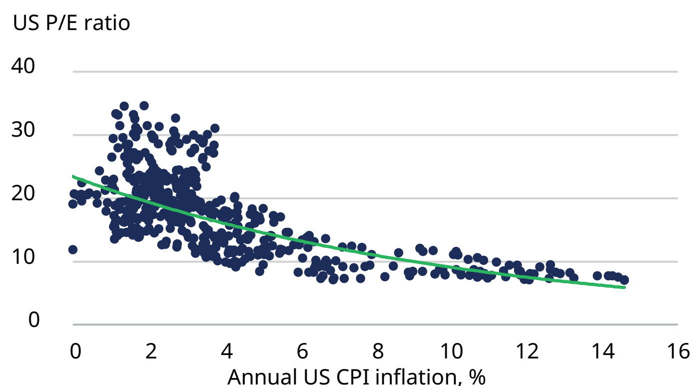
Commodity prices have a strong link with inflation because they are 1) raw materials used in the production of many goods and therefore a source of input costs for companies, and 2) are a key component of inflation indices. So by definition they will perform well when inflation rises. Gold, too, tends to thrive when inflation rises due to its reputation as a store of value and hedge against currency debasement fears.

Equities

It may come as a surprise that equities hedge inflation so poorly as, in theory, a rise in prices should correspond to a rise in nominal revenues. On the other hand, this may be offset by a contraction in profit margins given an increase in companies' input costs. In practice, the impact of inflation on earnings will vary by economic sector and its ability to pass on higher input costs to end consumers. But as long as input costs do not increase at the same rate as revenues, the rise in profit margins should translate into greater nominal earnings.

The problem is that the market will often discount those future earnings at a higher rate when inflation rises, as they are worth less in today's money. All else equal, the higher the level of inflation, the greater the discount rate applied to earnings and therefore the lower the price-to-earnings (P/E) ratio investors are prepared to pay (Figure 3). It is the net impact of higher expected nominal earnings versus higher discount rates that determines how equities behave in an environment of rising inflation.

Figure 3: High inflation tends to hurt P/E multiples



Source: Datastream Refinitiv and Schroders. Data from March 1973 to December 2020.

The lack of a statistically significant relationship between equity returns and inflation rate changes, as shown in Figure 1, suggests that, on average, these two effects may offset each other. In particular, it is unclear which effect dominates at low levels of inflation. For inflation rates approximately below 3%, there has been considerable dispersion of data points around the line of best fit, as illustrated in Figure 3.

Real estate

Conventional wisdom says that real estate should offer a partial inflation hedge via the pass-through of price increases in rental contracts and property prices. On the other hand, they suffer from the same affliction of traditional equities in that short-term movements in capital values can dominate any inflation-linked income from underlying assets. On average, we find that REITs (Real Estate Investment Trusts) have no significant relationship with annual changes in the inflation rate. We find similar results for private real estate (not shown).

This does not mean, however, that real estate should be completely ruled out as a potential inflation hedge, as specific periods in history can dramatically affect our analysis. Namely, if we strip out the period from 1973 to 1975, when inflation peaked at 12% and REIT share prices collapsed, then the inflation beta coefficient rises to 1.6 and is statistically significant. Evidently, the link between asset returns and inflation varies over time and should not be thought of as stable.

Frequency of outperformance

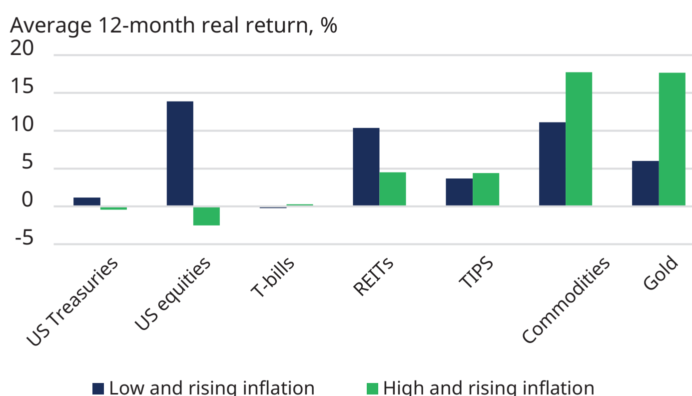
While an inflation beta captures the direction and magnitude of co-movement between an asset's return and inflation, it does not capture how frequently the asset outperforms inflation. This is another important consideration for most investors. After all, having a high inflation beta is of limited use if the hedge only works part of the time. Figure 4 shows the percent of rolling 12-month periods since 1973 when different asset classes posted positive real returns. This measures how likely an asset class was to outperform inflation over any given year. The colours represent how consistently it achieved this from red (poor), through amber (average), to green (good).

