MATRIX PRIVATE CAPITAL GROUP

Inflation Hedging...
Without Commodities

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An Old Foe Resurfaces

Like Lazarus, the topic of inflation has risen from the dead. The increase in headline inflation to 4.2% in April '21 is eyepopping and seemingly reinforces the fear that a continued surge in commodity prices, supply-demand imbalances from 'reopening' and fiscal stimulus, could cause further price increases. Indeed, that fear is evident as 10-year breakeven inflation rose to 2.54% (May 12th '21), which is in the top decile of its historical range since 2003.

With commodity prices accounting for about 36% of the Consumer Price Index (CPI) basket, investors naturally see it as a first line of defense in their asset allocation. Nonetheless, there are many other components that affect CPI, namely housing (where rent alone accounts for about 33%), transportation and medical care, which accounts for another 15% and 9%, respectively[1]. The diverse nature of the basket implies that there may be more than one way to hedge inflation.

Moreover, investing in commodities may not always be practical for a variety of reasons. Commodity futures may include carry costs which often reduces returns; commodity ETFs can have higher expense ratios and necessitate K-1s, and sometimes, a client's investment policy statement may not make room for the asset class. Are there equally effective ways to implement these views? We take a look at using specific equity industries, commonly available in ETFs, as an alternative.

Equity Industries as Inflation Hedges

Theoretically, some equity industries should be good inflation hedges because surging prices can cause revenues to rise faster than costs, resulting in higher earnings. As such, we think of equity industry returns as comprising two components: a market beta that earns the equity risk premia, and an idiosyncratic, industry-related component that can be correlated to inflation. Our goal is to separate the two investment decisions; i.e., without over/underweighting equities, can we change the composition of an equity portfolio to express our views?

We assess a list of ETFs in different industries (55 names in total including GICS sector ETFs) and regress rolling-12m excess returns of each ETF with two variables: the rolling-12m excess returns of the S&P 500 and year-on-year headline inflation, over 5 and 10-years. The coefficient on the inflation variable will tell us how sensitive these industries are to headline inflation, after controlling for market beta. For comparison, we also included the iShares S&P GSCI Commodity-Indexed Trust (GSG) in our analysis.

Display 1 shows the results over the past 5 years, with only statistically significant results shown. The results confirm that GSG is indeed highly correlated to headline inflation – in this case, a 25% rise in GSG corresponds with a 1% rise in headline inflation. Across equity industries, not surprisingly, we see that commodity-related areas such as oil and gas exploration, master limited partnerships, and, natural gas producers act as good hedges – in fact, many of them appear as effective as GSG, with similar inflation betas. Additionally, we also see real estate, transportation, and financials, like banks, on the list - this result perhaps might not be surprising as some of these components are material components of the CPI basket.

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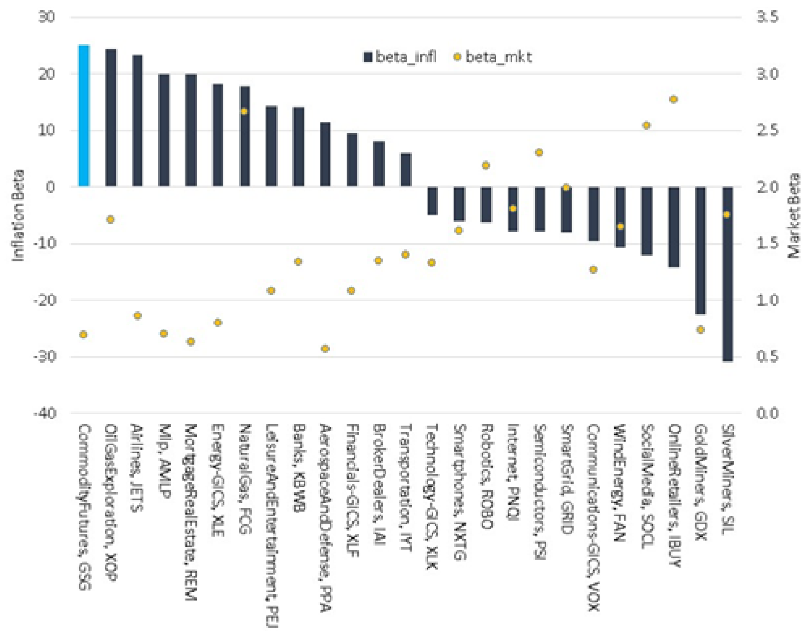
1. Source: Bureau of Labor Statistics: https://www.bls.gov/cpi/tables/relative-importance/2020.htm

