INFLATION AND THE WISDOMTREE MODEL PORTFOLIOS

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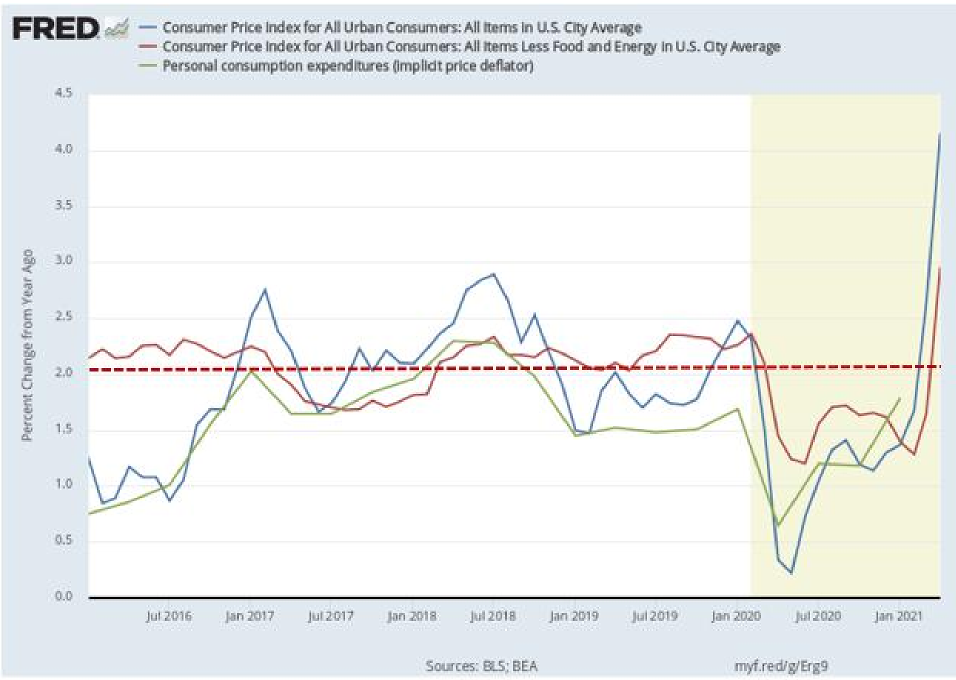
This article is relevant to financial professionals who are considering offering Model Portfolios to their clients. If you are an individual investor interested in WisdomTree ETF Model Portfolios, please inquire with your financial professional. Not all financial professionals have access to these Model Portfolios.

Inflation seems to be on everyone's mind right now. It is difficult to watch the news, open your laptop or pick up a newspaper or magazine without seeing stories and concerns about inflation.

We recently published a blog post discussing the drivers of inflation. In that post, we focused not just on the headline numbers (CPI, CPI ex-food and energy and PCE) but also on the numbers behind the numbers (wages and input costs). Let's begin by looking at the current level of these various numbers.

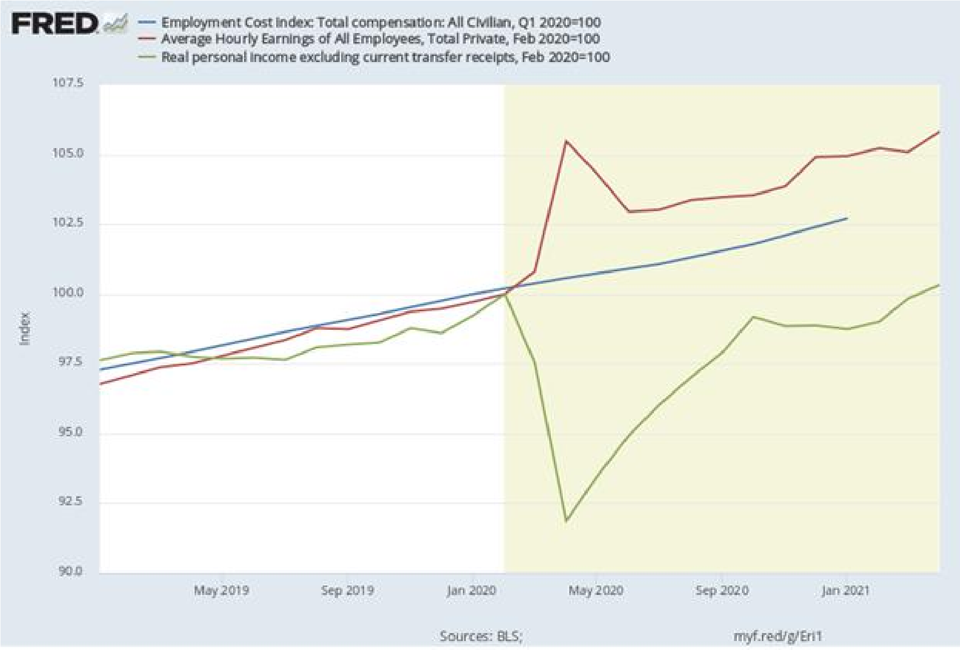
First, the headline numbers:



