

Broad Commodities, The hedge against inflation and supply-chain driven disruptions

Published 2 February 2022

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2021 will remain known as the year when both inflation and broad commodity investment woke up from their decade long slumber. While distracted observers may chalk this up to chance, specialists will recognise the effect of disrupted supply-chain and renewed demand on both. Historically, broad commodity investments, physical or futures contract-based, have been a strong inflation hedge. This is usually the case when inflation is unexpected, resulting from exogenous pressure or geopolitical effects. As inflation has proven more resilient than transitory, investors are searching for a way to protect their investments against erosion. If History is any guide, broad commodities stand head and shoulders above many other assets.

Can monetary policy fix the global supply chain?

US inflation has been printing above 5% since Q2 2021. The December 2021 reading of 7.0%¹ was the highest since July 1982. While the Federal Reserve (Fed) pointed to transitory inflation earlier, this language has progressively left Federal Open Market Committee minutes. Over time, Fed officials have turned more and more hawkish to a point where four hikes are on the table this year. Furthermore. Elevated inflation is a global phenomenon, with Europe and parts of Asia facing similarly elevated changes in prices. Euro Area inflation is at a series high (i.e., since the formation of the Euro Zone in 1999), with the December 2021 print at 5.0%². UK's December 2021 inflation topped 5.8%³ - the highest since April 1992. While most Asian nations are maintaining an inflation rate within central bank targets, South Korea and Singapore have seen an acceleration in prices in 2021.

Inflation is not only high, but readings have taken analysts by surprise. The Citi Inflation Surprise Indices (which measure the deviation between consensus surveys of economists and actual inflation readings), are at a series high for global, Euro Area and UK and are just coming off the highs for US. Looking for the source of this unexpected surge in prices across the globe, the disruption of the global supply chain is at the top of the list. The coronavirus and its multiple variant-driven waves have uncovered the weaknesses of an overspecialised, overly stretched supply chain, creating shortages and driving up prices. Fundamental changes to our society and way of work, illustrated by the "Great Resignation", have further emphasised those disruptions. Suppose such is the cause of inflation. It may not be immediately treatable through a course of monetary tightening, as quick or as strong as it is.

Broad Commodity, a natural inflation hedge and supply chain hedge

In such an environment, investors need to look for ways to hedge their portfolios. Growth companies, which have been driving the exceptional performance of equities over the last few years, are extremely vulnerable

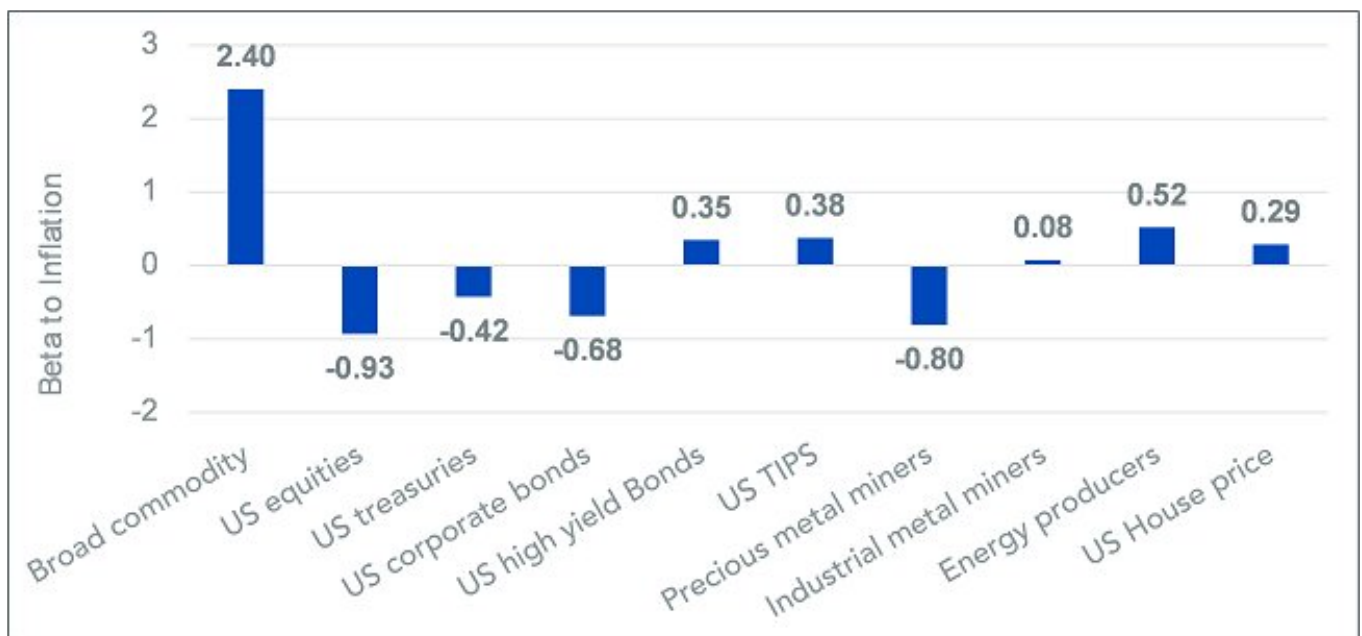
to inflation and rate hikes, for example. Interest rate rising outstrip future growth expectations, leading to a negative effect on the present value of the stock.

