COMMODITIES ARE MORE THAN JUST AN INFLATION HEDGE

Nitesh Shah – Head of Commodities and Macroeconomic Research, WisdomTree Europe
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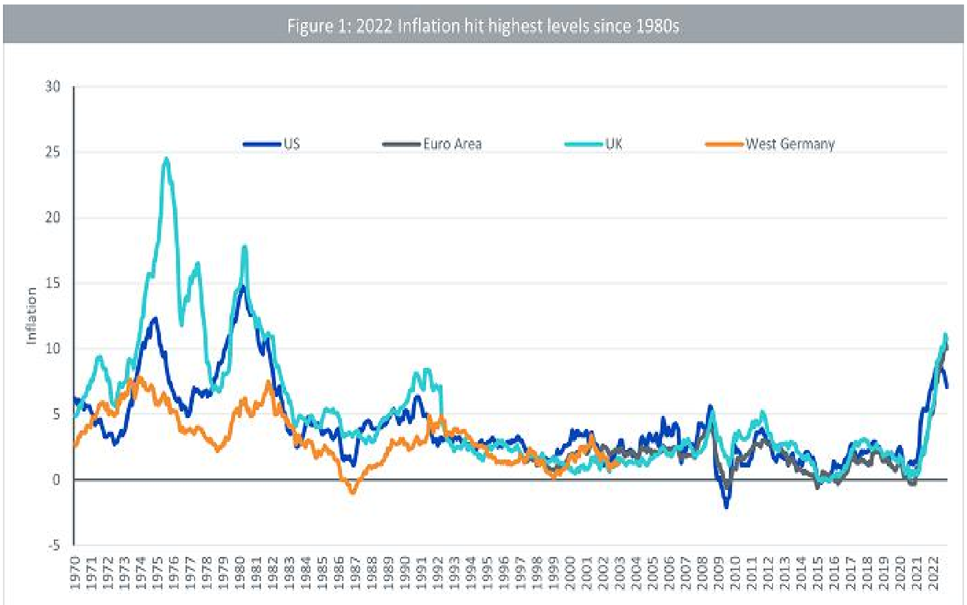
In 2022, we saw some of the highest levels of inflation in the US and Europe since the 1980s (Figure 1). Not only had central banks left the punch bowl at the party for too long, but many supply shocks had sent prices rising sharply. The Ukrainian war, for example, sent energy and food prices higher. Adjusting complex supply chains that showed their weaknesses in the COVID-19 pandemic has also contributed to pricing pressure. In 2021, when prices were rising on the back of monetary and fiscal stimulus, cyclical assets like equities performed very well. But as the punch bowl was belatedly removed in 2022, with a monetary tightening cycle that was the most aggressive since the 1980s, and input costs rose (think higher energy and labour costs compressing corporate profit margins), there was very little place for refuge. US equities were down 18%[1], global equities were down 20%[2], bonds were down 16%[3], Bitcoin Index was down 64%[4] and real estate was down 24%[5]. The one standout asset class was commodities[6], which was up 16%.



Source: WisdomTree, Bloomberg, US and UK: January 1970 to November 2022. West Germany: January 1970 to December 2002. Euro Area: January 1997 to November 2022.

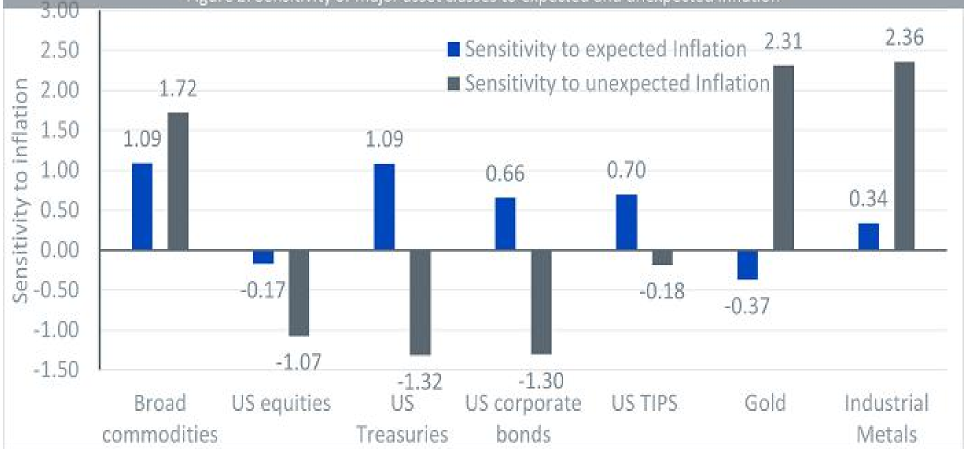
Historical performance is not an indication of future performance and any investments may go down in value.

Commodities and gold as an inflation hedge

European professional investors believe broad commodities (48%), gold (41%) and industrial metals (40%) are the best instruments for hedging against inflation according to a recent survey we commissioned[7].

