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Is There a Place for Defensive Strategies in an Inflationary World?

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- Long-term data confirms that higher inflation periods should not be confused with outperformance of riskier, cyclical stocks
- Higher inflation environments have actually been positive for defensive sectors like Health Care, Staples and Communication Services
- There is strong economic rationale behind the ability of defensives to provide an inflation hedge

As inflation prints continue to surprise investors on the upside, US Google searches for "inflation" have reached their highest level since recordings began in 2004. The recent jump in the US Core Consumer Price Index (CPI) reached +4.5% (year on year) in June – its highest rate since 2008. While the general consensus in markets is that inflation is largely transitory – driven by base effects, used cars, airline tickets etc, there is an ongoing debate about factors that could lead to a more persistent inflationary environment. For example, the merging of fiscal and monetary policy significantly increases the risks of sustained inflation (and in turn inflation expectations). At the same time, deflationary forces – such as demographic trends, debt accumulation and technological progress continue to exert downward pressures on inflation as they have done for decades.

For equity investors, the impact of higher inflation on their portfolios is often unclear, particularly as periods of high inflation have been few and far between over the past 30 years. In this note, we aim to provide some insights on how inflation impacts overall equity markets and individual sectors, and whether we can bet on defensives to generate excess returns in a high inflation environment.

High Inflation is Negative for Equity Markets

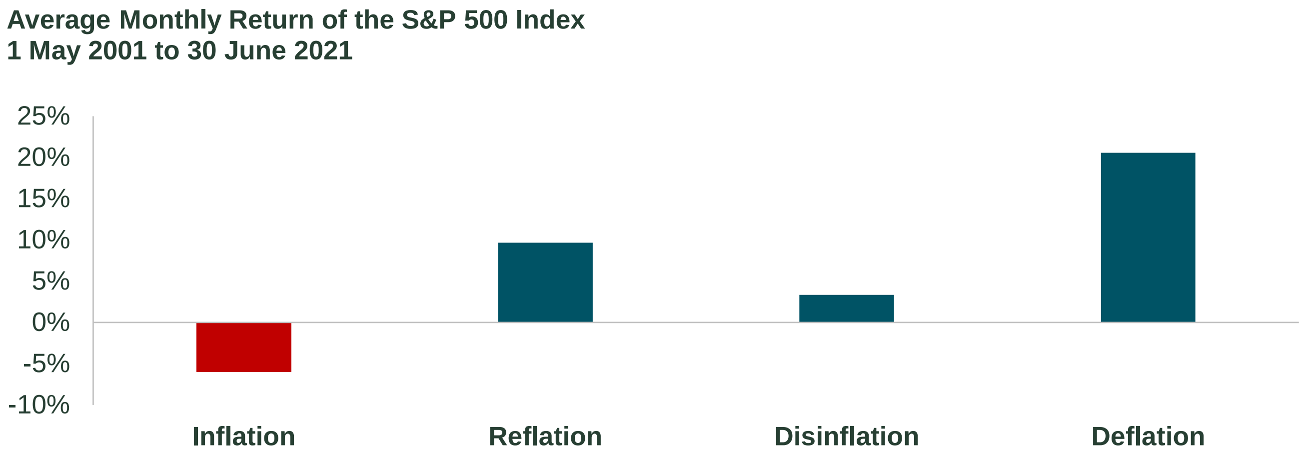
The relationship between inflation and overall equity market returns is not a straight-forward one. What we have observed over the long-term history is that, inflation generally isn't a problem for equity markets until investors begin to anticipate a monetary tightening in response. These environments are characterised by an inflation rate that is already running above the long-term median, and is still accelerating.

For the purposes of this analysis, we categorise inflation into four distinct regimes as follows:

Inflation Regime	CPI - % YoY change
Inflation	Above 2% and accelerating
Reflation	Between 0 - 2% and accelerating
Disinflation	Above 2% and falling
Deflation	Between 0 - 2% and falling

In Figure 1 below, the median inflation rate as defined using US CPI (excluding food and energy) over the past 20 years was ~2%p.a, and the US equity market has generally retraced when inflation was above 2% and accelerating – reflecting market concerns around Fed tightening and valuations. By contrast, market returns have generally been positive in other inflationary/deflationary regimes.

