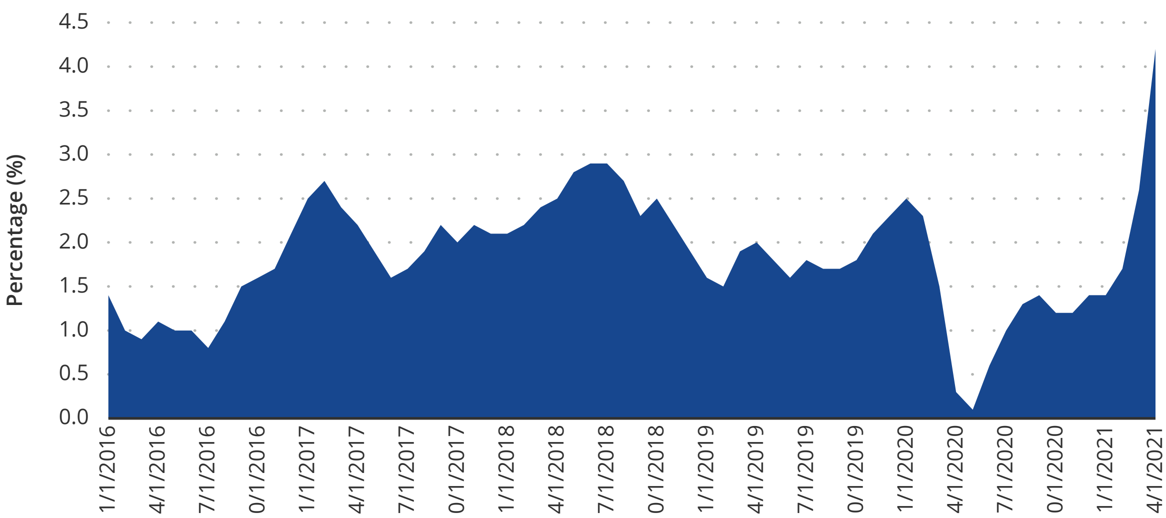
June 2021

# Inflation Is Here.
# Do Something About It!

**The purpose of this paper is to help investors navigate an investment climate that most have never experienced: high inflation.**

Many market observers believed that we would not have high inflation and that any inflationary forces would be mild. This was not correct. As of April 30, 2021, the year-over-year inflation change was 4.2%. The change in the Consumer Price Index ("CPI") in April alone was 0.80%. Looking back at the last 10 years, the April change represents close to nearly a 3 standard deviation event. This followed high readings from the previous months of 0.40% in February and 0.60% in March.

**CPI Year over Year %**




Source: Bloomberg. As of 5/31/2021

Fund managers and corporations are sounding their alarms on inflation. The April 2021 Bank of America Fund Manager Survey found that higher inflation is now the consensus and the biggest risk for markets. Warren Buffet, at the annual Berkshire Hathaway shareholder meeting on May 1, said: "We are seeing very substantial inflation. We are raising prices. People are raising prices to us and it's being accepted." And he is not alone in this regard. Forty seven companies in the S&P 500 Index have mentioned inflation on their earnings calls for Q1 2021—more than during any other quarter in the last 10 years.

Now, the case against inflation has pivoted from "high inflation will not occur" to "high inflation is here, but is only temporary." This was a significant pivot. Arguing against a risk that infrequently occurs, such as high inflation, is one thing. However, confidently arguing against a risk that is already here and escalating is completely different.

