

DUSTING OFF THE INFLATION PLAYBOOK

Joseph Tenaglia — Director, Model Portfolios

03/22/2021

Coming into the year, WisdomTree's Model Portfolio Investment Committee was positive on economic growth and [risk assets](#). The Committee believes a number of factors could drive global growth—and [inflation](#)—higher in 2021:

- A massive fiscal stimulus bill from the Biden administration, targeted at those with a higher marginal propensity to consume (with an additional infrastructure bill possibly in the pipeline).
- A vaccine rollout that is accelerating with new pharmaceutical solutions and distribution improvements.
- The [Federal Reserve's](#) new policy framework to let inflation run above its target, letting the economy 'run hot.'

As economic activity rebounds, many global supply chains face disruptions from COVID-19-induced capacity constraints. Inflation expectations are rising, as seen in the [breakeven inflation rates](#) shooting higher in recent months.

An Inflation Inflection

Rising inflation would be a new phenomenon for anyone who entered the industry in the last decade. Nine of the past 11 years saw [Consumer Price Index \(CPI\)](#) growth end the year either lower than or flat relative to the level at which it started the year. The Fed failed to achieve its 2% inflation target, despite some innovative policies.

From a multi-asset portfolio standpoint the [deflationary](#) playbook was simple, in hindsight—own [growth](#). Companies that could sustain revenue growth on their own without the cyclical leverage to the global economy saw massive price appreciation in the post-financial crisis era.

Now that the Fed is implementing its new policy framework, we believe investors need to dust off a completely different playbook: how to position portfolios for rising inflation.

Top Asset Classes: Commodities and Emerging Markets

[Commodities](#) have been the poster-child beneficiaries of rising inflation. Their trailing performance clearly shows how much they struggle when inflation disappoints. Commodities were a great way to lose money for the better part of a decade, with the [Bloomberg Commodity Index](#) returning a jarring cumulative -52% over the last 10 years.¹

Many investors gave up on the asset class but now find themselves reexamining it, for good reason. Dating back to 1987, during years when inflation accelerated, commodities averaged a 12.3% return—bested only by emerging markets (EM) equities.

This performance is all the more impressive when you consider the context of typical returns for commodities, which averaged just a 1.3% annual calendar year return.

This spread, between performance during an average year and an inflationary year, is far and away the best of the major asset classes outlined below.²

Additionally, EM equities look compelling in an accelerating inflationary environment as well. While EM equities have impressive historical performance over most extended time frames, the performance has been particularly strong during years of accelerating inflation.

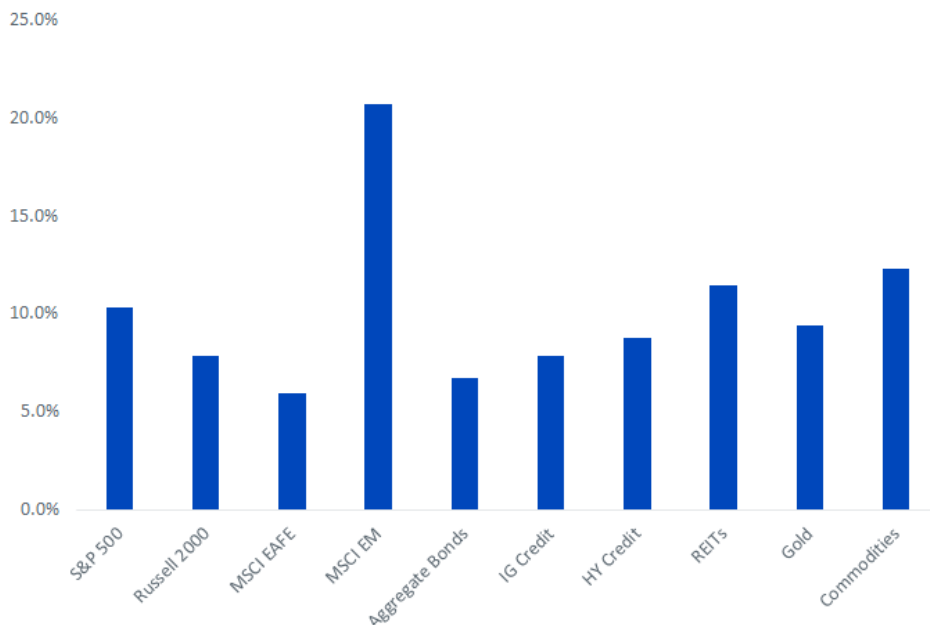
EM equities and commodities have long been linked due to their similar reliance on a weak dollar and positive investor risk appetite, along with the historical composition of the MSCI EM Index.