Looking back at 2021, it is no surprise that broad commodities have performed extraordinarily well, with +27.11%⁴. The last time commodities returned that much was in 2000. At the time, US Consumer Price Index (CPI) inflation was close to 4%. This is no coincidence. While most assets are a poor hedge against inflation, broad commodities are known for their capacity to hedge against inflation, as a matter of fact.

Commodities are intrinsic components of inflation indices around the world. Up to 50% of inflation baskets are directly or indirectly linked to commodity prices through food, energy or materials used in cars, buildings and infrastructure⁵. This is even more important today. The same mechanisms that transform supply chain disruption in inflation also create elevated commodity prices, such as increased agricultural products prices or increased metal prices.

Broad Commodities an effective hedge against expected and unexpected inflation

Looking back at historical data, we observed that broad commodities as the highest beta to inflation among many asset classes. US equities exhibit a very negative beta to inflation, indicating their tendency to perform poorly when inflation is trending up. Even equity sectors that have the reputation to hold up well against inflation, like miners or energy producers, do not come close to the beta exhibited by broad commodity futures. In fixed income, both treasuries and corporate bonds tend to suffer in periods of increasing inflation. High Yield bonds and Inflation-linked bonds (“TIPS”) fare better but, again, nothing as strong as broad commodities.



Source: WisdomTree, Bloomberg, S&P, Kenneth French Data Library. From January 1960 to November 2021. Calculations are based on monthly returns in USD. Broad commodities (Bloomberg commodity total return index) data started in Jan 1960. US TIPS (Bloomberg US Treasury Inflation-linked total return bond index – Series L index) data started in March 1997. US House Price (S&P Corelogic Case-Schiller US

National Home Price seasonally adjusted index) data started in January 1987. US Equities, Precious metal miners, Industrial metal miners and Energy producers are sourced from the Kenneth French Data Library. Precious metals miners data started in June 1963.

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

On top of being positively correlated to inflation, it is also very interesting to look at the behaviour of commodities in different inflation regimes. In Figure 2, we split every monthly returns since January 1960 into five quintiles by the level of realised inflation (i.e., US CPI) during those months. The low quintile, i.e., months when inflation is low, is the only type of period where the average broad commodities futures contract has performed negatively. Then as inflation increased, the performance of commodities has also increased.

Broad commodities are the only asset here that have historically performed the best in months where the inflation is the highest. US equities, miners and even US TIPS have historically performed the best in low inflation environments. This is again quite a powerful testament to commodities as an inflation hedge.

Figure 2: Performance depending on the level of realised inflation

Source: WisdomTree, Bloomberg, S&P, Kenneth French Data Library. From January 1960 to November 2021. Calculations are based on monthly returns in USD. Broad commodities (Bloomberg commodity total return index) data started in Jan 1960. US TIPS (Bloomberg US Treasury Inflation-linked total return bond index – Series L index) data started in March 1997. US Equities, Precious metal miners, Industrial metal miners and Energy producers are sourced from the Kenneth French Data Library. Precious metals miners data started in June 1963.

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Over the last year, WisdomTree has conducted in-depth research on the potential advantages of investing in broad commodities in a multi-asset portfolio (see here). Their historical inflation hedging properties sit squarely at the top of this list. With inflation stuck in high single-digit territory for the first time in decades, it may be high time for investors to take note of it once again.

1 US Bureau of Labor Statistics

2 Eurostat

3 Office for National Statistics

4 Source: Bloomberg. 31st December 2020 to 31st December 2021. Using the performance of the Bloomberg Commodity Total Return Index.

5 Source: WisdomTree, US Bureau of Labor Statistics, European Central Bank, UK Office for National Statistics. As of July 2021.

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