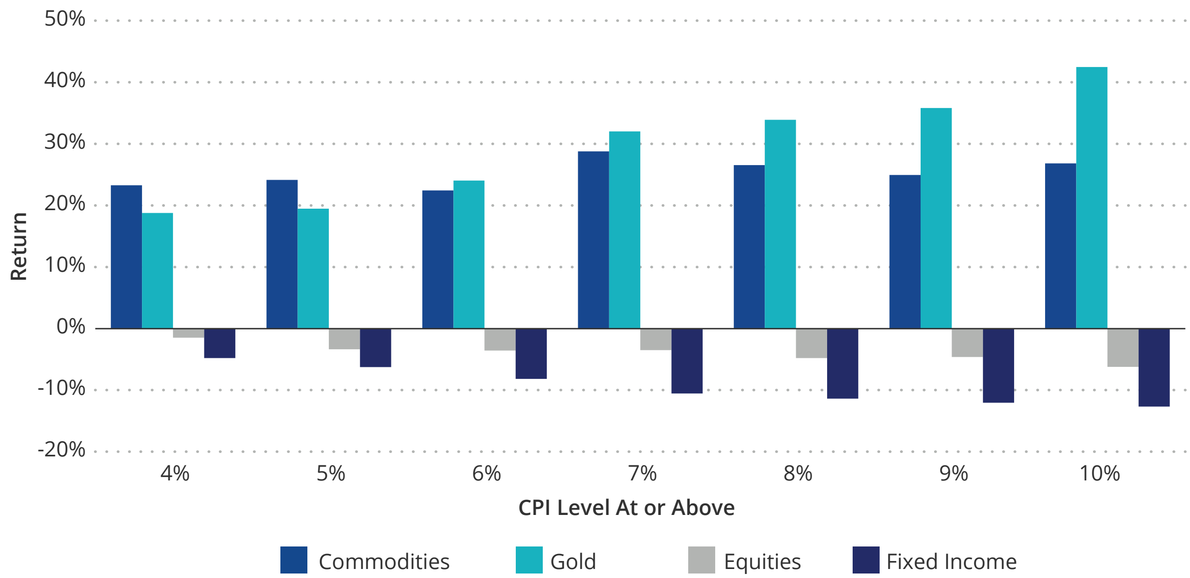
It is time to start taking the risk of an extended period of high inflation seriously by adjusting portfolio exposures into assets that protect against inflation. Those that have already done this have been outperforming (we will get to that).

## Inflation and Asset Prices in the 1970s

We often look to the past to understand the future. In the U.S., over the past 50 years, we have experienced persistent low levels of inflation. The highest level of inflation in the U.S. was in the 1970s, which became known as the Great Inflation. During that period the CPI reached nearly 15%, caused by monetary policy missteps in an effort to support employment. U.S. Federal Reserve Chairman Paul Volcker was able to rein in inflation by aggressively hiking short-term interest rates to nearly 20% (now known as the Volcker Shock), which sent the economy into a recession.

The chart below demonstrates asset price returns in the 1970s. As you can see, with high inflation, real assets (commodities and gold) outperformed and traditional assets suffered.

**Average 12-month real return when CPI is at or above certain levels (1969-1981)**




Source: Bloomberg. As of 5/31/2021

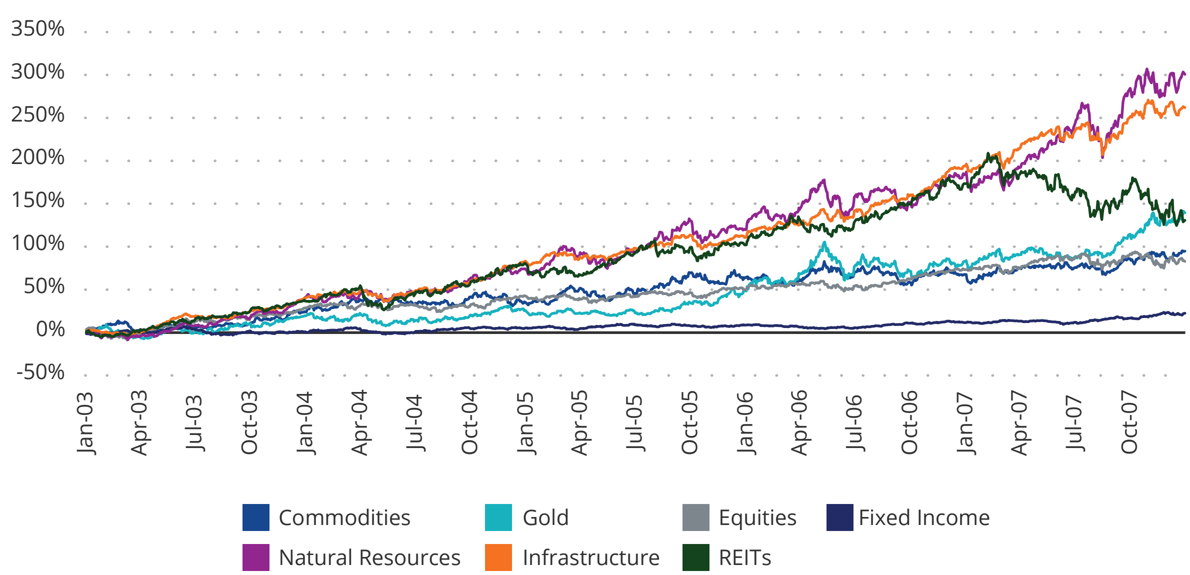
Gold prices rose with higher inflation because gold is de-linked from the inflationary pressures of fiat currencies (the paper money backed by government IOUs). Commodity prices, as today, responded quickly to changes in the supply and demand dynamics.

