Insight
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Real Assets and the Inflationary Awakening

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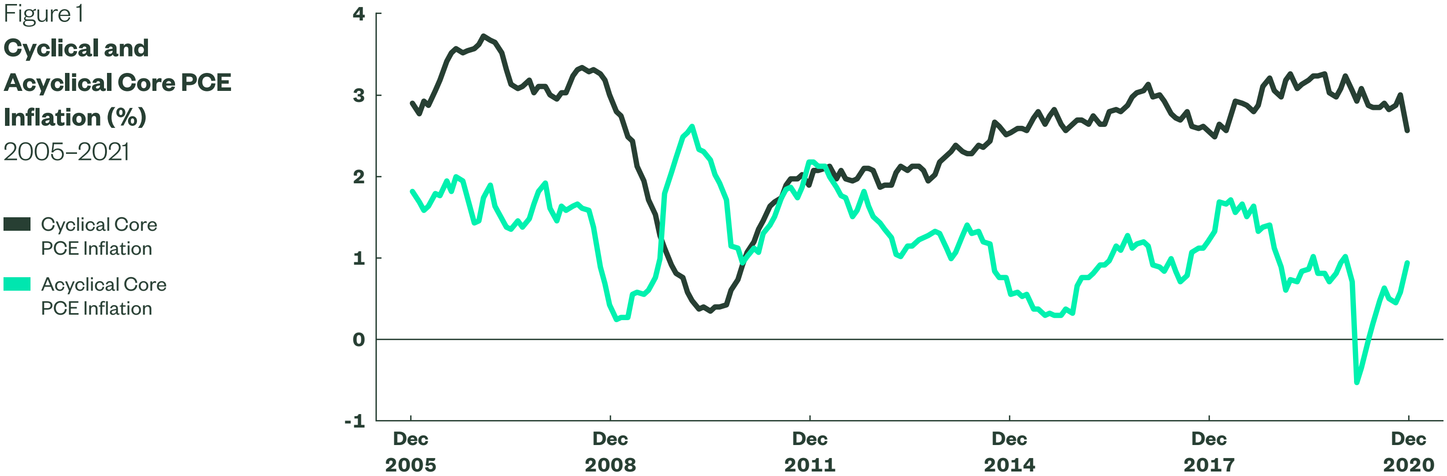
Over the last decade, inflation has been subdued around the globe and struggled to come close to central bank targets despite loose monetary policy actions. However, influenced by the economic effects of the global pandemic, inflation appears poised to re-emerge in 2021 and to have an impact in the years to come.

This should encourage a re-examination of portfolios that have largely benefited from robust equity and bond returns, and which may now face inflationary challenges. Investors who find themselves vulnerable to a sustained move higher in inflation should consider the inclusion of inflation-hedging assets, such as real assets, which have historically performed well and shown a higher beta and correlation to inflation than traditional assets.

Cyclical Inflation Drivers Accelerating

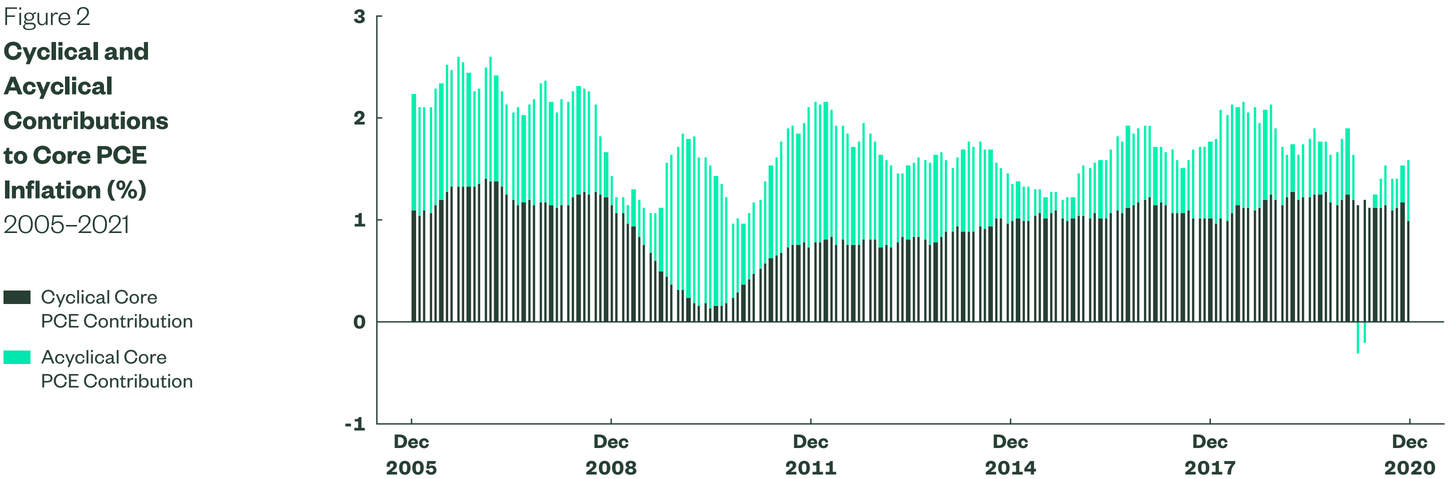
By keeping short-term interest rates low, the US Federal Reserve (Fed) expects to stimulate overall economic conditions and spark a business cycle expansion, which it hopes will be inflationary. The Federal Reserve Banks of San Francisco and Cleveland have explored the relationship between core inflation and the business cycle. They concluded that cyclical drivers of personal consumption expenditure (PCE) inflation (e.g., housing, recreational services, food services, select nondurable goods) have improved since the recession that followed the 2008 Global Financial Crisis (GFC), while acyclical drivers of PCE inflation (e.g., health care services, financial services, clothing, transportation) have remained stubbornly low and kept overall inflation subdued.[1,2] (See Figures 1 and 2.)

