T. Rowe Price

Hedging inflation risk

From the Field
April 2024

Key Insights

- Recession fears are fading, but inflation concerns have resurfaced as consumer price index expectations have steadily risen since the beginning of the year.
- To hedge against inflation risk, T. Rowe Price's Asset Allocation Committee is overweight stocks, with an overweight allocation to real assets equities.

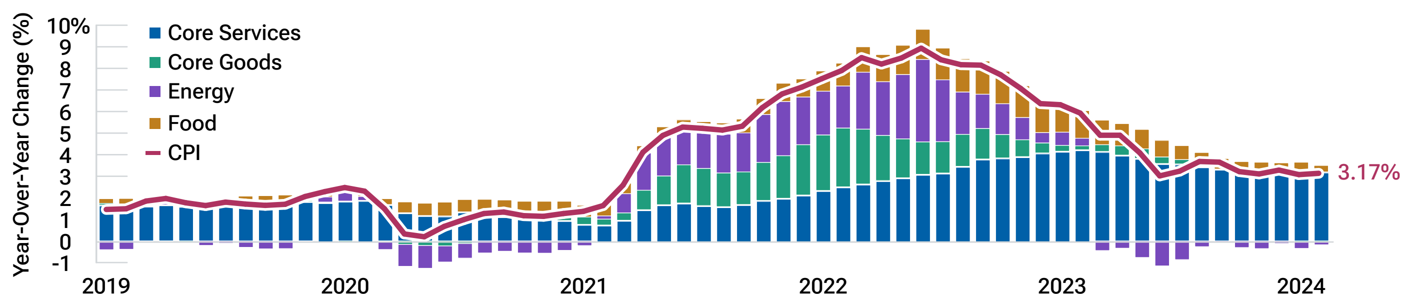
Tim Murray, CFA
Capital Markets Strategist
Multi-Asset Division

Risks have shifted. Recession fears are fading, and economists now expect a healthy 2.1% growth in U.S. gross domestic product in 2024. However, inflation concerns have resurfaced. Expectations for the U.S. consumer price index (CPI) have steadily risen from 2.2%—a level that would have been in line with the Federal Reserve's target—to 2.8% as of March 22, 2024.

CPI, a widely used measure of inflation, surged to a peak in June 2022 due to elevated goods prices, specifically in the food, energy, and core goods categories of the CPI basket. As supply chains normalized, inflation fell as prices in these categories declined. Meanwhile, services inflation has barely budged and now accounts for the vast majority of inflation (Figure 1).

Inflation has fallen since the 2022 peak but looks sticky

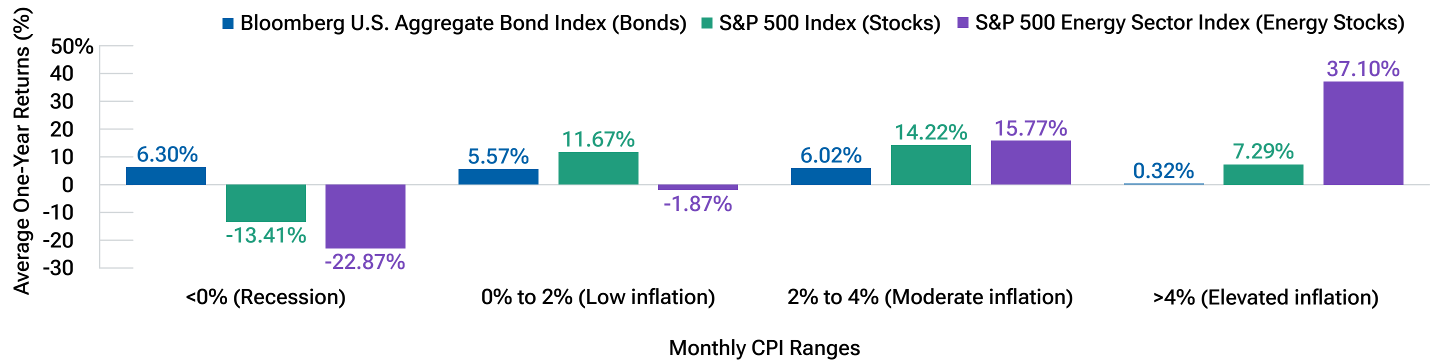
(Fig. 1) Components of the consumer price index



January 2019 to February 2024.
Sources: Federal Reserve Board, Federal Reserve Bank of Philadelphia, University of Michigan/Haver Analytics.

Energy stocks have performed well in high-inflation environments

(Fig. 2) Average one-year asset class returns by monthly CPI ranges



December 1989 to February 2024.

Past performance is not a reliable indicator of future performance.

Sources: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved. S&P and Bloomberg indexes. See Additional Disclosures.

This is concerning to investors. In order to meet the Federal Reserve's 2% target, not only will the stubborn services inflation have to moderate, but goods inflation will also have to remain dormant. This is a very optimistic assumption.

Given the shift from recession risk to inflation risk, we believe that investors should reconsider their asset allocation. A review of asset returns during various inflationary environments provides some useful insights (Figure 2).

As illustrated, bonds historically have been an excellent hedge in recessionary periods, but they have not been an effective hedge against elevated inflation. Meanwhile, stocks have outperformed bonds when inflation was at low, moderate, and even slightly elevated levels. But their returns dipped sharply during recessions and also weakened when inflation moved to very high levels.

Notably, stocks in the energy sector historically have performed quite well in periods where inflation is at very high levels. These results imply that a tilt toward stocks, with an emphasis on the energy sector, could be a way to hedge inflation risk.

The Asset Allocation Committee recently moved to an overweight position in stocks. We also hold an overweight position in real assets equities, which have a large allocation to energy and other commodity-oriented equities.

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