Real assets: a possible solution to successfully hedge potential inflation

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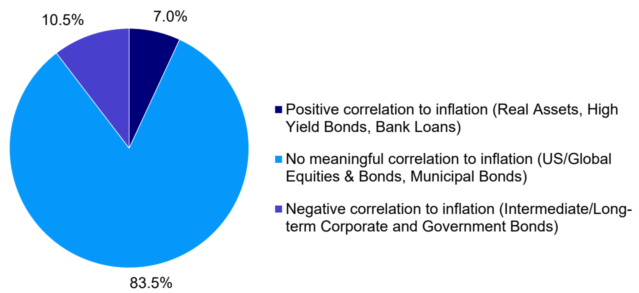
We expect the recent debate to continue over how high inflation might go in the United States and for how long, but here is what we do know–inflation is picking up, and predicting the course of future inflation is challenging. In light of these factors, investors may want to evaluate the use of real asset strategies as a partial potential hedge against inflation. Real assets include an array of strategies spanning real estate, infrastructure, master limited partnerships and natural resources. Any combination of these investments may make sense today.

Inflation is picking up. Inflation peaked in the United States at 15% in 1981 and has been declining every decade since then–until now. Having made a recent low of 0.1% during the pandemic-induced lockdowns last May, the consumer price index has rebounded to 5.0% in May 2021 while the producer price index has jumped to 8.7%, levels not seen in many years.[1] There are a number of variables which may be contributing to rising inflation including unprecedented amounts of fiscal and monetary stimulus, an acceleration of the domestic economy amid the uptake in COVID vaccines, a high level of pent-up consumer demand as well as the base effects of looking at year-over-year data.

Predicting inflation is challenging. Many market strategists and even Chairman Jerome Powell at the Federal Reserve (Fed) are currently assuring investors that the uptick in inflation is likely transitory. However, we understand from looking back at historical periods that predicting inflationary movements and patterns can be challenging. Market consensus on inflation has produced inconsistent results over many decades.

Are retail investors positioned for a potential uptick in inflation? We believe that hedging a broad-based portfolio against inflation risk may be easier said than done. The reason why is that many of the asset classes investors typically use as the base for their asset allocation (general large-cap and small-cap stocks, fixed income) have historically had no significant correlation with inflation, and at times even negative correlation. A recent case study by Bank of America Securities pointed out that since 1950 there are only a handful of investment areas that provide a meaningfully high correlation to inflation: diversified real assets, real estate, broad-based commodities and gold.[2] Looking at retail investor allocations in the United States – specifically assets invested in wrappers such as mutual funds and ETFs – the data reveal that only 7% of capital is invested in asset classes with meaningful correlations to inflation. This includes the aforementioned real assets plus pockets of fixed income including bank loans and high yield bonds. See Chart 1.

Chart 1: Real assets have historically had a positive correlation to inflation

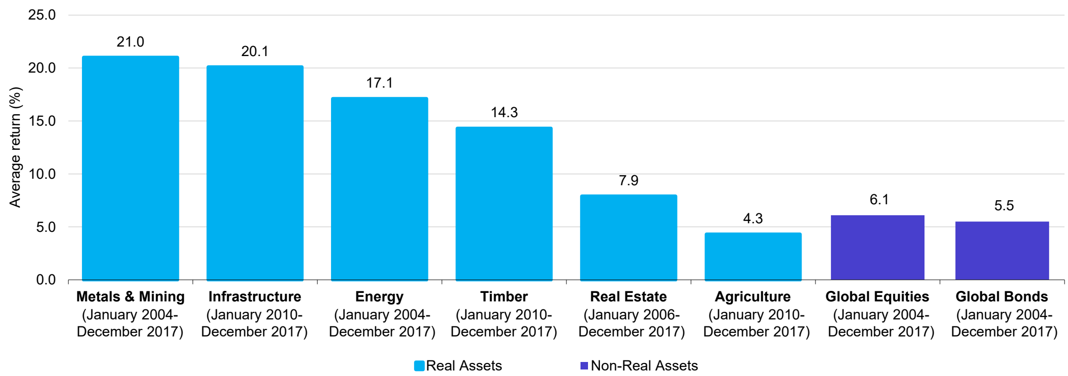


Source: Morningstar Direct for the period 3/31/2001-3/31/2021.

