Inflation – Are Equities a Good Hedge?

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Inflation, an enemy of the consumer with psychological effects which can impact us all. With persistent headlines in recent months showing that inflation is on the rise, is there a solution that we can make use of to preserve the real value of our savings?

Well, in theory, yes. There is a belief that stocks can act as a natural hedge against inflation – since even though companies will be met with higher costs of production, they can just charge higher prices to boost their revenues and thus continue to raise the stock price.

But are equities actually a useful solution? Perhaps one of the best methods to analyse this idea is to look at previous research. One paper titled "An Analytical Study of the Effect of Inflation on the Stock Market" from the Institute of Research Advances found that different countries have a different correlation between equity returns and inflation. For example, the paper found that Canada had a negative correlation between equity returns and inflation whereas Brazil produced a positive correlation between the factors[1].

[1] Sathyanarayana, S., Gargesa, S. (2018). An Analytical Study of the Effect of Inflation on Stock Market Returns. IRA-International Journal of Management & Social Sciences (ISSN 2455-2267),

Now, as disappointing as it may sound, there, unsurprisingly, is no formula to predict the outcome in a stock market regardless of considering inflation. Although, there are factors which we can study to give us a better understanding of the relationship between inflation and equity returns.

The first one is that higher inflation is typically a predecessor to higher interest rates. This will normally occur when the central bank decides to raise them to conserve the value of the currency and to slow down the economy. Even though not all companies are adversely impacted higher interest rates, in general the majority are, resulting in a slow down or reverse reaction on stock returns – this has been noticeable in UK and US markets within the last century. The reason this happens is because higher interest rates lead to greater input costs for a company, which in turn means that, all else being equal, less shareholder wealth is generated from the same amount of revenue. Using a loan as an example, this reasoning becomes clearer as the borrower would have to pay more interest for the same principal amount. Developing further on the thought of future payments, investors using a discounted cashflow model for evaluating their investments will become increasingly prone to selling their positions. Higher interest rates reduce the present value of future cashflows, meaning that investors are likely to place a lower value on a company's future cash flows in a high interest rate environment. If the price investors are willing to pay for a stock falls, this reduction in demand can lead to a sell off and subsequently a lower return for those still holding it.

The next facet is that inflation brings uncertainty causing some market pessimism. Touching on ideas from the research paper, this is believed since stakeholders will be unable to know the true effects of inflation on a business (or market) until later down the line. A business may see higher costs for their production, uncertain impacts on current debts or that their input costs may grow faster than the price at which they can sell their products or services. This can cause a company to be more conservative with their spending such as employing fewer people, unessential projects being put on hold or switching suppliers to try to maintain profit margins – often compromising on quality. The overall impact is that it becomes more apparent over the short to medium run that the company will focus less on growth and more on survival. When the market recognises this, it becomes clear why some equities may slack during periods of higher inflation.

The final factor to consider is that inflation can heavily impact dividend stocks due to investors attaining a lower real yield. Suppose that you are currently invested in a company that has low and constant growth but a dividend yield of 5%. On a normal year where inflation is 1% you could expect you make a satisfactory real yield of around 4%. However, if inflation spikes to 6%, you might not actually make a real return on your investment if the company has unsatisfactory growth and dividends remain unchanged. Often, companies can be slow to react to inflation and increase their dividends or they might not even change them at all. Consequently, investors only

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13(2), 48-64. doi:http://dx.doi.org/10.21013/jmss.v13.n2.p3 buying into a stock due to its dividend yield will start to move away to seek investments which better suit their interests causing a decrease in the overall price of the stock.

Taking all of this into consideration, it becomes understandable of why some might panic sell their portfolio when inflation has an unforeseen rise. However, this shouldn't always be the case. To oppose some of the above negativity, it's important that we continue to understand previous trends to aid our future decision making.

Using the United States as an example[2], we saw that during the 1970s, inflation averaged 7.4% per year and the S&P 500 had an annualised price return of 1.6%, causing a negative real return over the period. Whilst this outcome isn't great, it's important to factor in that companies still managed respectable revenue growth – with average annual earnings per share growth roughly 8%[3], which maintained profitability and lowered the chance of failure during the inflationary period. Whilst the returns might not make sense at first, the reason that there was a negative return, regardless that companies were surviving, was generally due to market pessimism in a similar manner to what we covered earlier in this article. Once inflation began to subside down to an annual average rate of 5.1% in the 80s, we saw an overall average price return on the S&P 500 of 12.6%, with real price returns sitting at roughly 7.1%.

Hence it can be argued that although returns can be impacted in the short run, over the longer term they can bounce back once the market gains optimism and potentially reward investors with better returns.

Overall, it can be considered that, in general, inflation will have a negative effect on some of the world's more developed economies, markets and stocks. However, as always, there are exceptions to this but they can be incredibly difficult to predict. Certainly, there is always still lots to learn about this economic impact and with current inflation in the US on the rise there will definitely be useful lessons that we can have in the future.

[2] Stats from http://www.simplestockinvesting.com/SP500-historical-real-total-returns.htm
Statistics do not take into account dividend reinvestment and as a result returns would be higher since receiving dividends would offset real losses.
[3] Calculated from https://www.in2013dollars.com/us-economy/s-p-500-earnings