But today's EM equity asset class, led by Asian technology heavyweights, looks very different from the last time we experienced a meaningful inflationary period, during the commodity 'supercycle' of the early 2000s.

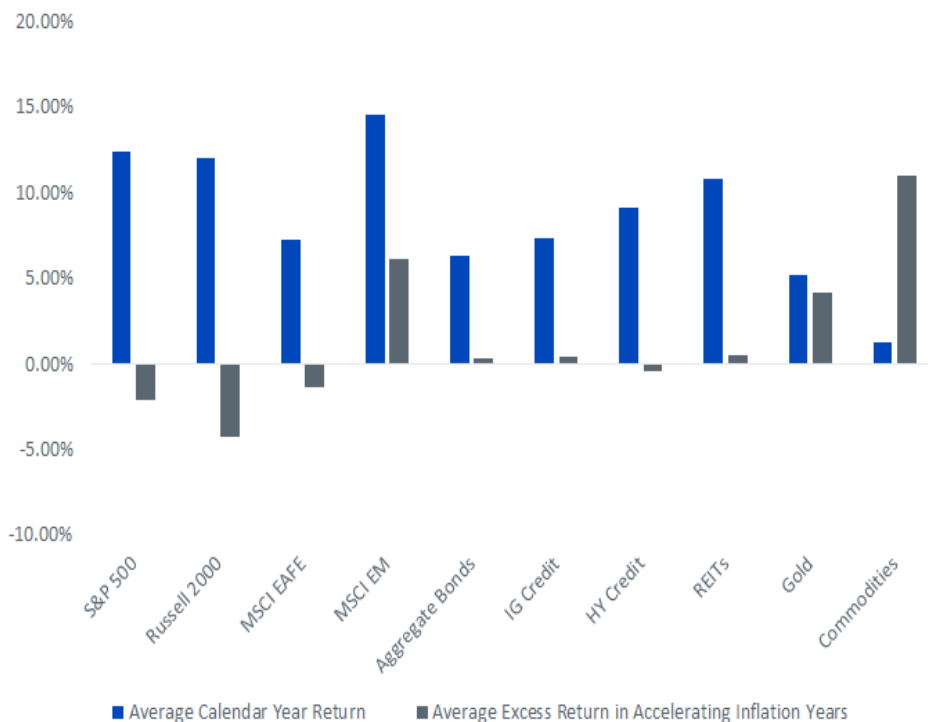
Admittedly, the sample size, imperfect CPI inputs and arbitrary calendar-year end points make this an inexact science. But look no further than the performance of both commodities and EM to start 2021 for validation of these trends playing out once again.

Through February, commodities are having the best start to a year since 2008, and EM is outperforming the [MSCI World Index](#) by 2.3%.³

Average Performance During Years of Accelerating Inflation



Emerging Markets Stand Out With and Without Inflation



Sources: WisdomTree, Bloomberg, MSCI, Zephyr StyleADVISOR. Data 12/31/1987–12/31/2020, and represents earliest date of available data. Aggregate Bonds: Bloomberg Barclays U.S. Aggregate Index. IG Credit: ICE BofA U.S. Corporate Index. HY Credit: ICE BofA U.S. High Yield Index. REITs: Wilshire REIT Index. Gold: Change in spot price of gold. Commodities: Bloomberg Commodities Index. Investments cannot be made in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges. Past performance is no guarantee of future results.

For definitions of indexes in the charts, please visit our [glossary](#).

How to Reposition Portfolios Today

WisdomTree has positioned for this rebound in our Model Portfolios for some time. [Many of our equity Models have been overweight EM equities for the last several quarters](#).

Additionally, in the [Siegel-WisdomTree Longevity Model](#), we increased exposure to commodities at the expense of fixed income during our December rebalance.

How do we obtain these exposures?