Figure 1
Cyclical and Acyclical Core PCE Inflation (%)
2005–2021



Source: Federal Reserve Bank of San Francisco.

Figure 2
Cyclical and Acyclical Contributions to Core PCE Inflation (%)
2005–2021



Source: Federal Reserve Bank of San Francisco.

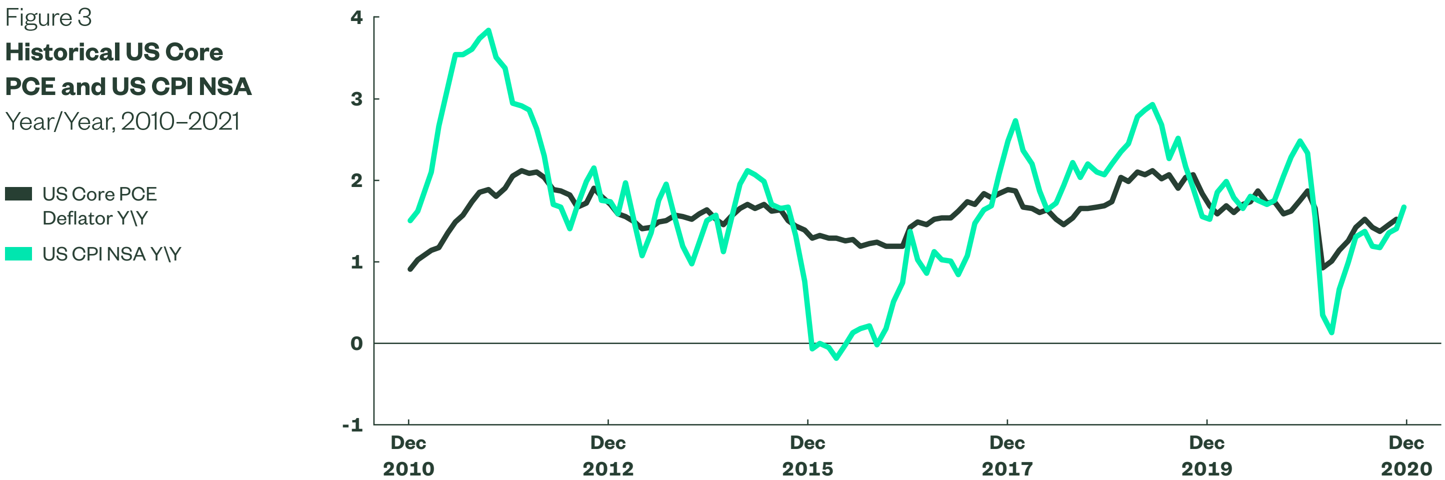
For 2021, State Street is anticipating increased economic growth, measured by GDP rising 5.3% in the US and 5.7% globally.[3] The V-shaped recovery in manufacturing is evidence of firming aggregate demand; along with supply constraints, the recovery has led to reduced stockpiles and higher commodity prices. Concerns about significant inflationary effects result from a resurgence of cyclical influences (e.g., healing labor markets) as well as from modestly rising acyclical influences.