Figure 1: Average US Equity Market Returns in Various Inflationary Scenarios

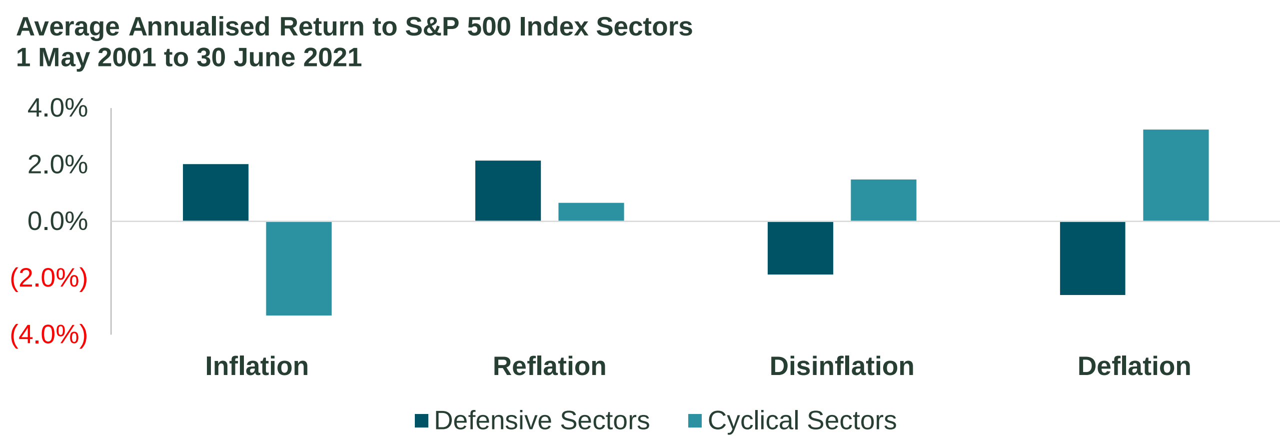


Source: State Street Global Advisors, Factset for the period 1 May 2001 to 30 June 2021. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Past performance is not a reliable indicator of future performance.

Defensive Sectors Outperform in Higher Inflation Environments

If we dive a little deeper and look at the sector level excess returns during higher inflation environments (i.e. accelerating inflation above 2%), we find that cyclical sectors were the most negatively impacted. Figure 2 shows the annualised excess returns of Defensive vs Cyclical sectors during each of the 4 inflation regimes, averaged over the past 20 years. So from a historical standpoint, Defensive sectors have been a better bet during rising inflationary environments.

Figure 2: Average US Equity Market Sector Returns in Various Inflationary Scenarios



Source: State Street Global Advisors, Factset for the period 1 May 2001 to 30 June 2021. Past performance is not a reliable indicator of future performance. Sectors and Weights are as at the date indicated, are subject to change, and should not be relied upon as current thereafter. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

Breaking it down further, all defensive sectors (Staples, Communication Services, Health Care and Utilities) have been able to generate outperformance over the broader index during higher inflation regimes. By contrast, the more cyclical sectors – Materials, Industrials, Financials and Energy have generally lagged the market in such environments, as shown in Table 1(a) and 1(b).

Table 1(a): Annualised Average Excess Returns of Defensive Sectors vs Inflation Scenarios (1 May 2001 to 30 June 2021)

Inflation Regime	Communication Services	Consumer Staples	Utilities	Health Care
Inflation	3.0%	2.5%	0.7%	3.9%
Reflation	-2.0%	7.2%	4.9%	0.6%
Disinflation	-6.3%	2.5%	-6.6%	1.0%
Deflation	-9.9%	14.3%	-12.9%	-4.5%

Source: State Street Global Advisors, Factset for the period 1 May 2001 to 30 June 2021. Past performance is not a reliable indicator of future performance. Sectors and Weights are as at the date indicated, are subject to change, and should not be relied upon as current thereafter. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

Table 1(b): Annualised Average Excess Returns of Cyclical sectors vs Inflation Scenarios (1 May 2001 to 30 June 2021)

Inflation Regime	Materials	Industrials	Financials	Energy	Consumer Discretionary	Technology
Inflation	-2.2%	-4.3%	-5.0%	-10.2%	0.2%	1.5%
Reflation	-1.4%	1.0%	-6.1%	2.5%	4.5%	3.5%
Disinflation	4.3%	-2.3%	-3.7%	2.2%	1.3%	7.0%
Deflation	3.9%	4.4%	4.9%	-4.2%	5.2%	5.3%

Source: State Street Global Advisors, Factset for the period 1 May 2001 to 30 June 2021. Past performance is not a reliable indicator of future performance. Sectors and Weights are as at the date indicated, are subject to change, and should not be relied upon as current thereafter. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

The reason that cyclicals have tended to lag in higher inflation environments is in large part related to inflation expectations. The relative performance of cyclicals vs defensives is less related to published inflation numbers and more related to future 'inflation expectations'. Investors have been conditioned to expect central banks to step in when inflation is high and accelerating. So the expectation of tighter monetary policy lowers future inflation and growth outlook, and in turn, lowers expected returns of cyclicals (relative to defensives).

How do Defensive Stocks Provide a Hedge Against Inflation?

There are robust fundamental intuitions supporting the link between inflation and outperformance of defensive sectors. For example, defensive sectors; Health Care, Consumer Staples and Communication Services are generally less sensitive to both real gross domestic product (GDP) growth and higher inflation. Their lower sensitivity to inflation is perhaps less obvious, given many carry longer duration cash flows and higher sensitivity to changing bond yields. But defensive companies are often able to weather inflation impacts due to the nature of their business models, for example:

- Higher sustained inflation negatively impacts future real economic growth; and riskier, more cyclical names have earnings that are much more leveraged to economic activity. Even though we may see short-term outperformance of cyclicals as inflation rises initially, they often lag over the longer-term because inflation eats away nominal growth – creating downside EPS growth surprises in real terms.

- Defensive stocks with strong pricing power can often provide a natural hedge against inflation. For example, REITs often have inflation linked leases so revenues are insulated, and Utility companies often have revenues that are CPI/bond yield linked. This will be particularly important if there is a full-blown inflation outbreak, particularly if we enter a period of stagflation where economic growth falters alongside high inflation.

The Bottom Line

Empirical data in the US shows that higher inflation periods should not be confused with outperformance of riskier, cyclical stocks. In fact, higher inflation environments have historically been linked to positive excess returns for defensive sectors – notably represented by health care, staples, communication services and utilities. We find strong economic rationale behind the ability of defensives to provide an inflation hedge. In the current uncertain environment, we believe a highly active, defensive strategy should be a consideration of one’s overall equity portfolio.

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