

June 7<sup>th</sup>, 2021

### Hedging the Right Inflation

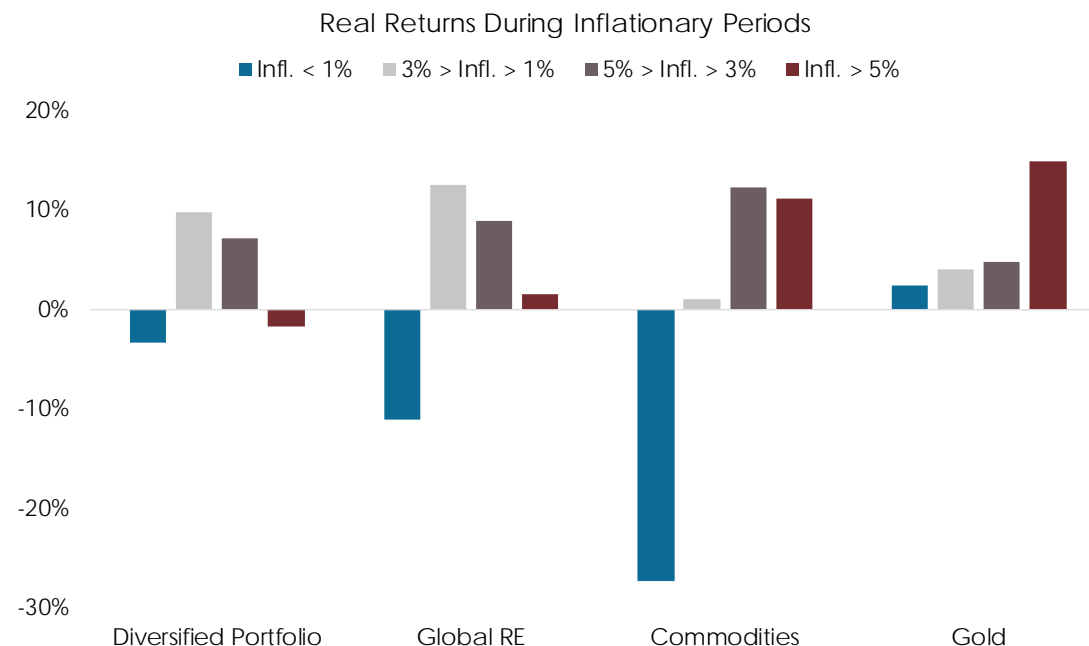
- Inflation Hedging – When and How
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## Inflation Hedging – When and How

- Inflation Sensitivity of Diversified Portfolios.** In order to know how to react or stay ahead of expected inflation, it is pivotal to understand that asset classes perform differently under varying inflation levels. A key observation of historical data is that during periods of relatively typical inflation, above 1% and up to as high as 5%, diversified portfolios generally perform quite well. However, diversified portfolios appear quite vulnerable to either very high inflation (above 5%) or dis-inflation/deflation (below 1%).
- High Inflation Hedges.** Rising inflation has led investors to search for assets that are good hedges against inflation but need to be careful assessing the particular inflation environment they need to hedge. Historically, inflation of more than 5% as well as significant inflation surprises, have favored a minority of assets – mainly gold and commodities. Such assets tended to not perform as well during environments of lower inflation but provide disproportionate performance during higher inflation or inflation shock environments.
- Real Estate’s Sweet Spot.** While not as much of a beneficiary during very high inflation or inflation shock environments, real estate has historically outperformed the diversified portfolio during periods of moderate to higher inflation, such as the one we are likely to experience in the next few years. Real estate’s inflation hedge comes from the appreciating prices of its real assets (e.g., buildings) that firms own which tend to capture inflation through rents and rent escalation clauses, which remain relatively fluid.