Traditional stocks and bonds do not have these benefits. High inflation leaves companies in a cat and mouse game to adjust prices. This results in unstable and declining profit margins at a time when general economic conditions are typically deteriorating. Bond investors are negatively impacted by higher inflation through decreased purchasing power and declining prices.

### Inflation and Asset Prices in the Mid-2000s

Now, let's look at the second, and much milder, inflation bout that we contended with in the mid-2000s. From 2005 to 2008 the CPI level briefly reached 5%, driven by higher oil and food prices. The global financial crisis ("GFC"), which halted economic activity, was a hugely deflationary force that put a swift end to this period of inflation.

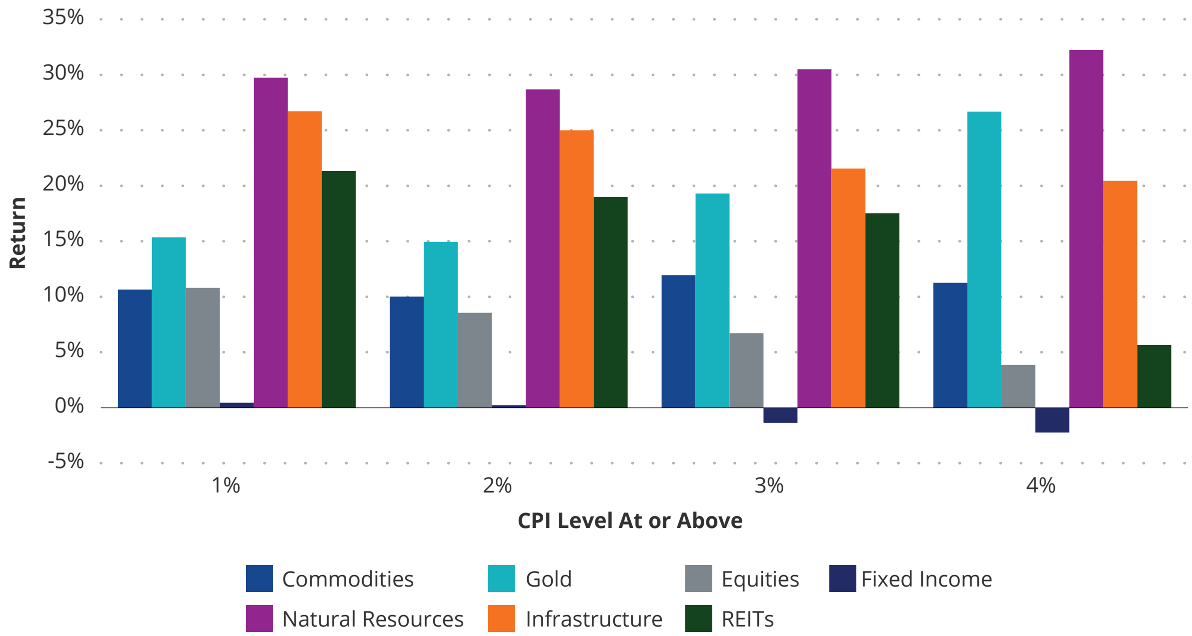
With the explosion in indexation over the past 20 years, we are able to demonstrate how some other real assets performed during the high inflation period of the mid-2000s. During this period, the top performing real asset was natural resource equities, followed by infrastructure, gold, REITS and then, commodities.




Source: Bloomberg. As of 5/31/2021

Below are the real returns of assets, based on CPI levels, during the inflationary period in the 2000s.

