Inflation: Problem or Passing Concern?

July 2021

DelMarche

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Abstract

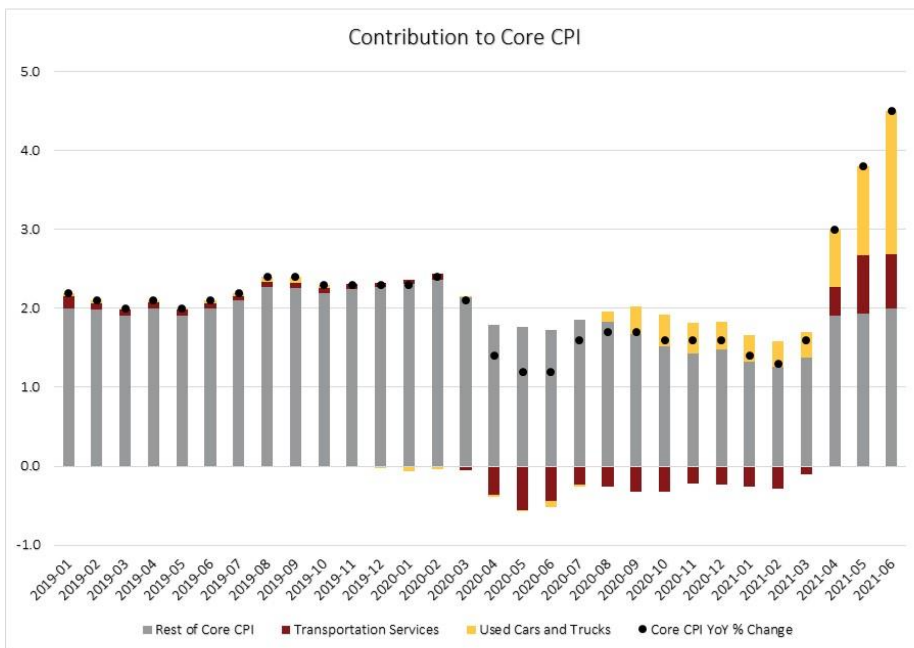
With U.S. inflation reports reaching multi-year highs and a constant barrage of headlines about supply chain issues and rising prices, many investors are questioning what can be done to safeguard their portfolios during this time of uncertainty.

In this paper, we will assess the recent spike in inflation against a larger macroeconomic backdrop and will discuss proactive steps that institutions should contemplate as they consider portfolio allocations going forward, as the U.S. and broader global economies continue to recover from the pandemic aftermath.

Headline inflation numbers have hit multi-year highs coming out of the pandemic, but should you adjust your portfolio or stay the course?

