In the fight against inflation, consider these sectors and styles

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During periods of disruptively high inflation, investors may want to rethink their allocations to certain equity sectors and investment styles. For example, the energy and consumer discretionary sectors have historically fared better than consumer staples and utilities during inflationary periods. The value, momentum and quality styles have also done well, on average.

Key takeaways

- Companies in the energy and materials sectors (among others) have closer links to physical assets and commodities, so their asset values and product prices tend to rise when inflation does
- Investors who employ style investing may want to consider value, momentum and quality: research shows that they have tended to outperform during inflationary periods
- Among the factors pushing inflation to the highest level in decades: the global pandemic has disrupted global supply chains in general, while the invasion of Ukraine has specifically disrupted the supply of energy, fertiliser and grain

With inflation near its highest levels in a generation, many investors want to know how a prolonged period of inflation might affect the financial markets – and their portfolios. Looking back at market performance over time, we can see that when inflation is high, some sectors (such as energy) have historically fared much better than others (such as utilities). This is often linked to the fact that some companies set prices while some "take" prices. There is also solid research showing that certain investment "styles" (including value and momentum investing) have also tended to outperform in inflationary periods. That's why it may make sense for investors to form their inflation-fighting strategies by differentiating not only between traditional sectors, but investment styles as well.

With inflation set to remain high, where can investors turn?

Although periods of high inflation are not unusual to the economic cycle, there are aspects of this particular inflation cycle that are very different. The global pandemic has disrupted global supply chains in an unprecedented manner. And the invasion of Ukraine by Russian armed forces has disrupted the supply of energy, fertiliser and grain. These factors have conspired to increase prices at the highest rate seen in decades. On top of that, the pandemic has also profoundly changed the labour market. This has led wage inflation and made inflation more persistent.

So how can investors form a defense against inflation? Equities have historically performed relatively well in times of economic expansion and modest inflation. Although equities may suffer a short-term downturn when inflationary expectations increase, they are generally viewed as a good "hedge" against inflation in the long-term. But equities are not all the same, and it is worthwhile to drill down and see how different sectors are affected by inflation cycles.

Different sectors have responded differently to inflation

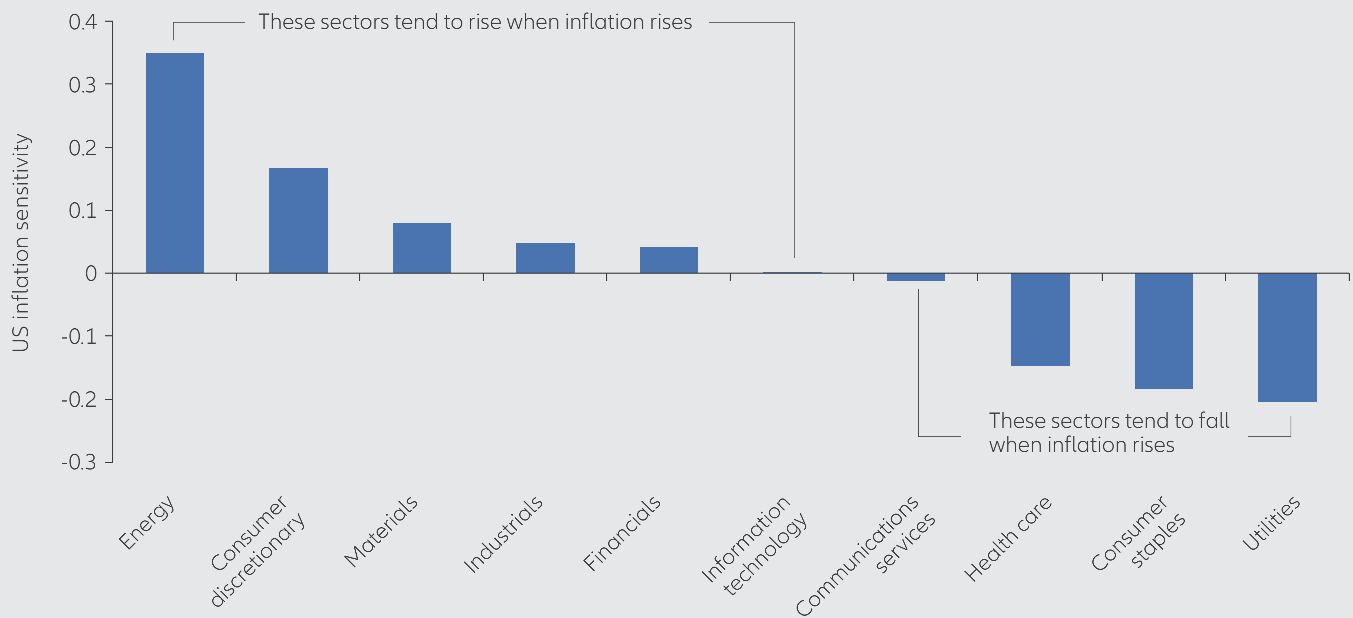
Let's start with an industry-level view of the US economy – which is where we find the most robust inflation data. **Exhibit 1** shows US sector sensitivities to inflation (as measured by changes in the US Consumer Price Index) for US stocks as a whole (as measured by the MSCI USA Index). Of note:

- Companies in certain sectors (such as energy and materials) tend to own or control physical assets; they may also sell commodity-based products. Since the value of their assets and the prices of their products increase with inflation, their stock prices are positively correlated with inflation. That means that typically, their stock prices move higher when inflation moves higher.
- Conversely, companies in sectors such as consumer staples and utilities have negative correlations with inflation. That's in large part because these companies consume commodities, which increases their input prices. On average, this has adversely affected their profit margins and stock prices.