**Average 12-month real return when CPI is at or above certain levels (2003-2007)**



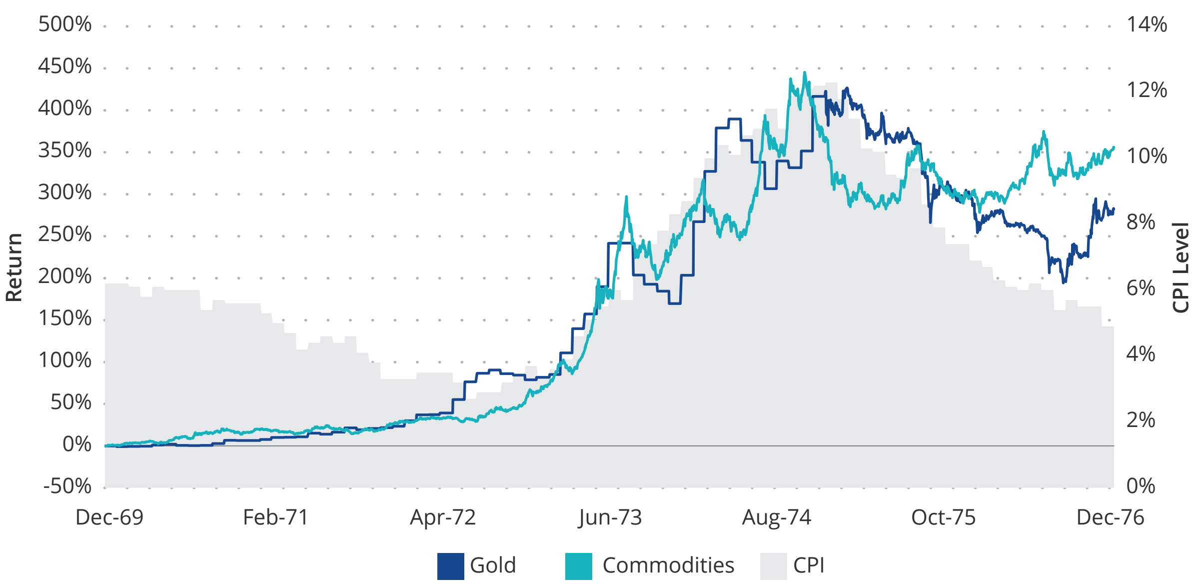

Source: Bloomberg. As of 5/31/2021

Investing in natural resource equities provides access to the revenues of companies involved in the production and distribution of commodities. These companies historically benefit from higher commodity prices because their revenues are linked to commodity prices. Investments in infrastructure companies may provide strong inflation protection due to their ability to quickly pass through inflation to consumers through regulations and contracts. REIT investments also offer some inflation protection because real estate rents and values rise with inflation.

## Gold: The Second Half Team

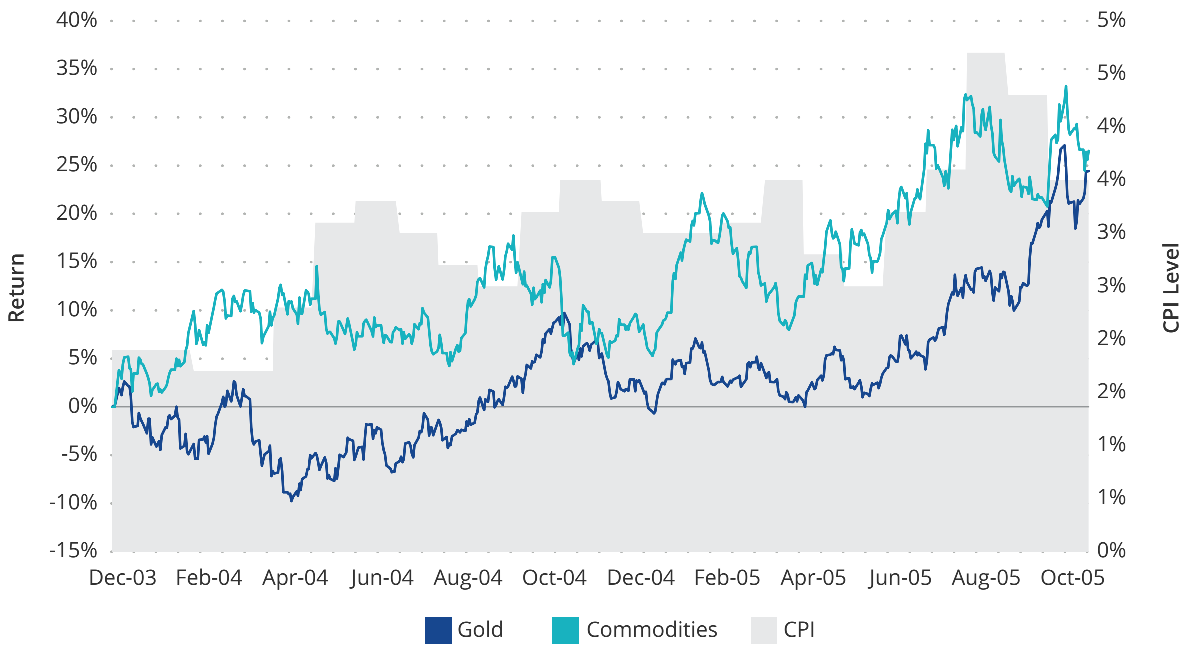
Commodity and gold prices rose together during the first half of the high inflation regimes of the 1970s and mid-2000s. Commodity prices responded to the changing supply and demand dynamics, while gold responded to investors seeking a store of value asset.