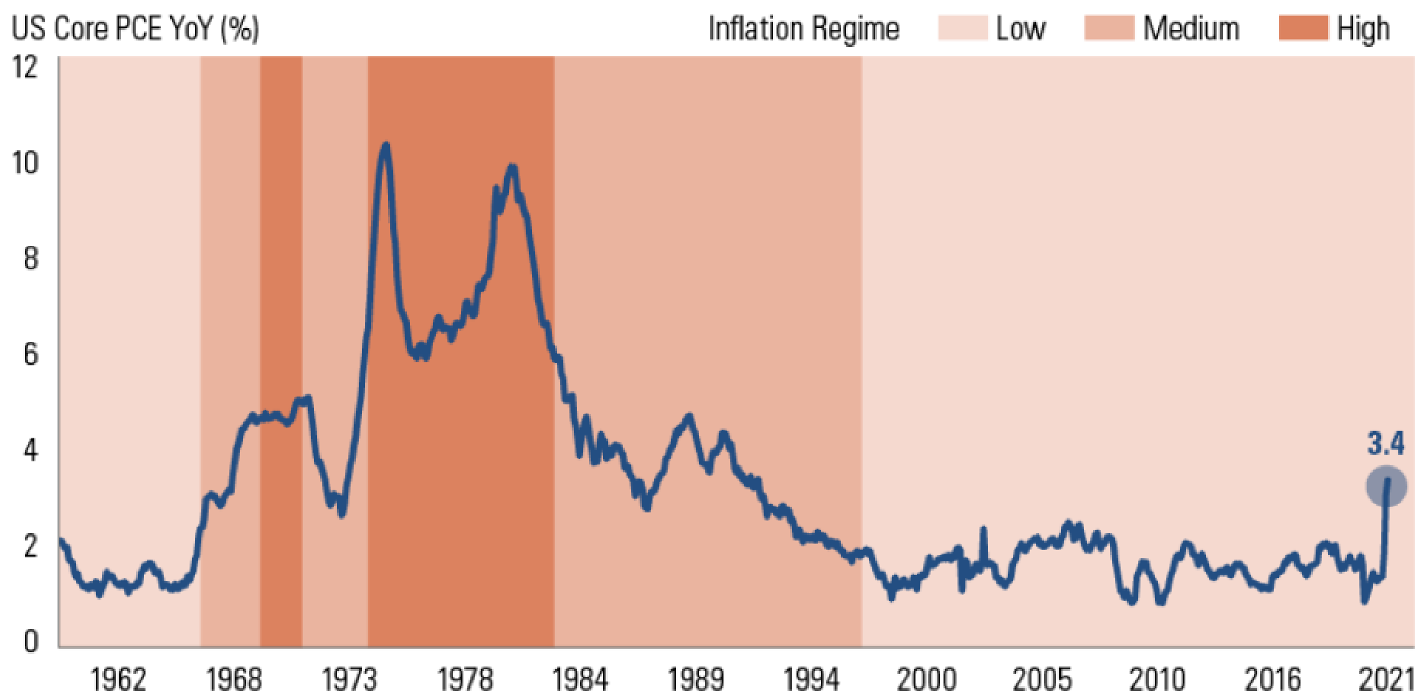
Perspective on Inflation

Inflation has been at the forefront of conversations across financial news outlets, with a number of reports showing a significant bounce in the CPI coming off of the depths of the pandemic. The most recent data, released in June, showed that headline CPI increased 5.4% year-over-year while core CPI, which excludes food and energy, increased 4.5%, the largest monthly jump since 1991. While the overall numbers may sound alarming compared to the recent trend of around 2%, it is important to consider what goods are driving the increase in reported inflation. As a result of pandemic-related shutdowns and staggered reopening across various geographies, supply chain disruptions have been widespread, and a global computer chip shortage has had a particularly large impact on many industries. The chart below highlights the impact transportation and automobiles have had on CPI, two segments of the market most impacted by the chip shortage. Used truck and car prices, for example, were up 45% year-over-year and accounted for one-third of the June CPI measure.



With this context in mind, we believe that the supply chain issues are the main culprit in the recent uptick in inflation rather than any form of a larger structural shift in long-term inflation expectations.

It has been the DeMarche view that the U.S. has been in a moderate-growth supercycle since 2000. Over this period, the economy has been hit by three recessions which have seen historic levels of Fed stimulus paired with modest levels of inflation. We find that inflation throughout this supercycle has been constrained by the impact of demographic trends, changes to banking regulations, and expanding globalization. The DeMarche moderate-growth supercycle perspective is mirrored by Goldman Sachs' research on inflation regimes, as seen in the chart below.

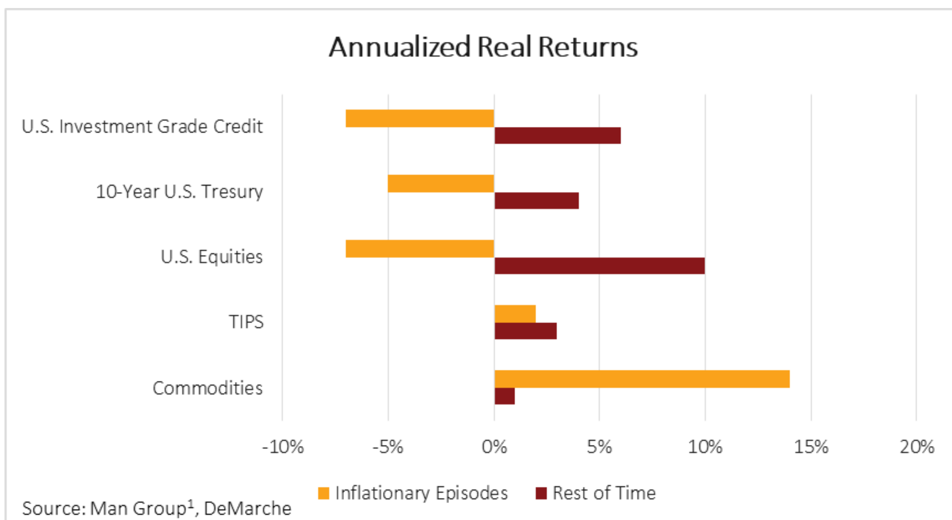


Source: Bloomberg and Goldman Sachs Asset Management. As of June 25, 2021.