## Chart of the Week:

### The Best Inflation Hedge Depends on the Inflation Environment



Source: Glenmede

Data shown are annualized real returns, total return minus inflation, for a diversified portfolio during various inflationary environments since 6/30/1971. The diversified portfolio is represented by the following mix of proxy indexes: 5% Cash (Bloomberg Barclays Treasury Bellwethers 3M Index), 24% Muni Bonds (Barclays U.S. Muni 1-10 Index), 6% Muni High Yield (Barclays U.S. Muni High Yield Index), 33% U.S. Large-Cap (S&P 500 Index), 5.5% U.S. Small-Cap (Russell 2000 Index), 16.5% Int'l (MSCI ACWI ex-U.S. Index), 5% Global RE (FTSE EPRA NAREIT Developed Index), 5% Absolute Return (HFRI Fund of Funds Index). Other indexes shown include Commodities (Bloomberg Commodity Index) and Gold (CRB Commodity Index, Gold). Inflation periods and real returns are based on the Consumer Price Index (CPI), which measures the percentage change in the price of a basket of goods and services consumed by households in the U.S. Data reflects past performance which may not be indicative of future results. One cannot invest directly in an index.

While high inflation should favor commodities and gold, still-contained inflation should favor diversified portfolio and real estate

## Inflation's Big Week Ahead

- **High Near-Term Inflation.** Inflation has quickly developed into one of the most pressing concerns among investors, as April's 4.2% U.S. Consumer Price Index (CPI) reading was the highest in nearly 13 years. This upcoming Thursday, markets will be keenly awaiting the release of May's U.S. CPI reading to get another gauge on near-term inflation. With the U.S. economy recovering and soft year-ago inflation comparisons, expect this higher near-term inflation landscape to persist through the summer.
- **Transitory Inflation Surge.** The sharp rise in prices is raising concerns that higher inflation will persist further into the future, which could potentially directly impact business profits and/or place pressure on the Fed to increase rates prematurely. Such concerns should eventually fade as a significant degree of this inflation may prove transitory. Nearly half of the above-average spike in inflation comes from the base effects of last year's weakened economy. Secondly, supply shortages should prove transitory as companies increase productivity and begin to meet pent-up demand.
- **Inflation Expectations.** The market-implied inflation expectation (10Yr) currently sits at ~2.5%, implying that the U.S. will experience levels of inflation that have not been seen since 2012. However, this expected inflation level is far below the most recent near-term reports. Inflation is likely to remain above 3% for most of the summer, and we could possibly see a report of over 5%, but inflation is likely to settle into the more moderate 2.5% trajectory that is currently priced into financial markets as the transitory factors dissipate.

Inflation concerns are likely to persist through the summer, but moderate as transitory factors dissipate

## Employment's Sluggish Improvement

- **An Expected Reversal.** Friday's employment report showed material improvement from April's report in non-farm payrolls (+559k vs. +278k), an expected reversal in one of the most widely watched and highlighted but also most volatile and heavily revised government data series. Despite the improvement, the trajectory of employment growth remains sluggish. The unemployment rate ticked lower to 5.8% but remains well above normal levels, and labor force participation was little changed at 61.6% but remains well below its pre-pandemic level of 63.3%.
- **Transitory Tightness.** Labor market conditions have been highlighted by numerous businesses and business surveys that note an inability to find new hires to fill open positions and have led to some concerns about wage inflation. Average hourly earnings showed another large month-over-month increase (+0.5%), seeming to confirm the near-term wage inflation pressure. Reasons for these conditions range from pandemic-related factors such as fear of infection and childcare needs to the large unemployment insurance incentives provided by recent stimulus bills.
- **Patient Fed Reaction Function.** The labor market's recovery may remain relatively sluggish through the summer, but such conditions are likely to prove transitory due to company efforts to enhance job incentives, diminishing COVID concerns, and the expiration of the extra unemployment benefits from COVID relief bills. The Fed is patiently waiting for further improvement in the labor market to begin removing some monetary stimulus through tapering.

Expect the Fed to remain patient as labor markets normalize amid the recovery from the pandemic



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