**First Half of the 1970s High Inflation Regime**




Source: Bloomberg. As of 5/31/2021

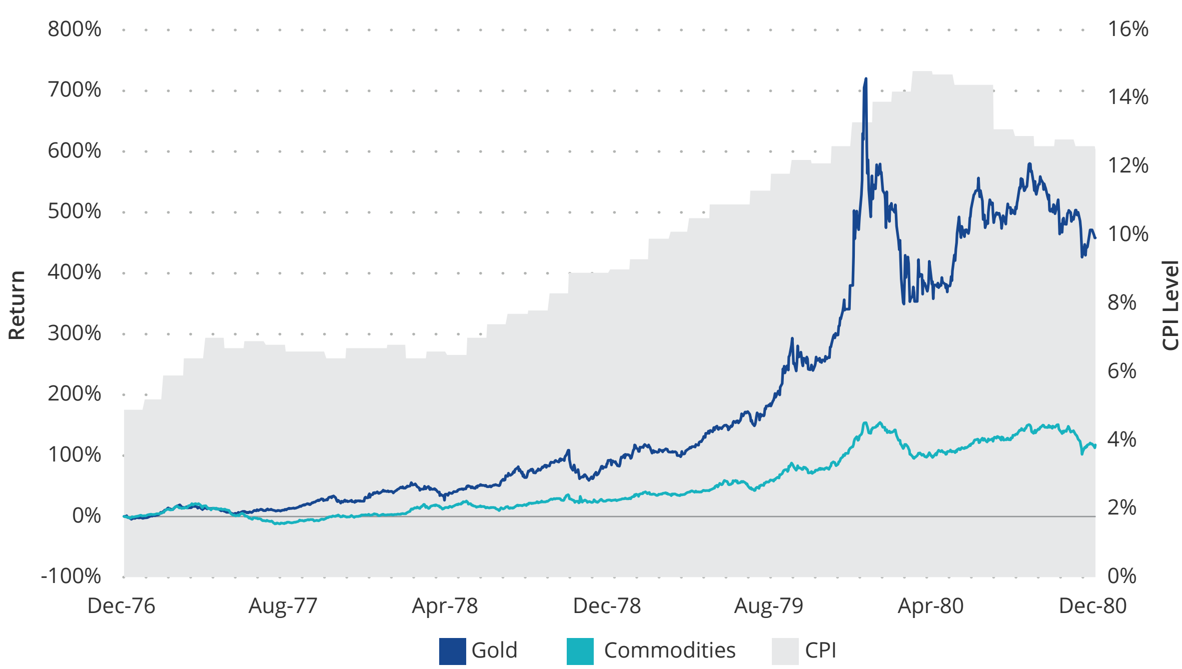
**First Half of the Mid-2000s High Inflation Regime**