We agree that commodities are one of the best hedges for inflation. Looking back at long-term historic data, we can see that commodities are one of the most inflation-sensitive assets classes (Figure 2). We separate inflation into 'expected' and 'unexpected' components. We proxy 'expected' inflation using the T-Bill interest rate. 'Unexpected inflation' is the 'realised inflation rate' minus the T-Bill rate. Very few assets rise with unexpected inflation. Commodities and gold are clearly in a category of their own here, with industrial metals excelling as an unexpected inflation hedge. To stress, the inflation we have been living with in the past 2 years has been largely of the unexpected nature[8].

Figure 2: Sensitivity of major asset classes to expected and unexpected inflation



Source: WisdomTree, Bloomberg, S&P. From January 1960 to November 2022. Calculations are based on monthly returns in USD. Broad commodities (Bloomberg commodity total return index) and US equities (S&P 500 gross total return index) data started in Jan 1960. US treasuries (Bloomberg US treasury total return unhedged USD index) and US corporate bonds (Bloomberg US corporate total return unhedged USD index) data started in Jan 1973. Gold (physical gold) data started in 1968. US Treasury Inflation Protected Securities (TIPS) started in Apr 1997. Sensitivity is measured through the asset class beta with inflation (the higher the beta the more the asset tends to rise with inflation). In statistical terms, beta represents the slope of the line through a regression of the asset class returns and inflation. We proxy the expected inflation using the T-Bill interest rate. Unexpected inflation is the 'realised inflation rate' minus the T-Bill rate.

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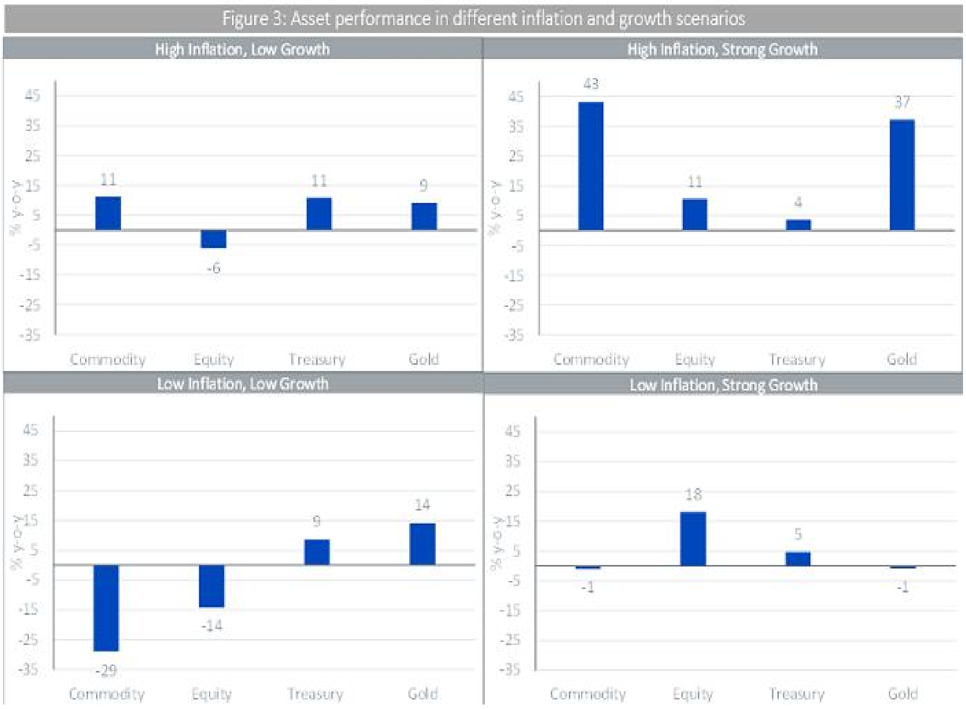
Broad commodities also do well in hedging against expected inflation (Figure 2). Only US Treasuries have a sensitivity to expected inflation as high as broad commodities. So, as inflation surprises temper, we could find commodities remain an important hedging instrument.

Moving to the next phase of the business cycle

In 2021, when monetary and fiscal conditions were loose, we saw very strong economic growth and high inflation. That was the goldilocks scenario for commodities. Looking back at data since 1961 (Figure 3), we can see that commodities have returned on average 43% in high inflation and strong growth environments. Gold has returned 37% over the same period. In 2021, commodities returned 27%. In 2022, when developed world central banks started to tighten monetary policy, growth faltered while inflation remained high.

Looking back at data since 1961, we can see that in high inflation/low growth environments, commodities do not do so badly, with an average 11% growth, which is on a par with Treasuries. In 2022 we know that commodities outperformed Treasuries by a long stretch (+18% vs. -10%). Historically, in high inflation/low growth environments gold also performs positively. In 2022, gold was about flat, after facing extraordinary headwinds from a strong US dollar and rising bond yields.