Source: St. Louis Fed (FRED), data through 3/31/21.

The Federal Reserve's (Fed) historical target rate was 2% (though it has adjusted to a more fluid "average inflation targeting" approach). Certainly, part of the dramatic increase this year is because of base effects—that is, inflation was zero at this point last year during the COVID-19 lockdowns, so the year-over-year increase is amplified. But we see a distinct upward trend.

How about the numbers behind the numbers? First, we will look at wages and personal income:



Source: St. Louis Fed (FRED), data through 3/31/21

We are beginning to see an upward trend in wages as the economy reopens and employers, finding it difficult to find enough qualified workers, are raising wages to attract suitable employees.

Finally, how about input prices? (We will use the New York Fed's numbers as a proxy for the nation.)

Source: St. Louis Fed (FRED), data through 4/30/21.

We see a dramatic increase in prices paid, the number of firms reporting higher input prices and — important for our inflation story — prices received (the purple line). Companies are paying higher input prices but increasingly passing those increases to their clients and consumers.

For now, the Fed suggests that these upward inflationary pressures are transitory, brought on by supply chain disruptions, the global pandemic, massive fiscal stimulus in the U.S. and huge pent-up demand by consumers as the economy finally reopens.

Perhaps, but we are not so sure. And, it seems, neither are some current Fed members, who have suggested that perhaps the Fed will have to revisit its hugely accommodative monetary policies sooner than was previously signaled.

WisdomTree Model Portfolio Positioning

As we've posted previously, two of our primary investment themes for 2021 and beyond are reflation and cyclical rotation. By cyclical rotation, we mean a factor and asset class rotation back to things that work best during a cyclical economic recovery—value and small cap in particular.

Our Model Portfolios have a variety of investment objectives. But they do have certain common characteristics, given the nature of most of the WisdomTree strategies we include in them. Unless asked to build custom models to meet firm-specific objectives, our models are:

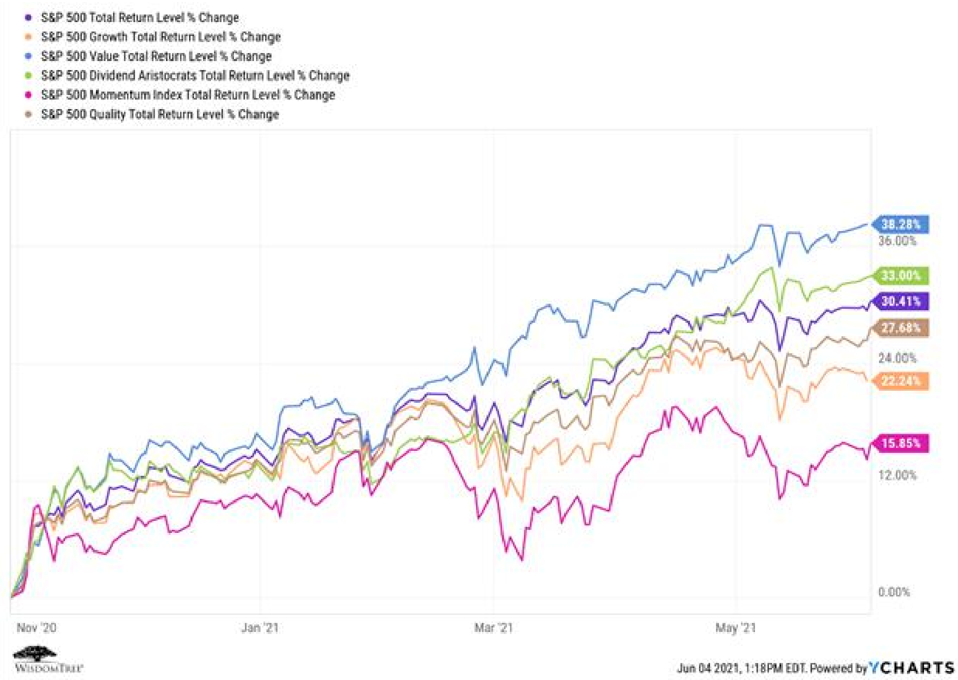
- Global in nature
- ETF-focused to optimize fees and taxes
- "Open architecture" (will include both WisdomTree and third-party strategies)
- "Core-satellite" in their portfolio construction—that is, they will allocate to both cap-weighted and active factor-tilted strategies (size, dividends, quality, earnings, value, etc.)
- Diversified at both the asset class and risk factor levels to seek more consistent performance over full market cycles