Source: Bloomberg. As of 5/31/2021

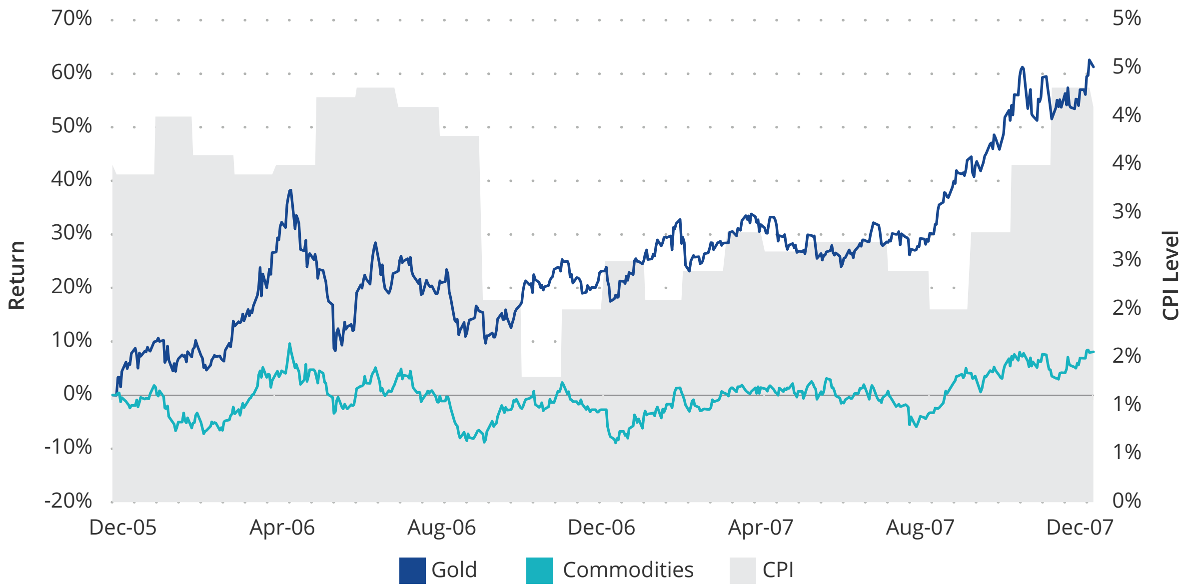
However, as concerns over inflation intensified in the second half of the high inflation cycles, gold prices soared and outperformed commodities. The chart below demonstrates that gold was the clear winner in the second half of both high inflation regimes.

**Second Half of the 1970s High Inflation Regime**




Source: Bloomberg. As of 5/31/2021

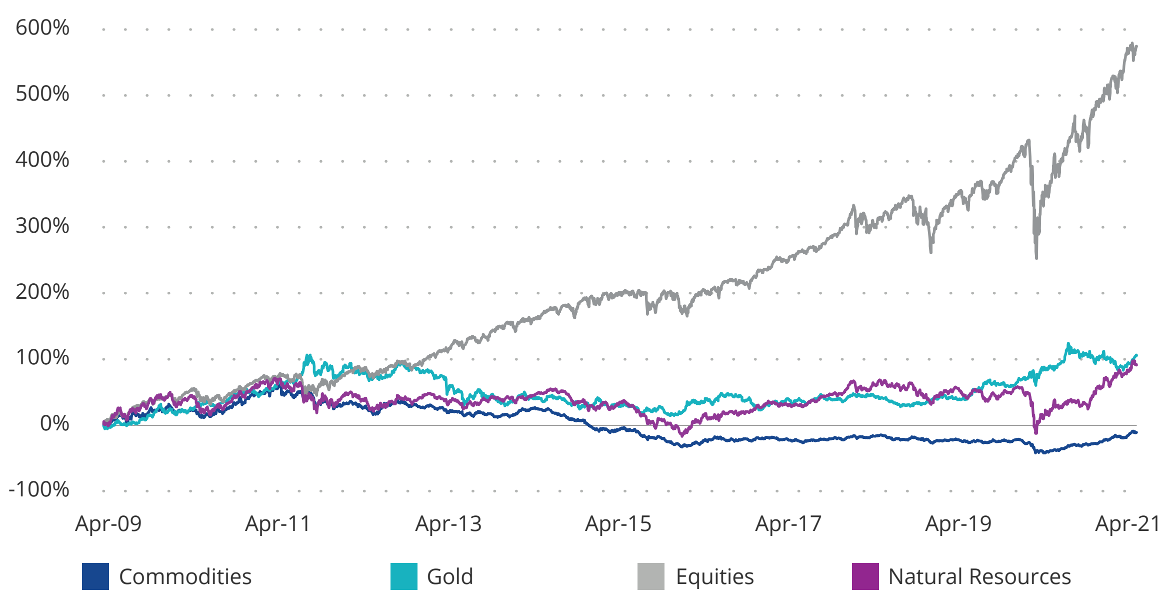
**Second Half of the Mid-2000s High Inflation Regime**