Looking to 2023, we believe that inflation will remain stubbornly high (at least above 3.5%, the threshold we use for 'high' in this analysis). That means we could be stuck in this phase of high inflation/low growth period for longer. We stress that is not bad for commodities. In fact, with the US dollar no longer appreciating, broad commodities and gold have one headwind removed. With US bond yields appearing to have peaked, gold also has another headwind removed.



Source: WisdomTree, Bloomberg. From June 1961 to November 2022. Inflation based on US Consumer Price Index data. Growth based on the OECD composite leading indicator (CLI) which is designed to provide early signals of turning points in business cycles, showing fluctuation of the economic activity around its long-term potential level. CLIs show short-term economic movements in qualitative rather than quantitative terms. CLI is amplitude adjusted, Long-term average = 100. Asset price calculations are based on yearly returns in USD. Broad commodities (Bloomberg commodity total return index) and US equities (S&P 500 gross total return index) data started in June 1961. US treasuries (Bloomberg US treasury total return unhedged USD index) and Gold (physical gold) data started in 1968. High inflation is when CPI inflation is above 3.5%. Low inflation is when CPI is below 1.5%. High growth is when CLI is above 101.4 for high inflation scenarios and 100 for low inflation scenarios (CLI threshold is lowered for the latter because of the low number of observations with inflation below 1.5 and CLI above 101.4). Low Growth is when CLI is below 98.6.

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Commodities are not just an inflation hedge

While inflation has been a key concern for investors over the past 2 years, and will continue to be an important consideration for the coming year, we believe that there are more reasons to consider allocations to commodities than just inflation.

Commodities generally have a low correlation with most other assets (Figure 4). That makes it a nice asset to diversify with.

Figure 4: Historical Correlation Between Asset Classes

	Broad Commodities	US Equities	World Equities	Global Aggregate Bond	US Corporate High Yield
Broad Commodities	1.00				
US Equities	0.29	1.00			
World Equities	0.37	0.91	1.00		
Global Aggregate Bond	0.25	0.25	0.35	1.00	
US Corporate High Yield	0.26	0.65	0.63	0.33	1.00

Source: WisdomTree, Bloomberg. From December 1982 to December 2022. Broad commodities = Bloomberg commodity total return index. US equities = S&P 500 gross total return index. Global Aggregate Bond = Bloomberg global aggregate credit total return. US Corporate High Yield = The Bloomberg US Corporate High Yield Bond Index.

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In fact as we argue in [The Case for Investing in Broad Commodities](), these low correlations hold even in times of crisis (that is, when US equities are falling more than 5%). On average, in all the months since the 1960s where US equities have lost more than -5%, commodities have lost -0.65%. In all the months where US equities gained more than 5%, commodities gained 1.13%. This compares to -7.8% and 7.5%, respectively, for US equities themselves. So, while commodities are cyclical (that is, they tend to lose and gain broadly at the same time as equities), the amplitude of such gains is significantly more muted. So, any investors fearing further downside to equities, could hedge with commodity exposure.

Positioning for the future

We believe we are in a time of profound change. The energy crisis of 2022 laid bare the need for Europe to wean itself off Russian energy sources. REPowerEU, the European Union’s plan to reduce reliance on Russia, accelerates an energy transition to renewable energy sources. We believe that will be metal demand positive. An electrification of energy production (that comes with a move to renewables instead of combusting hydrocarbons) will require more distribution and transmission cables, more energy infrastructure, and more batteries. This trend will be industrial metal positive. With most nations across the world behind in their climate change targets, we believe there will be an acceleration in the adoption of decarbonising technology as they play catch-up. At the same time, an underinvestment in traditional energy sources has left oil and gas markets (which the world is still highly reliant on) very tight. Commodities provide the essential materials to manage this transition and are likely to benefit.

Conclusions

As many professional investors have identified, commodities, gold, and industrial metals are typically excellent tools for inflation hedging. Commodities are a valuable asset for portfolio diversification in general. Commodities may play an increasingly important role in hedging against climate risk and industrial metals demand, in particular, is likely to benefit from the energy transition megatrend.

Sources

[1] S&P 500 equity total return index (31/12/2021 to 30/12/2022)

[2] MSCI ACWI total return (31/12/2021 to 30/12/2022)

[3] Bloomberg global aggregate credit total return (31/12/2021 to 30/12/2022)

[4] Bloomberg Galaxy Bitcoin total return (31/12/2021 to 30/12/2022)

[5] FTSE EPRA Nareit Global REITS (31/12/2021 to 30/12/2022)

[6] Bloomberg Commodity Index Total Return (31/12/2021 to 30/12/2022)

[7] Pan European Professional Investor Survey, September 2022, 600 respondents, conducted by Core Data Research.

[8] For example, the Citi Inflation Surprise Indicator, which measures whether inflation readings have been coming in above or below consensus expectations (calculated in a 3-month rolling window), has been positive for 28 consecutive months to November 2022 (i.e. inflation has surprised to the upside) for the US and UK and 24 consecutive months for the Euro Area.

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