In addition, we charge no strategist fee.

Cyclical Rotation

Since the announcement of the Pfizer COVID-19 vaccine last November, we've seen a strong cyclical rotation out of the large-cap, growth and momentum factors that led the market for years and back into the factors that historically performed best during periods of economic recovery: value and small cap (with the bonus of a nice rally in dividend-paying stocks).

Value and dividends:



Source: YCharts, data from 11/1/20 to 6/3/21. You cannot invest in an index, and past performance does not guarantee future results.

Small cap:

Source: YCharts, data from 11/1/20 to 6/3/21. You cannot invest in an index, and past performance does not guarantee future results.

The small-cap rally is equally visible in non-U.S. markets.

Developed international:

Source: YCharts, data from 11/1/20 to 6/3/21. You cannot invest in an index, and past performance does not guarantee future results.

Emerging markets:

Because of the nature of many of the WisdomTree strategies we deploy in our models, most of them have distinct and explicit tilts toward smaller-cap stocks, dividend-paying stocks and value-oriented stocks. Perhaps somewhat uniquely, we also have explicit allocations to international and emerging market small caps.

As such, our performance has benefited nicely from this cyclical rotation trend, which we believe will continue throughout 2021.

Reflation/Inflation

Here is an interesting chart illustrating the historical performance of different equity sectors under various inflation regimes:

Figure 8_rising and falling inflation

We suggest we are in a "low and rising" inflation regime. Look at some of the asset classes and strategies that historically performed best in this regime—gold, commodities, EM equity, small cap and value. Those are exactly the factor tilts built into most of our models.

In addition, our **Endowment** model has explicit allocations to real assets, including gold, commodities, [master limited partnerships (MLPs)]() and infrastructure, while our [Siegel-WisdomTree Longevity]() model has explicit allocations to gold and commodities. Because the Longevity model is allocated 75% to equities, it may provide additional inflation protection, as stocks historically have been an effective hedge against moderate and increasing inflation.

Conclusions

Two of WisdomTree's primary investment themes for 2021 and beyond are cyclical rotation and reflation. We are witnessing both themes play out in full force so far this year.

It is always nice to have market winds at your back rather than in your face, but we believe our portfolios are (1) well-positioned to take advantage of these current winds while (2) remaining diversified at both the asset-class and risk-factor levels so that they may stay upright and afloat, regardless of which way the winds blow.

Financial advisors registered on the WisdomTree website can learn more about our Model Portfolios on the Model Adoption Center.

For definitions of indexes in the chart, please visit our glossary.

Important Risks Related to this Article

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Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development.

Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

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Investments in emerging, offshore or frontier 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.

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.

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.

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You cannot invest directly in an index.

DEFINITIONS

Inflation : Characterized by rising price levels.

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.

Core CPI : Long run trend in the price level that excludes items frequently subject to volatile prices, like food and energy. Can also be known as, CPI ex-Food & Energy

Personal Consumption Expenditure (PCE) Price Index : measure of price changes in consumer goods and services in the U.S. economy.

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

Fiscal Stimulus : Using fiscal policy as a tool to provide economic growth.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Size : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

Dividend : A portion of corporate profits paid out to shareholders.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

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.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Reflation : The term is used to describe the first phase of economic recovery after a period of contraction. This period is typically characterized by the act of stimulating the economy through accommodative central bank policies and reducing taxes, to bring growth and inflation back up to the long-term trend.

Master limited partnership (MLP) : Investment structure where holdings typically must derive most of their cash flows from real estate, natural resources or commodities, combining the tax benefits of a partnership—taxes occur when holders receive distributions—with the liquidity of a publicly traded company.