Source: Bloomberg. As of 5/31/2021

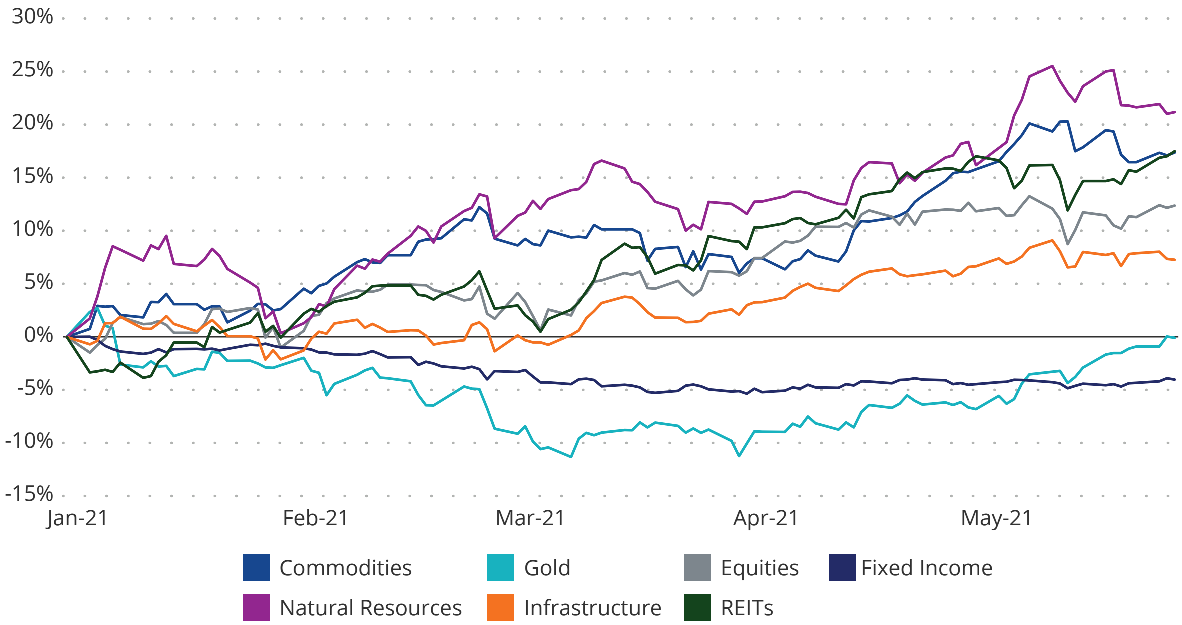
## Inflation and Asset Prices Today

Commodities and other real assets have significantly underperformed the stock market since the GFC. Following the market bottom, in March 2009, the S&P 500 Index has returned a gain of 561% versus a loss of 15% for the Bloomberg Commodity Index.




