Growing Hardy Inflation Hedges With Natural Resource Equities

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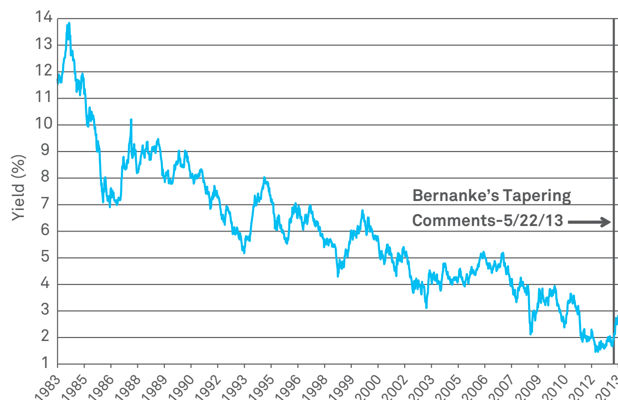
We believe the era of easy money in the U.S. is coming to an end. The Federal Reserve has cut its quantitative easing (QE) program of bond purchases by $10 billion at each of its last three meetings. The current pace of tapering suggests that QE will reach zero in just a few more months and some observers even expect the fed funds rate to rise in the spring of 2015.

A strengthening U.S. dollar will effectively export inflationary pressures throughout the world.

This combination of events reinforces our belief that interest rates bottomed last summer, as investors reacted to the planned reduction of QE measures worldwide, as shown in Figure 1. Years of QE have lulled many investors into complacency about the central bank's actions, but Fed Chair Janet Yellen's comments indicate that a rate hike is less than a year away. Those comments are feeding fears of impending inflation as the effect of QE shifts from providing stimulus to creating excess liquidity.

Figure 1: Charting the 10-Year U.S. Treasury Yield (November 1983 – November 2013)



Source: Bloomberg

Higher rates point to a strengthening U.S. dollar, which will effectively export inflationary pressures throughout the world. Most of the world's commodities—not to mention many other goods and services—remain priced in U.S. dollars. If a relatively healthy economic outlook prompts U.S. rates to rise more quickly, the dollar will strengthen against other currencies and exacerbate those inflationary pressures.

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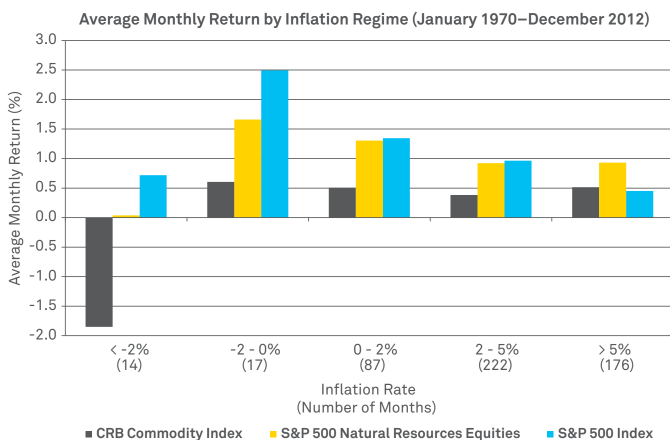
This dynamic will be most apparent in countries with current account deficits, and it has been blamed for much of the sell-off in emerging-market equities during the past year.

Not surprisingly, investors are seeking ways to hedge their portfolios against this likely rise of inflation. Commodities are typically the first tools they reach for. Many investors believe that hard assets such as oil and gold outperform traditional securities such as stocks and bonds in times of high inflation. However, this is not necessarily the case, as Figure 2 shows. We believe that their relative performance shows that natural resource equities are better at hedging inflation than commodities.

