RED-HOT INFLATION KINDLES A FLAME FOR COMMODITIES AND GOLD

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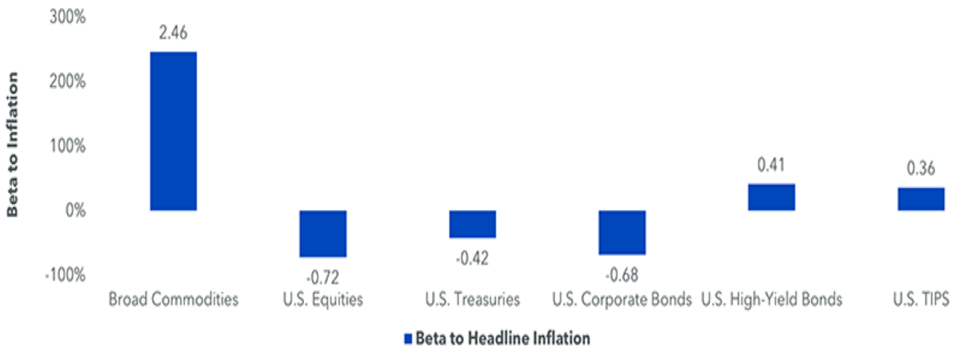
U.S. CPI inflation rose 6.2% in October 2021, marking the highest level of inflation since 1990. The print, released on November 10, 2021, outstripped the Bloomberg consensus survey of 5.9%. The fact that the market keeps being surprised by inflation indicates that something is missing from its expectations. We believe that supply-side shocks are both larger and more persistent than the market expects. Tell-tale signs of supply bottlenecks are littered through the details, including elevated energy and auto prices. Even services are showing broad-based price increases, indicating a shortage of labor.

Broad Commodities as an Inflation Hedge[1]

When it comes to assets that can hedge against inflation, commodities have historically stood out as winners. The asset class had the strongest inflation beta of all assets we have analyzed. It beat assets that are supposed to be structurally linked to inflation, such as U.S. Treasury Inflation-Protected Securities (TIPS).

Figure 1: Beta to U.S. Headline Inflation (CPI) of Different Assets

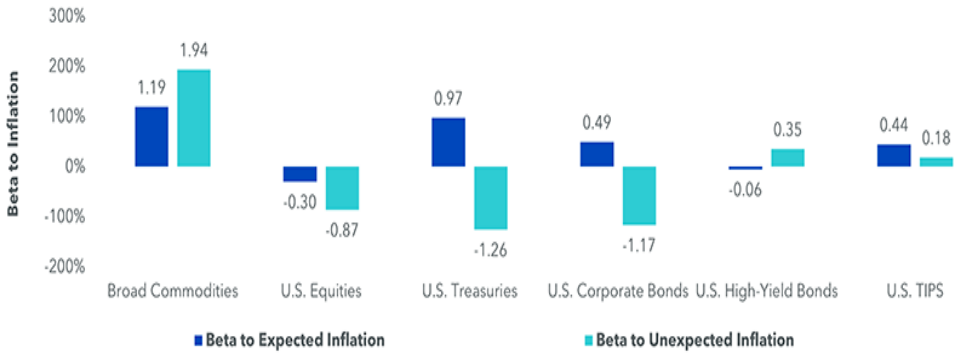


Sources: WisdomTree, Bloomberg, S&P, January 1960–September 2021. Calculations are based on monthly returns in U.S. dollars (USD). Broad commodities (Bloomberg Commodity Total Return Index) and U.S. equities (S&P 500 Index gross total return) data started in January 1960. U.S. Treasuries (Bloomberg U.S. Treasury Total Return Index Unhedged Index) and U.S. corporate bonds (Bloomberg US Corporate Total Return Value Unhedged USD Index) data started in January 1973. Historical performance is not an indication of future performance.

Commodities Have Historically Excelled at Hedging Against Unexpected Inflation

We believe commodities are an attractive hedging tool especially given today's environment, given the nature of what is driving inflation. Commodities' beta to unexpected inflation is even stronger than its beta to expected inflation.[2] If the drivers of inflation today are unexpected, then based on our research, commodities are the place to turn to.

Figure 2: Beta to Expected and Unexpected Inflation of Main Asset Classes



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Has Gold Rediscovered its Mojo?

So far this year, gold has disappointed. It has historically been a good hedge for inflation, especially during periods of elevated inflation. Given that we have been in a period of elevated inflation for the past year, this really should have been the time for the metal to shine. Unfortunately, it has not lived up to its reputation, highlighting the fact that there are no guarantees. However, after the U.S. CPI inflation print of 6.2%, gold started to move strongly higher, breaking through US$1,862/oz on 11/11/21 for the first time since 06/14/21. Gold unfortunately did not hold onto those gains, falling to US$1763/oz by 12/02/21 i.e. retracing back to levels last seen at the at the beginning of November 2021.[3] Gold has been under pressure from an appreciating US Dollar.[4] The next CPI inflation data release will be on 12/10/21. We will have to see if that acts as a catalyst for gold prices when it is released.

Figure 3: Gold Price Hit a 5-Month High After Inflation Print, but Most Gains Have Dissipated

Sources: WisdomTree, Bloomberg, 5/31/21–12/02/21. Historical performance is not an indication of future performance.

It is yet to be seen whether gold has shaken off its bad mood and returned to its normal behavior. Our models indicate that with this strength of inflation, gold she be trading higher than it's currently valued. We think the potential strength in the US Dollar and rise in Treasury yields likely to result from the Federal Reserve's tightening path (both in terms of tapering bond purchases and future signaling of rate increases), gives credence to this indication. We have argued that Q4 2021 is a critical time for gold to prove itself. We certainly hope that the next inflation reading acts as a defibrillator to bring the metal back to life on a more consistent basis.

[1] For a detailed analysis of commodities and its relationship with inflation, please see The Case for Investing in Broad Commodities.

[2] We use the short-term t-bill rate as a proxy for the market's inflation expectations and unexpected inflation is measured as the actual CPI rate minus the nominal interest rate at the beginning of each period.

[3] Gold was US$1765/oz on 11/03/21.

[4] The DXY basket has risen from 93.96 on 11/9/21 to 96.15 on 12/02/21.

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Nitesh Shah is an employee of WisdomTree UK Limited, a European subsidiary of WisdomTree Asset Management Inc.'s parent company WisdomTree Investments, Inc.

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DEFINITIONS

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.

Inflation : Characterized by rising price levels.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

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

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Treasury Inflation-Protected Securities (TIPS) : Bonds issued by the U.S. government. TIPS provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

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

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.