Clearly, the impact of inflation on real returns depends not just on its direction of travel (i.e. is inflation rising or falling), but also on the level of inflation. For example, when inflation was low (below 3% on average) and rising, equities delivered positive real returns a whopping 90% of the time, more than any other asset class and in spite of their poor inflation sensitivity. But when inflation was high (above 3% on average) and rising, commodities offered the most consistent outperformance, while equities and Treasuries fared no better than a coin toss.

Investors must be mindful, however, that yesterday's winners can easily become tomorrow's losers. Commodities and gold stand out as obvious examples. They outperformed in only 37% and 31% of high and falling inflationary periods respectively. This is expected given their high inflation beta, so falling inflation should correspond to worse returns. Meanwhile, REITs can be viewed as an "all-inflation-weather" solution, as they outperformed fairly consistently, regardless of the level or direction of inflation.

Although gold has been less consistent than some of its peers in times of high and rising inflation, the magnitude of its outperformance was still far superior. On average, over a 12-month period, gold returned 18% above inflation during such episodes. So when gold outperformed, it did so exceptionally well. In contrast, REITs and TIPS posted positive real returns that were four times lower, although still modest (Figure 5).

Figure 5: How assets stack up in rising inflation regimes



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Source: Datastream Refinitiv and Schroders. Data from March 1973 to December 2020, except TIPS from March 1997.

Figure 4: % of rolling 12-month periods when asset class returns exceeded inflation rate, 1973 to 2020

Inflation regime	Rate of occurrence	US Treasuries	US equities	T-Bills	REITs	TIPS	Gold	Commodities
Low (<3%) and rising	24%	57%	90%	36%	69%	71%	58%	67%
High (>3%) and rising	26%	47%	48%	47%	67%	63%	64%	83%
High (>3%) and falling	26%	80%	76%	78%	80%	56%	31%	37%
Low (<3%) and falling	23%	84%	81%	69%	79%	72%	51%	28%

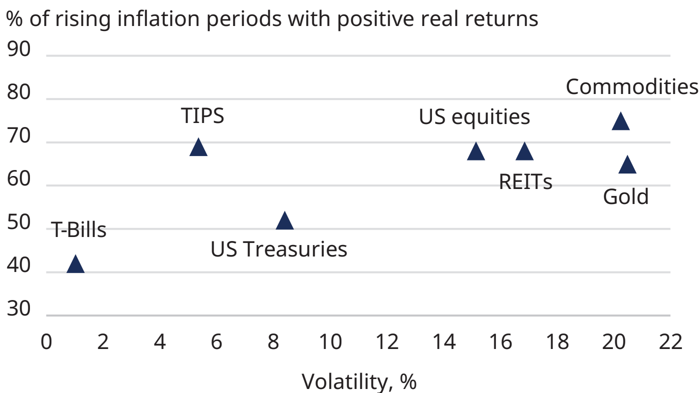
Past performance is not a guide to future performance and may not be repeated.

Source: Datastream Refinitiv and Schroders. Data from March 1973 to December 2020, except TIPS from March 1997. Notes: based on monthly rolling annual returns relative to the contemporaneous rate of inflation, where frequency <50% (red), 50%<X<67% (amber), >67% (green). Low/high inflation is defined as the average inflation rate over the preceding 12-month period. Rising/falling is defined as the change in the inflation rate over 12 months. Rate of occurence refers to number of rolling 12-month periods in each inflation regime.

