Portfolio Risk And Performance

When Stock-Bond Diversification Fails

Managing inflation risk in investor portfolios

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Unprecedented monetary stimulus, coupled with extraordinary fiscal stimulus and supply chain disruptions stemming from the COVID-19 pandemic, has led to concerns about the potential for upside shocks to inflation for one of the first times in over a quarter-century. This uncertainty around the future path of inflation should prompt investors to question how different inflationary outcomes can impact their portfolio.

We evaluate the sensitivity of traditional markets to inflation, showing potential underperformance in environments of rising or surprisingly high inflation. We then assess other asset classes often considered more resilient to inflation, including real estate, commodities, and inflation-linked bonds. We illustrate 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. Lastly, we identify two strategies offering potential outperformance during both upside and downside inflation surprises – price trend following and macro momentum.

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