Quick Takes

Quick Clips: When Stock-Bond Diversification Fails

Managing Inflation Risk in Investor Portfolios

October 27, 2021

Unprecedented monetary stimulus coupled with extraordinary fiscal stimulus and potential supply chain disruptions stemming from the Covid-19 pandemic have raised renewed concerns about the potential for upside shocks to inflation.

In 2021, inflation increased sharply, reaching 5.4% in the U.S. for the year ending in June, and maintaining that rate three months later. Perhaps even more notably, U.S. core CPI, which strips out more volatile energy inputs, exceeded 4% for the first time since the early 1990s. Many have suggested these pressures may be short-lived, and longer-term expectations remain fairly well-anchored as of September 2021. Nevertheless, uncertainty around the future path of inflation should prompt investors to question how different inflationary outcomes can impact their portfolio.

In our latest paper, we introduce measures that isolate the elements of inflation data that are most relevant to asset prices – in other words, the "news" components of inflation. Using these measures, we find that both stocks and bonds have both underperformed in environments of rising or surprisingly high inflation.

Inflation is a serious risk for investors with portfolios primarily consisting of stocks and bonds (0:38)

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We next evaluate other asset classes that are often considered to offer more resilience to inflation, including real estate, commodities, and inflation-linked bonds. We show that allocations to some (but not all) of these asset classes can provide valuable diversification in inflationary episodes and thus reduce portfolio sensitivity to inflation.

Evaluating the ability of real assets to protect against rising inflation (0:43)

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Diving deeper into the relationship between asset classes and inflation, we see a tendency for equities to also underperform during periods of falling inflation – potentially due to these episodes having coincided with adverse growth shocks in our sample. This pattern highlights the benefit to investors of strategies that might offer upside inflation protection without suffering in disinflationary recession outcomes.

Two strategies have tended to thrive during both upside and downside inflation surprises (0:38)

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We conclude by analyzing the impact of an allocation to a “real return” basket, including commodities, TIPS breakevens, price trend, and macro momentum, showing meaningfully improved resilience to the inflation environment.

Putting it all together – a balanced approach to addressing inflation risk (0:25)

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