Figure 2: Natural Resource Equities Outperformed Commodities Across Inflation Regimes



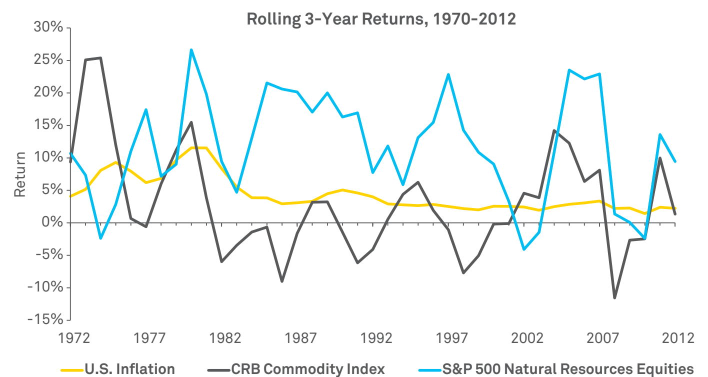
Source: St. Louis Fed, Commodity Research Bureau, FactSet

This chart shows how the Standard & Poor's 500, natural resource equities and commodities (as defined by the Thomson Reuters/Jefferies CRB Index) performed across various inflationary regimes. Equities are the clear outperformers in times of low to moderate inflation. But as inflation begins to rise, natural resource equity returns catch up to and eventually overtake the broader stock market. Meanwhile, commodities tend to lag both categories of equities in almost every inflationary regime, only outperforming the S&P 500 in times of very high inflation.

This is because of the nature of commodities. They have an expected return of zero because any new investment return opportunities are eventually competed away and no competitive advantage exists. Equities have a positive expected return because company managements invest above their costs of capital to drive profits, which broadly translates as an equity risk premium.

As Figure 3 shows, the rolling three-year returns of the CRB index have oscillated wildly above and below the rate of inflation over the past 40 years. By contrast, natural resource equities have a built-in equity-risk premium that has allowed them to outperform commodities over a full risk cycle. We cannot posit a direct correlation between commodity returns and inflation, as the chart shows they do not appear to closely track U.S. inflation levels.