While we believe that long-term inflationary pressures are low, the supply and demand imbalances that have developed as the global economy comes out of the pandemic are leading to spikes in prices for certain goods.

Asset Class Returns During Inflation Spikes

Institutional investors often incorporate inflation expectations into their portfolios over a strategic investment horizon of 5-10 years. This means that short-term inflation spikes may not make it into a longer-term portfolio view on inflation and asset class return expectations. Let's take a look at how broad asset classes have performed during inflation spikes in the past.



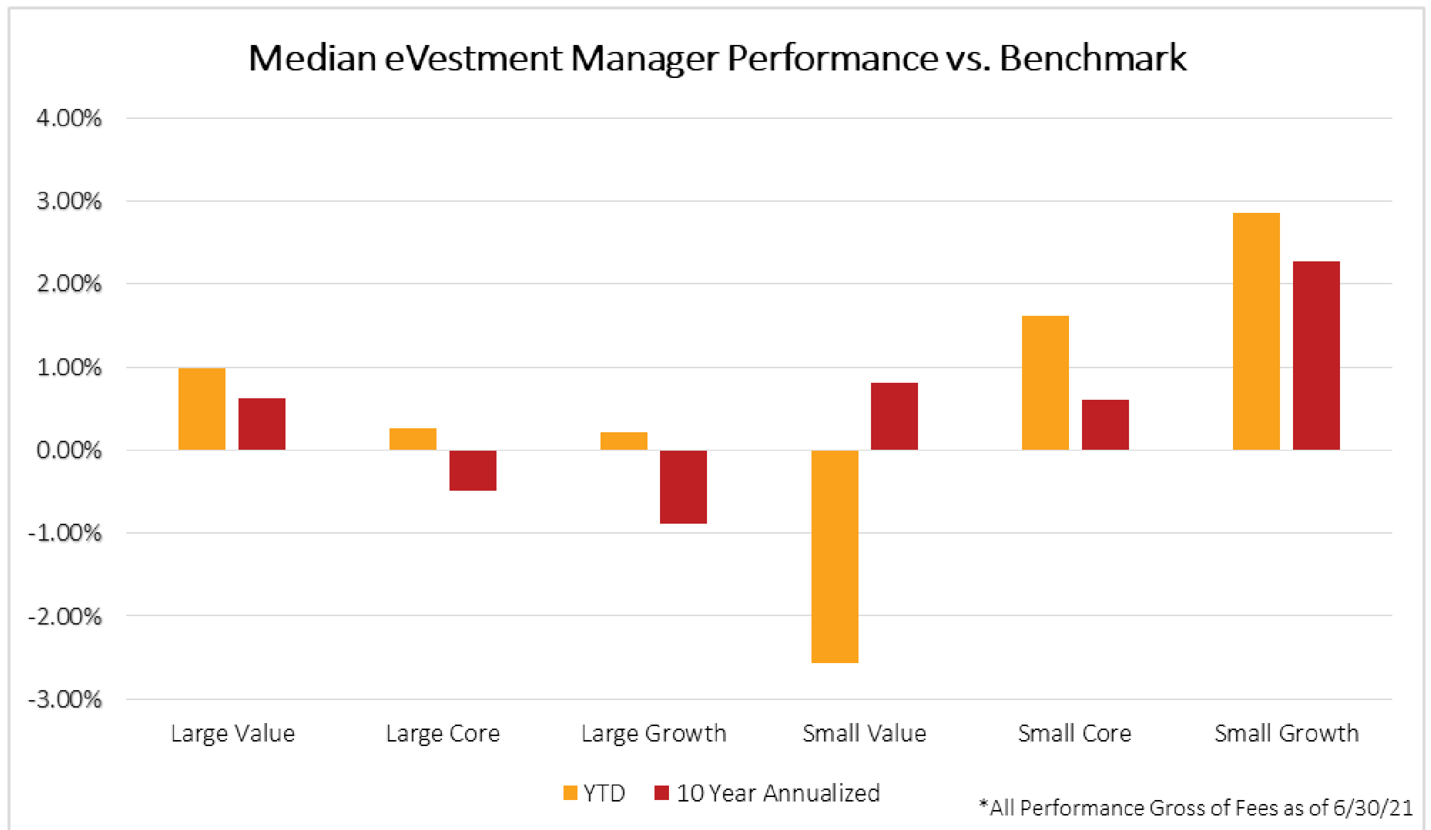
This chart shows annualized real returns during eight major rising inflationary periods[1] vs. other market periods. As is convention, commodities perform strongly during inflationary periods, followed by TIPS, while equities and treasuries experience weaker real returns. While the evidence shows that commodities may provide strong inflation protection, over the long term, commodities have not provided strong returns relative to other major asset classes. Investors who want to make