State Street Inflation Outlook

Market expectations for inflation recently touched 2.6%, with 5-year breakevens reaching a level not seen since July of 2008, i.e., before the GFC sank inflation expectations. The implied inflation pick-up moved from a pre-pandemic reading of 1.7% to a low of 0.18% in mid-March of 2020, when investors fully considered the implications of continued easy monetary policy, massive fiscal stimulus, potential dollar weakness, and declining economic slack in the future.

We expect that, over the next few months, inflation measures will get a significant bump due to negative base-effects rolling off from 2020 and higher recent energy and food prices. The St. Louis Fed's President James Bullard has suggested that the US economy is going to recover more quickly than many forecasters expect, and unlike recent experience he foresees more price volatility and higher inflation. In fact, he would embrace inflation over 2% on a sustained basis and accept it staying 0.5 percentage points above the Fed's target for an extended period.[4] Further, purchaser and manufacturer input costs have accelerated in the first two months of 2021, experiencing their largest gains since December of 2009. (See Figures 3 and 4.)

Figure 3
Historical US Core PCE and US CPI NSA
Year/Year, 2010–2021



CPI = Consumer Price Index.
NSA = Not seasonally adjusted.
Source: Bureau of Economic Analysis, US Bureau of Labor Statistics, and FactSet.

Figure 4
US Core PCE Deflator and US CPI SA
January 2020 to February 2021, Month/Month

Date	US Core PCE Deflator M\M	US CPI SA M\M
Jan-20	0.17	0.19
Feb-20	0.15	0.05
Mar-20	-0.10	-0.32
Apr-20	-0.43	-0.70
May-20	0.20	-0.10
Jun-20	0.35	0.52
Jul-20	0.28	0.51
Aug-20	0.31	0.35
Sep-20	0.18	0.25
Oct-20	0.02	0.12
Nov-20	0.00	0.18
Dec-20	0.30	0.24
Jan-21	0.25	0.26
Feb-21	0.09	0.35

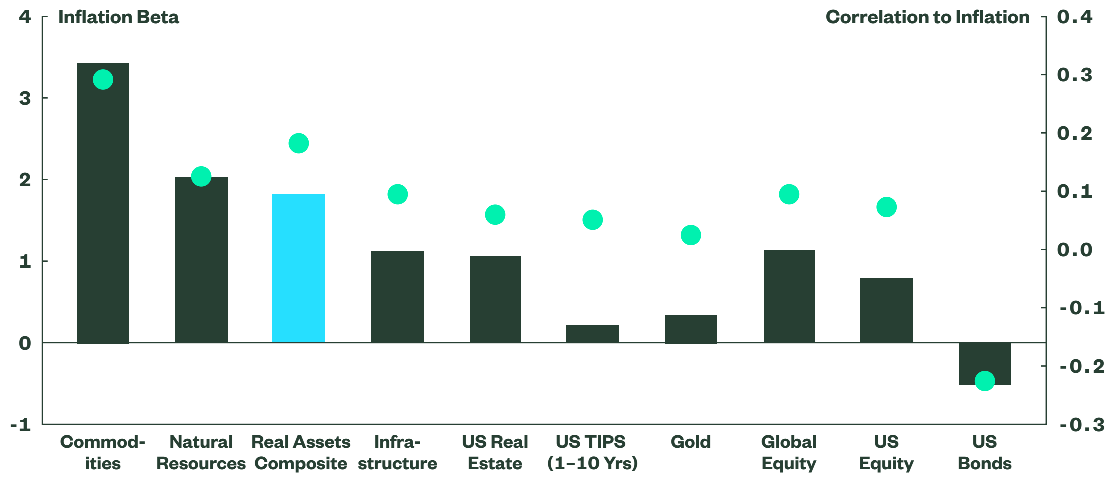
SA = Seasonally adjusted.
Source: Bureau of Economic Analysis, US Bureau of Labor Statistics, and FactSet.

Inflation-Hedging Asset Strategies

Investors currently under-allocated to inflation-hedging assets are vulnerable to a sustained move higher in inflation. Real assets have historically performed well in such an environment, with higher beta and correlation to inflation than traditional assets. (See Figure 5.)

Figure 5
Asset Class Inflation Beta and Correlation to Inflation
April 29, 2005 to February 28, 2021

Inflation Beta
Correlation to Inflation



Source: State Street Global Advisors and FactSet.