The anchor EM allocation in our Model Portfolios is the [WisdomTree Emerging Markets ex-State-Owned Enterprises Fund \(XSOF\)](#). The approach of removing [state-owned enterprises \(SOEs\)](#) has historically led to superior performance, alignment with [ESG \(environmental, social and governance\)](#) objectives and has [minimized risk of the political malfeasance common in many EM countries](#).

For commodities, we use the [WisdomTree Enhanced Commodity Strategy Fund \(GCC\)](#). The Fund employs an intelligent approach to contract commodity selection in order to increase [carry](#), and seeks to be more diversified than other commodity funds that are heavily correlated to oil prices.

Lastly, the [WisdomTree Emerging Markets High Dividend Fund \(DEM\)](#) may offer the best of both worlds. Relative to the [MSCI Emerging Markets Index](#), DEM has a combined 14.6% overweight to the energy and materials sectors and a higher correlation to commodities.⁴ For anyone looking for commodities within emerging markets, we believe DEM should be well positioned for the inflationary acceleration that we anticipate in the near future.

¹Bloomberg, as of 12/31/20.

²Bloomberg, MSCI, Zephyr StyleADVISOR, as of 12/31/20.

³Bloomberg, as of 2/28/21.

⁴FactSet, Bloomberg, as of 12/31/21.

Important Risks Related to this Article

Prior to 12/21/20, the ticker symbol "GCC" was used for an exchange-traded commodity pool trading under a different name and strategy.

There are risks associated with investing including the possible loss of principal. An investment in this Fund is speculative, involves a substantial degree of risk and should not constitute an investor's entire portfolio. One of the risks associated with the Fund is the complexity of the different factors which contribute to the Fund's performance. These factors include use of commodity futures contracts. Derivatives can be volatile and may be less liquid than other securities and more sensitive to the effects of varied economic conditions. The value of the shares of the Fund relate directly to the value of the futures contracts and other assets held by the Fund and any fluctuation in the value of these assets could adversely affect an investment in the Fund's shares.

GCC will not be invested in physical commodities. Futures may be affected by backwardation and contango.

Backwardation: A market condition in which a futures price is lower in the distant delivery months than in the near delivery months. As a result, the Fund may benefit because it would be selling more expensive contracts and buying less expensive ones on an ongoing basis. **Contango:** A condition in which distant delivery prices for futures exceeds spot prices, often due to costs of storing and insuring the underlying commodity; opposite of backwardation. As a result, the Fund's total return may be lower than might otherwise be the case because it would be selling less expensive contracts and buying more expensive ones.

Commodities and futures are generally volatile and are not suitable for all investors. Investments in commodities may be affected by overall market movements, changes in interest rates and other factors such as weather, disease, embargoes and international economic and political developments.

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments in emerging or offshore markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Funds focusing their investments on certain sectors and/or regions increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. The Fund invests in the securities included in, or representative of, its Index regardless of their investment merit and the Fund does not attempt to outperform its Index or take defensive positions in declining markets.

Please read each Funds' prospectus for specific details regarding the Fund's risk profile.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

Related Blogs

- + [XSOE: "If you trade it, liquidity will come"](#)
- + [Why We're Bullish on Commodities in 2021](#)
- + [Reflation, Flation, What's Your Nation?](#)

Related Funds

- + [WisdomTree China ex-State-Owned Enterprises Fund](#)
- + [WisdomTree Emerging Markets Quality Dividend Growth Fund](#)
- + [WisdomTree U.S. SmallCap Quality Dividend Growth Fund](#)

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Inflation : Characterized by rising price levels.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Break-even inflation rate : For a given bond maturity, for example five years, the interest rate on the five-year nominal bond minus the interest rate on the five-year inflation adjusted bond; meant to approximate expected inflation over that time frame, in this case five years.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Deflation : The opposite of inflation, characterized by falling price levels.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Commodity : A raw material or primary agricultural product that can be bought and sold.

Bloomberg Commodity Index Total Return : formerly known as Dow Jones-UBS Commodity Index Total Return (DJUBSTR), tracks a broadly diversified basket of commodity futures contracts.

State-owned enterprise : Companies in which governments have a significant ownership stake and the potential to influence the firms' actions over time.

ESG : An acronym for environmental, social and governance, ESG standards quantify the degree to which a company is socially responsible.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

MSCI Emerging Market Index : The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.