Drilling a little deeper, one might ask if some companies within an industry are more affected by inflation than others. Now, we're entering the realm of active portfolio managers and their ability to seek to identify the winners. Consider that some companies can increase prices and pass their increased costs on to consumers. Active investors can aim to identify such companies by closely following changes in sales and profit margins – looking for high-quality companies with large and stable profit margins since they tend to do better in times of high or increasing inflation.

Exhibit 1: identifying sectors with positive (or negative) correlations to inflation

Sector sensitivities to changes in US CPI (MSCI US Index, April 2022)



Source: Allianz Global Investors. Data as at March 2022.

Different styles have also reacted differently to inflation

Many investors employ style investing in an attempt to achieve higher returns than the broad market on average. How does style investing do in times of high inflation? Researchers in the Systematic Equity team at Allianz Global Investors examined the performance of several well-known equity style factors during eight periods of high inflation in the United States since 1940.[1 2] Exhibit 2 plots the average returns in excess of a capitalisation-weighted market benchmark for three equity styles: value, momentum and quality.

- Attractively valued stocks (known as value stocks) outperformed the benchmark in six of eight periods.
- Stocks selected based on their performance during the previous 12 months (known as momentum stocks) on average continued their streak, and also outperformed the benchmark in six of eight periods. These stocks had higher average excess returns in inflationary times than in normal times.
- More profitable companies or those with a better balance sheet (known as quality stocks) outperformed the benchmark in four of the six periods for which data was available.

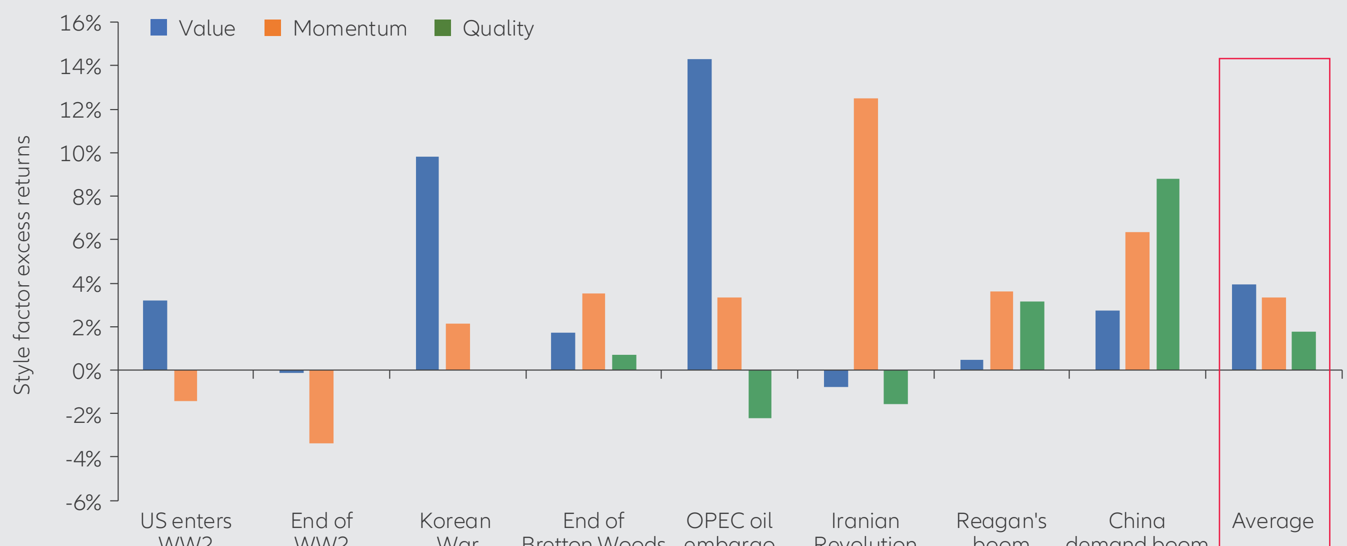
What it means for investors

Here are four takeaways that investors may want to keep in mind:

1. Although equities may suffer a short-term downturn when inflationary expectations increase, they are generally viewed as a good "hedge" against inflation in the long-term.
2. Companies in the energy and materials sectors have historically had a positive correlation with inflation, which means the value of their assets and the prices of their products tend to increase as inflation rises.
3. Within sectors, some companies are in a better position to increase prices and pass their increased costs on to consumers – and active asset managers can seek to identify these companies by closely following changes in sales and profit margins.
4. Historically, the value, momentum and quality investment styles have tended to outperform in inflationary periods.

Exhibit 2: value, momentum and quality have outperformed, on average, when inflation is high

Equity style factor performance vs market in inflationary periods



Source: Allianz Global Investors; K French; H Neville, T Draaisma, B Funnell, C Harvey and O Van Hemert. Key dates: US enters WW2 (Apr 1941-May 1942); end of WW2 (Mar 1946-Mar 1947); Korean War (Aug 1950-Feb 1951); end of Bretton Woods (Feb 1966-Jan 1970); OPEC oil embargo (Jul 1972-Dec 1974); Iranian Revolution (Feb 1977-Mar 1980); Reagan's boom (Feb 1987-Nov 1990); China demand boom (Sep 2007-Jul 2008).

1. Source for inflationary periods: Henry Neville, Teun Draaisma, Ben Funnell, Campbell R. Harvey and Otto Van Hemert, 2021, "The Best Strategies for Inflationary Times." https://ssrn.com/abstract=3813202.

2. Source for style factor data: Ken French, https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html. Factor definitions are as follows: value (BIG HiBM – Mkt); momentum (BIG HiPRIOR – Mkt); quality (BIG HiOP – MKT).

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