This current cyclical pick-up in inflation may, therefore, also counsel the consideration of investments such as commodities and global natural resources, as well of value-oriented equities in areas like infrastructure. For the latter, the potential approval of increased fiscal spending directed toward infrastructure in the later part of 2021 could prove to be another tailwind.

Real estate has been hit particularly hard over the last two years but has begun to recover and adjust its business models to the new reality of the pandemic-changed work environment and to the increased shift to e-commerce.

While inflation-linked bonds may have already experienced much of the increase in inflation expectations, shifting exposure to shorter-duration securities would be a way to mitigate interest rate volatility and better align with future inflation moves — without giving up too much yield at current levels.

And what if actual readings surpass current consensus expectations? If inflation overshoots at sustained higher levels, gold may play a larger and more significant roll due to the negative effect inflation can have on broad equity and fixed income exposures.

Closing Thoughts

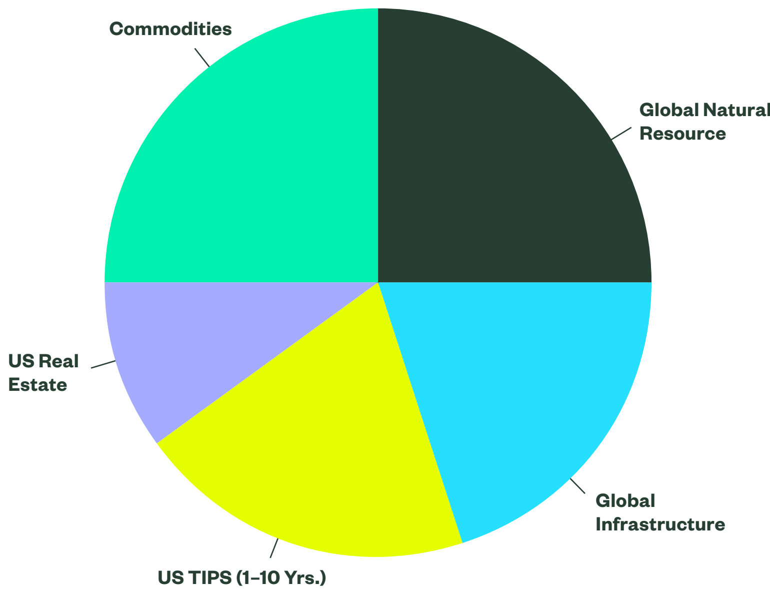
The current inflation outlook is more complex than it has been in some time. Massive monetary and fiscal stimulus, the release of pent-up demand in depressed service areas, pressures on global supply chains, and a weaker US dollar are all influencing expectations. And while output gaps may serve to cap the amount of the rise, a cyclical recovery likely will lift inflation almost everywhere.

Higher inflation may not surprise the markets, but the accompanying volatility will test investors' asset allocation strategies. All investors may soon find themselves vulnerable to a sustained move higher in inflation, and should consider the inclusion of inflation-hedging assets, such as real assets, in their portfolios because of strong historical performance during inflationary periods.

About the State Street Real Asset Strategy

State Street offers investors a seasoned, diversified multi-asset strategy that combines exposure to a broad array of liquid real asset securities. (See Figure 6.) The Real Asset Strategy is expected to perform best during periods of increasing inflation or rising unexpected inflation. The Strategy is meant to be a complement to traditional equity and bond assets, providing further diversification, attractive returns, and a source of income in a low-yielding environment. For complete information, please contact your State Street representative.

Figure 6
Components of the State Street Real Asset Strategy
Illustrative Allocation



Source: State Street Global Advisors.

Endnotes

1 Mahedy, Tim, and Adam Shapiro. 2017. "What's Down with Inflation?" Federal Reserve Bank of San Francisco *Economic Letter* 2017-35, November 27, 2017.

2 Zaman, Saeed. 2019. "Cyclical versus Acyclical Inflation: A Deeper Dive." Federal Reserve Bank of Cleveland *Economic Commentary* 2019-13. September 4, 2019.

3 *Weekly Economic Perspectives — GMPR Quarterly,* State Street Global Advisors, March 22, 2021.

4 Jeremy D. Schwartz, 2021. "Behind the Markets Podcast: St. Louis Fed President Jim Bullard," Episode 227, *Behind the Markets Podcast*, March 5, 2021.

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- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 31 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $3.47 trillion* under our care.

* This figure is presented as of December 31, 2020 and includes approximately $75.17 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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