The price-tag for inflation protection

Inflation-hedging is not as simple as adding a suitable asset class to a portfolio, as this may increase a portfolio's risk profile. For example, equities, REITS, gold and commodities have a high likelihood of delivering positive real returns in times of rising inflation, but this may come at the expense of more volatile returns (Figure 6). TIPS, on the other hand, deliver less volatile returns and offer similar levels of inflation protection. These implicit costs should not be ignored and should be factored into asset allocation decisions.

Figure 6: Inflation protection may come at the expense of higher return volatility



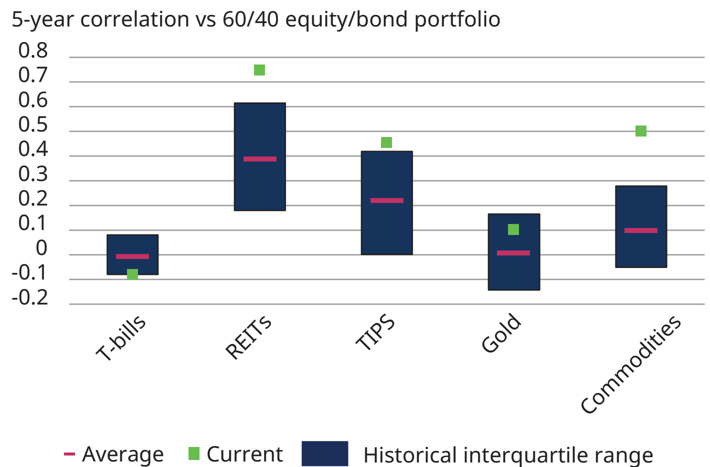
Past performance is not a guide to future performance and may not be repeated.

Source: Datastream Refinitiv and Schroders. Data from March 1973 to December 2020, except TIPS from March 1997. Notes: rising inflation periods are on a 12-month basis, volatility is calculated as annualised standard deviation of monthly returns.

Whether or not a prospective hedge ultimately increases portfolio volatility will depend on its correlation with other assets in an investor's portfolio. All else equal, the lower the correlation, the bigger the reduction in risk. The problem is that correlations can be highly unstable over time. And the less stable the correlation, the more ambiguous the potential diversification benefits. We can illustrate this using a balanced 60/40 equity/bond portfolio. In reality investors are likely to have more diversified portfolios so we recognise that this is a simplified example.

Figure 7 shows the current, average and interquartile range of historical 5-year correlations between five prospective inflation-hedging assets and a 60/40 portfolio. We can observe that gold and cash have held a low and stable correlation range with a 60/40 portfolio. Conversely, REITs and TIPS have held a relatively high and unstable correlation range. Although commodities have a comparable correlation range to gold, their current 5-year correlation is significantly elevated versus their long-term average.

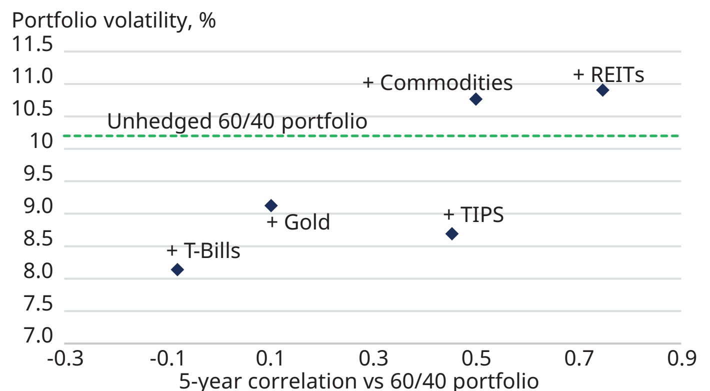
Figure 7: Unstable correlations can render an asset's diversification benefits ambiguous



Source: Datastream Refinitiv and Schroders. Data from March 1973 to December 2020, except TIPS from March 1997. Notes: correlations are calculated on a rolling 5-year basis using monthly returns.

Even so, it is not necessary for correlations to be low or stable in order for an asset to have a positive impact. For example, using current 5-year correlations, replacing 20% of the equity/bond allocation with TIPS results in a reduction in portfolio volatility from 10.2% to 8.7% (Figure 8). Similarly, a 50/30/20 portfolio with a 20% allocation to either T-Bills or gold also reduces portfolio risk relative to the unhedged 60/40 portfolio.