Figure 3: Risk Premium Drives Better Through-Cycle Returns

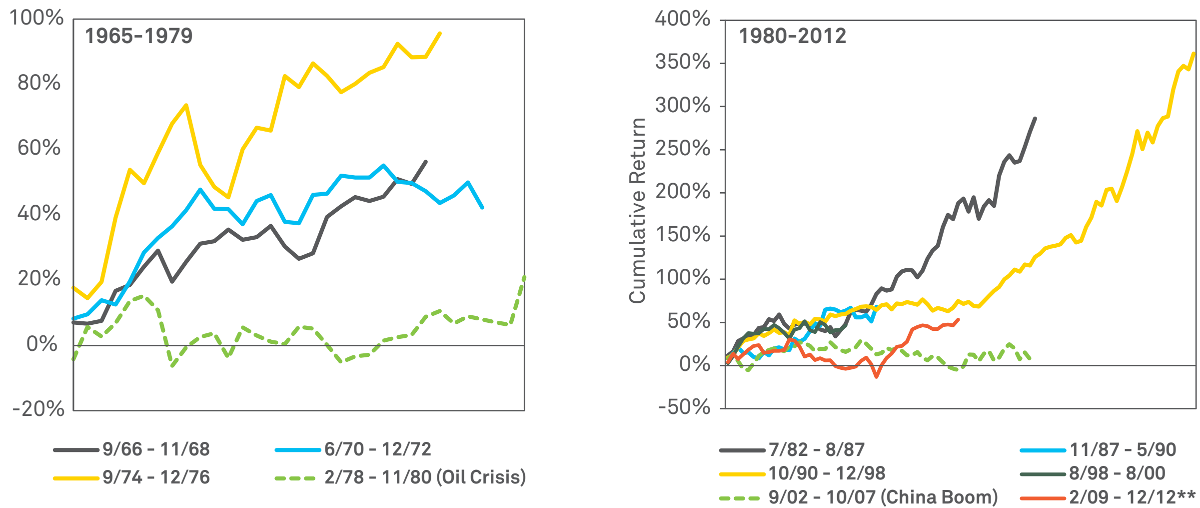


Source: St. Louis Fed, Commodity Research Bureau, FactSet

Commodities' low correlation to equities means that holding them theoretically makes sense as a means to diversify a portfolio. But such diversification may come at a steep price if stocks continue rising. In Figure 4, the colored lines track the performance of the S&P 500 and the CRB Index during equity rallies, and commodity markets usually underperform in most instances we have tracked since 1965. Only twice in this time period have commodities kept pace with equities. The first time was from 1972 to 1978, which coincided with the supply shock of the global oil crisis. The second instance was the period from 1999 to 2002 when China's boom spurred a surge in demand for commodities. Both events were outliers that dramatically reshaped the supply/demand dynamic for commodities.

Figure 4: Commodity Investments a High-Cost Drag on Portfolios

Performance of NR Equities vs. Commodities, After Stock Market Correction*



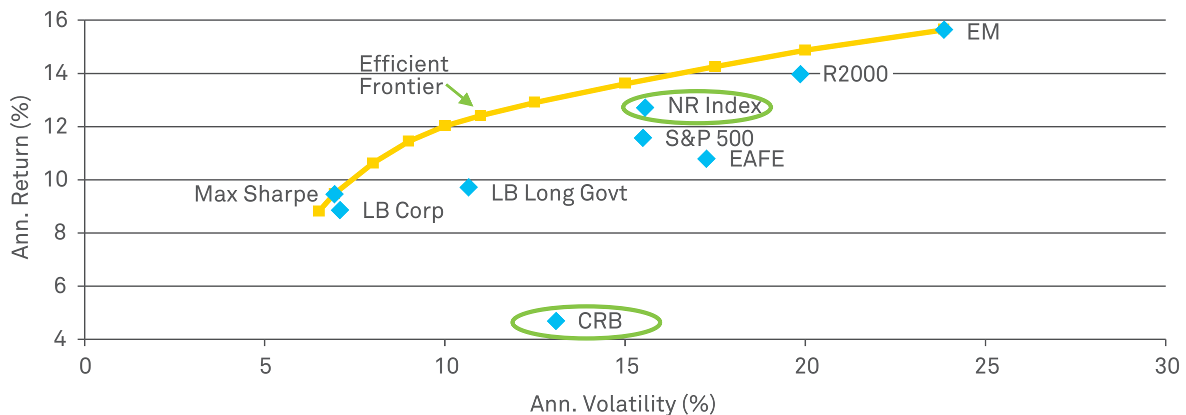
Source: Morningstar, Bloomberg. *Equity market (S&P 500 total return) recoveries from declines of 10% or more, trough to subsequent peak. **2009 rally has not reached peak at this point.

Diversification is a key objective of most investors' portfolio-construction process, but we believe commodities are not the best way to achieve it. Consider the concept of the efficient frontier, which maps out the optimal investment opportunity set based on expected returns and risk levels. As Figure 5 shows, the CRB Index representing commodities is far from the efficient frontier, indicating that commodities do not provide sufficient expected return to compensate for the level of risk they pose. On the other hand, equities are above and to the right of commodities on the chart, which represents more risk, but also higher expected returns.

As the economy strengthens and interest rates rise, savvy investors will plan ahead for inflation and position their portfolios accordingly. We believe they should consider natural resource equities as part of their hedging strategies, given their compelling historical relative performance and attractive risk/reward proposition, particularly compared to that of commodities.

Figure 5: Commodities Inefficient; Natural-Resource Equities Offer Better Risk/Reward

Asset Classes Along Efficient Frontier



Source: Bloomberg. Efficient Frontier based on historical monthly returns as follows: EAFE, S&P 500, Natural Resources Index, and CRB Index – Jan70-May13; Barclay's Corporate Bond Index, Barclay's Long Government Bond Index – Jan76-May13; Russell 2000 – Jan79-May13; MSCI Emerging Markets Index – Jan88-May13.

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