Many institutional investors are already well allocated to inflation hedges. According to a recent survey of almost 400 institutions, two-thirds of respondents have allocated capital to real estate while one-third have allocated to infrastructure and one-third have allocated to natural resources.[3] Significantly, the average target allocation for these institutional investors was 9.0% of their assets to real estate, 4.5% to infrastructure and 3.5% to natural resources.[4] The size of these target allocations – an average of 17% collectively - leads us to believe that institutions consider these real asset exposures to be critical components of their overall portfolios.

Real assets can help. Real assets can offer a combination of attractive returns, diversification and yield. Significantly, they can also help to hedge inflation risk. Historically, listed real asset securities have outperformed global stocks and bonds by a meaningful margin during periods of rising inflation.

Chart 2: Average outperformance of Real Assets to Global Equities during rising inflation: 801 bps



Source: Bloomberg L.P. using data from January 1, 2004 - December 31, 2017. Total returns shown in USD. Annual update with latest available data. Periods of world inflation acceleration (calculated as above 3% rate) include January 1, 2004 – December 31, 2004, January 1, 2006-December 31, 2007, January 1, 2010-December 31, 2011 and January 1, 2016 - December 31, 2017. Performance was calculated from each index's inception date.
Metals & Mining is represented by MSCI World Metals and Mining Index, inception date: September 1999; Infrastructure by Dow Jones Brookfield Global Infrastructure Index, inception date: July 2008; Energy by MSCI World Energy Index, inception date: September 1999; Timber by S&P Global Timber and Forestry Index, inception date: August 2007; Real Estate by FTSE EPRA Nareit Developed Index, inception date: February 2005; Agriculture by S&P Global Agribusiness Index inception date: May 2008; Global equities by MSCI World Index inception date: March 1986; Global bonds by Bloomberg Barclays Global Aggregate Index, inception date: January 1999.
Note: Not all indexes participated in all periods of rising inflation. Timber, Real Estate, Infrastructure and Agriculture did not participate in the first world inflation acceleration period (1/1/2004-12/31/2004). Agriculture and Infrastructure did not participate in the second world inflation acceleration inflation period (1/1/2006-12/31/2007).
An investment cannot be made directly in an index. For illustrative purposes only. Past performance is not indicative of future results.

Conclusion. Inflation in the United States has been subdued since the global financial crisis. Yet the Fed has recently adopted a more dovish approach that could allow inflation to run above target in the aftermath of persistent inflation shortfalls.[5] This is especially true since governments around the world have used more than three times the amount of stimulus employed to combat the global financial crisis to fight this pandemic, and they have done so in one fourth the time.[6] We believe some portfolios, particularly in the retail space, may not be positioned for a potentially negative surprise from rising inflation. Investors who are concerned that the recent uptick in inflation could be more than transitory may want to consider a strategic allocation to real assets.

Sources

1. Bloomberg, June 2021. Consumer price index represents the US Consumer Price Index (All Urban Consumers) and producer price index represents the US Producer Price Index (Finished Goods).
2. M. Hartnett, et al., BofA Securities, "Trading the Inflation Theme," 3/11/21.
3. Prequin Investor Outlook: Alternative Assets, 1H 2020.
4. Prequin Investor Outlook: Alternative Assets, 1H 2020.
5. J. Powell, Board of Governors of the Federal Reserve System, "New Economic Challenges and the Fed's Monetary Policy Review," 8/27/20.
6. Z. Cassim, et al., McKinsey & Company, "The $10 trillion rescue: How governments can deliver impact," 6/5/20.

Consumer price index measures the change in the prices of goods and services contained in a basket of consumer items.
Producer price index measures the average change over time in teh selling prices received by domestic producers for their output.

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