On The Mark

Defend with an Inflation Buffer

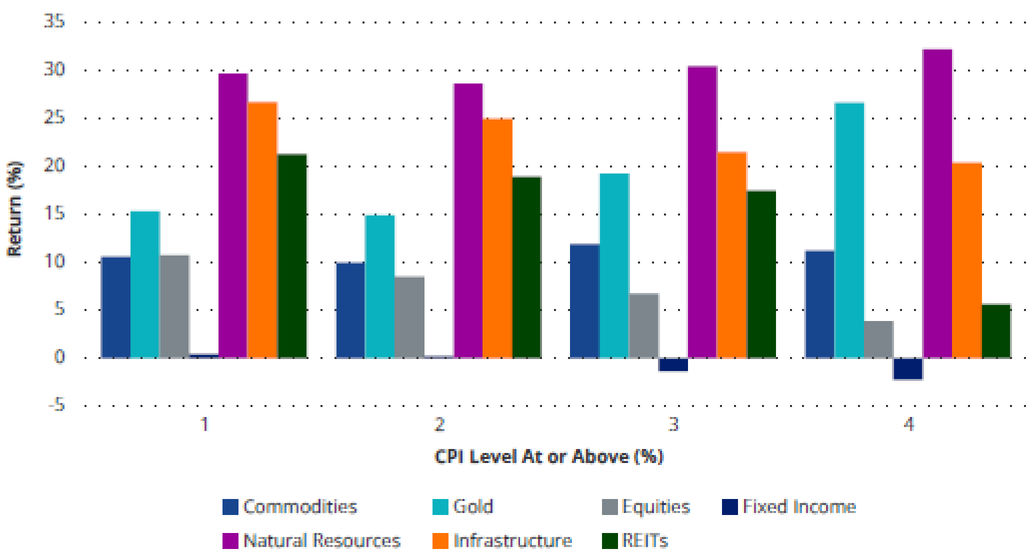
Special Edition

With US inflation experiencing record highs and financial markets in correction territory, investors and their portfolios are being stress tested for the first time since the pandemic-induced drawdown of March 2020. With some components of inflation slowing in terms of price trends, others are starting to pick up which likely means that inflation will remain higher for longer. This environment offers no shortage of challenges and it could be time to consider your defensive playbook to help buffer inflation.

Inflation Beneficiaries

Asset classes respond differently to inflation and those experiences can differ substantially based on the level of inflation currently in action. Commodities and gold have been standouts in terms of benefiting from higher inflation, and have outperformed equities and bonds on a real return basis when inflation is above four percent. Looking at the last inflationary period of the 2000s, there were additional components that helped during times of higher inflation. The chart below shows how commodities and gold can be complemented with natural resources, infrastructure, or REITs to help create an inflation buffer. Natural resource miners, for example, benefit from the inflation-elevated prices that vehicle manufacturers are willing to pay for nickel and copper to keep up with the surging demand for electric vehicles.

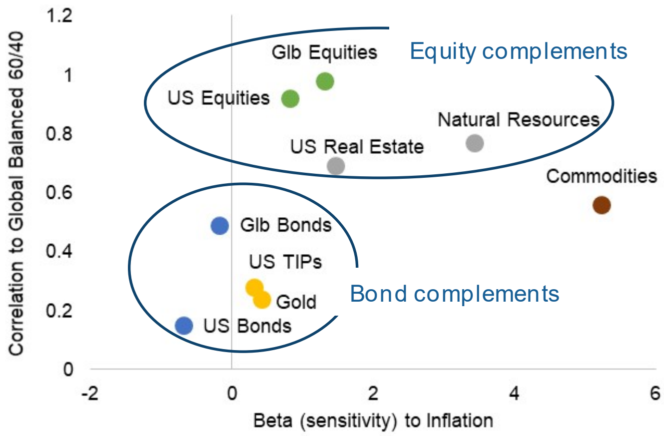
Average 12-month real return when CPI is above certain levels (2003 – 2007)[1]



Sensitivities and Interactions

Knowing how asset classes perform during levels of higher inflation is only half the battle. Knowing how sensitive they are to changes in inflation and how they interact or correlate with other asset classes and the traditional balanced portfolio is critical.

Asset class sensitivities to inflation and correlation to a Global 60/40 portfolio (Nov 2001 – Jun 2021)[2]



The chart above shows that commodities have the greatest sensitivity to inflation and are a good addition to a portfolio, but it's only part of the story as they don't clearly complement just equities or just bonds. REITs and natural resources complement equity exposure since they have similar characteristics but provide higher sensitivity to inflation. Inflation is a nemesis to bonds as seen by their negative beta. Alternatively, Treasury Inflation-Protected Securities (TIPS) and gold provide a similar low-correlation experience to help with risk management in addition to typically faring better during inflationary environments.

Portfolio construction 101 tells us to diversify assets to help manage overall portfolio risk. The same applies to building an inflation buffer. It's essential to think about having a broad mix of investments, pinpointing the right areas to diversify into while building in some defense into the portfolio to enhance your results over the short and long term.

Sources:

1. VanEck, "Still Early Innings for Inflation", March 2022
2. AssetMark, Zephyr Style Advisor

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