Figure 8: Adding a prospective inflation-hedge may reduce portfolio risk



Source: Datastream Refinitiv and Schroders. Data from March 1973 to December 2020 except TIPS from March 1997. Notes: correlations are calculated on a rolling 5-year basis using monthly returns. Volatility is calculated as annualised standard deviation of monthly returns.

1 Admittedly, a reduction in volatility is likely to also lead to lower expected returns. However, an examination of the trade-off between inflation protection and portfolio returns is beyond the scope of this paper.

Although adding REITs and commodities does increase portfolio risk, some may question whether the past five years are truly indicative of how these assets might behave in an environment of rising inflation. If we assume that correlations instead revert back to their long-term average, then our analysis finds that adding REITs or commodities does indeed reduce portfolio risk. This is not an unreasonable assumption to make, as their correlations were close to or below average back in 2007 when inflation was rising and eclipsed 4%.

Summary

While some investors may view rising inflation as a tail-risk, it would be nonetheless prudent to prepare for this scenario given the damaging effects it may have on traditional portfolios. For those seeking to manage this risk, we show that nominal bonds and equities may be a poor choice. Rising inflation erodes the value of fixed income payments, damaging their current market values. Equities would perform well initially, but may suffer once inflation takes off. The possibility of this double whammy, with both bond and equity prices falling, should be taken seriously.

T-Bills are unlikely to yield better results. Despite their strong historical ties to inflation, the US Federal Reserve has indicated that interest rates will remain close to zero for at least the next three years as it aims to hit its new objective of a 2% average inflation target, making any interest rates hikes in response to a rise in inflation unlikely.

In contrast, TIPS should benefit from current loose monetary policy. Falling real yields (due to rising expected inflation), coupled with the increased investor demand for inflation protection, is likely to boost their current values. When combined with their relatively modest risk profile and diversification versus a 60/40 portfolio, TIPS offer more promising inflation-hedging potential. However, investors seem to have already taken note of these advantages, as real yields on these bonds have been driven into deeply negative territory.

REITs are another compelling option. Historically, they have posted fairly consistent returns above inflation, regardless of its level or direction. But given their high volatility and unstable correlation range, it is unclear whether they can offer meaningful portfolio diversification to investors. Moreover, their level of outperformance relative to inflation is not as strong as some other asset classes.

Gold appears more appealing on this front. Although less consistent, its level of outperformance in times of high and rising inflation has been considerably greater than its peers. It also has a low and stable correlation with a 60/40 portfolio.

Commodities are less fortunate. They have been the most likely to outperform in times of high and rising inflation, but at the expense of potentially more volatile returns and less portfolio diversification.

Figure 9 summarises our analysis and assigns a score for each asset class on four metrics using a scale from red (poor), through amber (average), to green (good). Clearly, there is no perfect shelter from rising inflation. Investors must decide how much inflation protection they desire and what implicit costs they are willing to tolerate. We believe holding a diversified portfolio of inflation-hedging assets is likely to mitigate at least some of these costs.

Figure 9: Inflation-hedging scorecard

Asset class	Inflation sensitivity	Likelihood of outperformance	Risk	Diversification vs 60/40 portfolio
US Treasuries	🔴	🔴	🟡	-
US equities	🔴	🟡	🔴	-
T-Bills	🟡	🔴	🟢	🟢
REITs	🟡	🟢	🔴	🟡
TIPS	🟢	🟡	🟡	🟢
Commodities	🟢	🟢	🔴	🟡
Gold	🟢	🟡	🔴	🟢

Source: Schroders. For illustrative purposes only.

Appendix

Asset class	Index	Start date
US Treasuries	ICE BAML 7-10 Year US Treasury Index	March 1973
US Equities	MSCI USA Index	March 1973
T-Bills	Datastream US 3-month Treasury Bill index	March 1973
REITs	FTSE NAREIT All Equity US REITs Index	March 1973
TIPS	Bloomberg Barclays US TIPS Index	March 1997
Commodities	S&P GSCI Commodity Total Return Index	March 1973
Gold	Datastream Gold Bullion LBM $/t oz	March 1973
Inflation	US All Items Consumer Price Index	March 1973

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