On the other hand, technology companies and precious metal producers appear to be most adversely affected by inflation. A regression analysis like this does not tell us specifically why, and the interaction of the underlying economic factors could be more complex. For example, the linkage between precious metal producers or banks, and, inflation is likely through interest rates. To the extent inflation drives rates expectations, we believe the relationship between returns and inflation will endure. It is important that we are aware of the limits of these relationships and apply fundamental analysis accordingly.

Display 1: Sensitivity of Equity Industries to Headline Inflation (Trailing 5-Years ending March 2021)*



Source: Matrix Private Capital Group; Date range: March 2016 - March 2021

*Note: Only statistically significant results are shown, using a 5% confidence interval with Newey-West adjusted standard errors because of overlapping data

For completeness, we also include trailing 10-year results for the same analysis (the subset of ETFs to analyze drops a bit to 51). Yet again, we see some similar patterns: commodity producers are good inflation hedges, even better than GSG in one case, and more innovation-focused industries across healthcare, technology and energy, are more susceptible.

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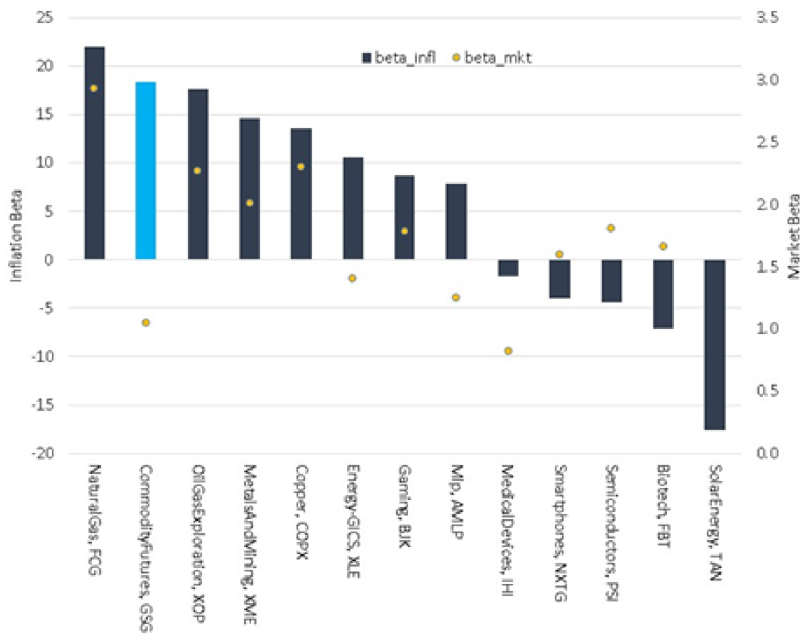
Display 2: Sensitivity of Equity Industries to Headline Inflation (Trailing 10-Years ending March 2021)*



Source: Matrix Private Capital Group; Date range: March 2011-March 2021

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Practical Implementation

How should we use this information? As mentioned, to express tactical views, one can simply replace some broad equity market exposure with an industry of choice above, being cognizant of market beta. As the S&P 500 has a zero-inflation beta over a 5-year period, over/underweighting these industries will introduce some sensitivity to inflation. Secondly, from a risk management perspective, the analysis could also provide an investor with some idea of hidden risks lurking in a portfolio that holds stocks in these areas. In turn, he/she can add or reduce exposure where necessary to align the portfolio with specific data-backed views on inflation.

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