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Markets in a Minute
Investing in an Inflationary Environment

Equity prices reached new highs in 2021 and, unfortunately, so did inflation. One question that now looms large is whether we're entering a prolonged period of high inflation. And, if so, what can investors do to mitigate risk?

Historically, the stock-market sectors that have tended to shine during periods of high inflation focus on the goods and services people need, as opposed to what they want:

- This trend played out in dramatic fashion in the 1970s and early '80s, which was the last time the U.S. had very high levels of inflation. During this "Great Inflation", the Consumer Price Index (CPI) peaked at nearly 15% in March 1980.
- As prices surged, Americans tended to show a preference for buying essentials (think gas, utilities, pharmaceuticals and groceries) and spent less on discretionary goods and services. It's worth noting that the Great Inflation coincided with two severe energy shortages that led to dramatic increases in oil prices.
- So, it's not surprising that companies in such S&P 500 sectors as Energy, Consumer Staples, Utilities and Health Care had positive inflation-adjusted returns, according to research from Kailash Concepts.
- Meanwhile, Financials, Industrials, Consumer Discretionary and Tech underperformed.

High inflation doesn't necessarily mean stocks overall will underperform. Research shows that markets can still enjoy broad gains when inflation is elevated:

- Post 2000, during shorter periods of inflation, equity gains were more broad-based than they had been during inflationary bouts prior to the turn of the millennium.
- Consider the performance of Industrials. Between 1972 and 2000, the sector generally underperformed on a relative basis during inflationary periods (characterized by average CPI increases of roughly 5%).
- After 2000, Industrials tended to beat the S&P 500 during inflationary periods, when the CPI rose by a more moderate 4-6%.

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- Energy has had the most-consistent outperformance during inflationary periods, with one important caveat: When inflation has been more-moderate, the sector has generally underperformed.

S&P 500 Sector	6/30/1972 to 12/31/1974	12/31/1976 to 3/31/1980	7/31/1983 to 3/31/1984	12/31/1986 to 10/31/1990	3/31/1998 to 3/31/2000	1/31/2002 to 9/30/2005	10/31/2006 to 7/31/2008	8/31/2009 to 9/30/2011	4/30/2015 to 7/31/2018	5/31/2020 to 1/31/2021
Energy	-5.0	42.2	14.7	56.8	10.3	94.9	30.5	13.2	-5.6	1.7
Communication Services	-18.5	-13.8	-1.0	34.7	56.5	-16.1	-16.1	19.9	51.2	20.8
Health Care	-20.2	-1.1	-8.1	66.9	7.7	-4.7	-3.8	11.2	24.1	11.9
Consumer Staples	-38.7	-18.5	5.3	100.7	-27.9	9.0	6.5	20.3	10.7	8.8
Information Technology	-44.8	-11.0	-10.6	-15.6	198.7	-12.0	1.9	18.1	67.0	32.0
Industrials	-49.4	8.8	-3.4	10.4	14.3	10.5	-1.7	16.1	34.7	25.8
Materials	-17.0	-17.1	-0.4	9.3	-10.6	25.0	20.5	3.4	18.5	27.7
Consumer Discretionary	-58.6	-37.7	-12.4	2.6	29.6	22.5	-23.7	35.7	60.0	30.5
Utilities	-38.3	-17.1	-5.0	11.2	-2.4	24.2	6.8	15.9	19.4	4.6
Financials	-61.7	-12.5	-5.6	-30.5	1.7	14.0	-40.2	-25.0	39.5	24.1
S&P 500 Index	-36.0	-5.0	-2.1	25.5	36.0	8.7	-8.0	10.9	35.0	22.0
CPI Rise***	**963**	**562**	**234**	**519**	**238**	**354**	**429**	**535**	**315**	**128**

***CPI rise is the increase in the Y/Y growth rate, trough to peak, in basis points

Green shade means sector has outperformed the S&P 500 while red has underperformed. Real Estate excluded due to lack of history. Source: S&P Dow Jones Indices.

Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index. Source: NDR with data from S&P Dow Jones Indices. Index proxy: S&P 500 from June 30, 1972 to January 31, 2021.

What factors have fueled the current bout of inflation, which saw the CPI climb by 7% year over year in December? The answer offers clues as to what it will take for inflation to cool:

- Inflation has been driven just as much by increased demand for certain types of goods as it has by constrained supply. Fiscal stimulus put more money in consumers' pockets and thus helped stoke demand.

- Since the onset of the pandemic, spending on durable goods has soared, while spending on services has taken longer to recover. In December, goods prices climbed by more than 12%, while service prices rose by about 4%.

- Rising energy and auto prices (particularly for used cars and trucks) have been large drivers of consumer price inflation. Gas prices climbed nearly 44.5% last year.

- Housing prices in many areas of the United States have skyrocketed, according to Case-Shiller data and other measures of housing inflation. (Note: CPI data show muted gains, but the index has some limitations as a measure of housing-price inflation.)

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We believe inflation should begin to cool later this year as supply chain disruptions ease; the Omicron wave subsides and consumers begin spending more on dining out, travel and other services; and the Fed raises rates, which should slow housing-price increases. Of course, much of this depends on how the pandemic plays out.

In the meantime, inflation remains a headwind. While certain assets (like energy and Treasury Inflation Protected Securities) can help investors hedge against inflation, their collective track record outside of inflationary environments is mixed. That's why it's important for investors to regularly revisit their exposure to such assets and maintain a diversified portfolio.