money on an inflation trade not only have to accurately time moving assets into inflation hedges prior to inflationary periods, but must also correctly identify when to shift assets back to less inflation-sensitive asset classes, or risk losing out on returns over the long term. The tactical nature of a successful inflation trade is one of the great challenges in investment management and does not often align well with the way most institutions are structured to manage their portfolios.

How Strategic Investors Can Manage Inflation

While not every investor has the in-house ability to tactically move in and out of asset classes to address inflation concerns, there are still ways investors can take action. For example, some institutions may seek to retain an Outsourced CIO (OCIO) service to tactically manage their portfolio's allocations to take advantage of market dislocations, including inflationary spikes. OCIO providers are able to devote 100% of their time to monitoring markets and are better positioned to execute on tactical opportunities when they arise, due to their greater depth of investment and trading resources.

For institutions that do not wish to pursue a tactical approach to managing their asset allocations, active management can also be an effective tool in combatting the impact of inflation on portfolio returns. Within each asset class there are certain sectors or types of companies that tend to perform better than others during inflationary periods. In theory, an active manager should be able to implement ideas in their portfolio that have a better chance of outperforming their benchmark and the broader asset class during periods of higher inflation.



So far in 2021, evidence is starting to indicate that this has been the case during the recent spate of inflation, as the median active managers in various U.S. equity categories have performed better versus their benchmarks year-to-date. The case where this trend does not hold is in the small cap value space, where managers have struggled significantly to match the Russell 2000 Value's performance, which has been led heavily by "meme" stocks GameStop and AMC. This index trend will be covered in more depth in our August white paper.

Conclusion

While it is important to consider new economic information such as inflation, it is also important to consider the driving forces behind the data and the long-term goals that the portfolio is trying to achieve. During inflationary environments, there is empirical evidence to support shifting into certain asset classes such as commodities, but it requires both a correct call on when to shift into the asset class and then back out of the asset class in order to generate meaningful excess returns. For most investors who do not make specifically timed tactical calls, we would advise that they address their inflation concerns by conducting an updated asset allocation study that incorporates a more recent assessment of inflation into the risk and return expectations of the portfolio's asset classes. Additionally, we advise investors to consider the retention of active managers in key asset classes where managers may use inflation-related dislocations to outperform broad benchmarks. For investors interested in implementing a tactical approach to address inflation and other macroeconomic events, we believe that OCIO services present one of the more compelling opportunities for institutions to generate outsized returns versus peers and benchmarks.

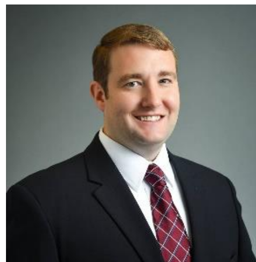
1) Man Group defines inflationary regimes as time periods where the YoY realized inflation rate rises materially beyond 2%. They define "materially beyond 2%" as reaching 5% or more. They define the regime end as the point at which CPI year over year reaches its peak without having fallen below 50% of its maximum annual rate in rolling 24-month observation windows. There were eight regimes since 1926 while using this definition.

Sources Utilized:

- *BLS*
- *Goldman Sachs*
- *eVestment*
- *Man Group*

Put Research to Work

with the DeMarche Team



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