Source: Bloomberg. As of 5/31/2021

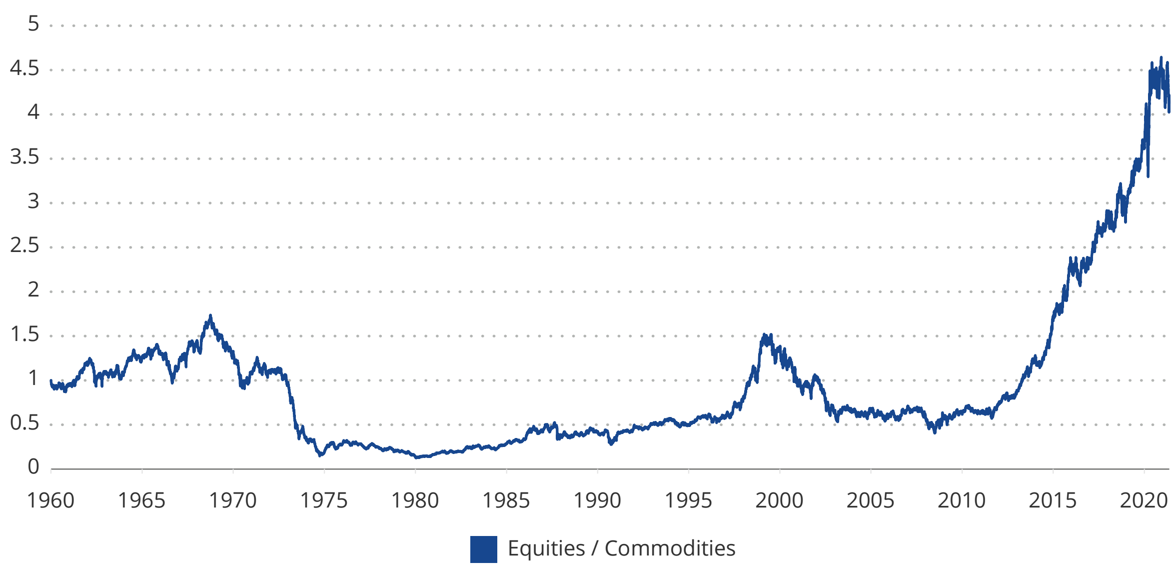
With higher inflation, real assets have finally awoken from their decade plus hibernation and most are leading the markets higher.




Source: Bloomberg. As of 5/31/2021

We believe that the lost decade plus in commodities has created a situation where, relative to stocks, the prices of commodities and natural resource equities may still be cheap and have a lot more room to run. The chart below demonstrates this relative cheapness with the ratio of prices of the S&P 500 Index and the Bloomberg Commodity Index.

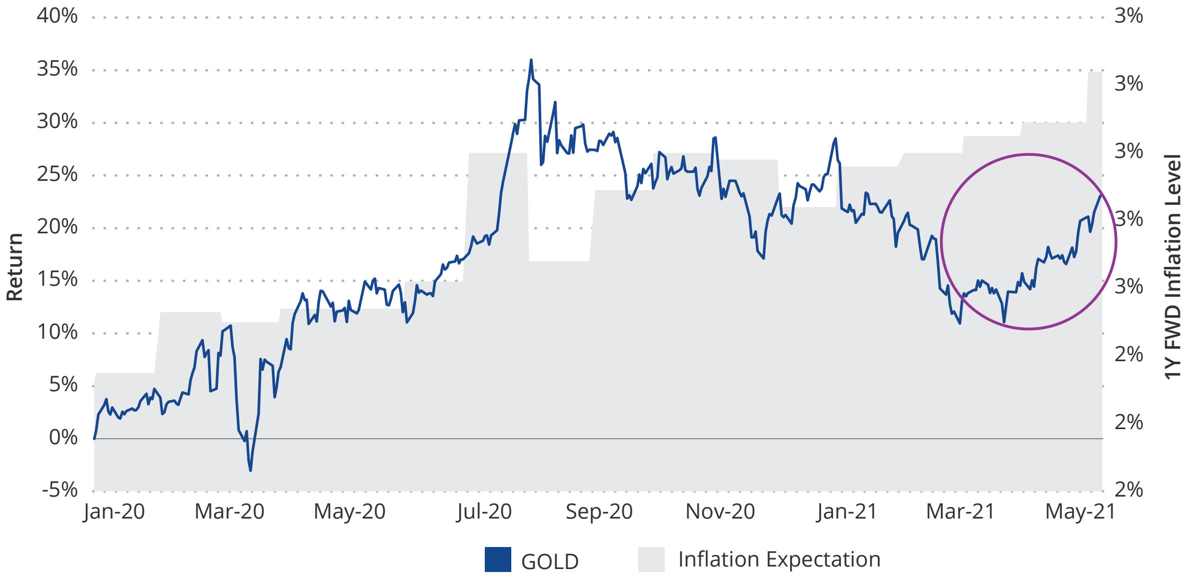
**Commodity prices remain historically cheap vs. the S&P 500 Index**




Source: Bloomberg. As of 5/31/2021

Gold has, so far, been left behind in the latest inflation-led rally, but that may be starting to change as inflation concerns rise. The chart below plots gold prices and inflation expectations.

**Gold & Inflation Expectations**



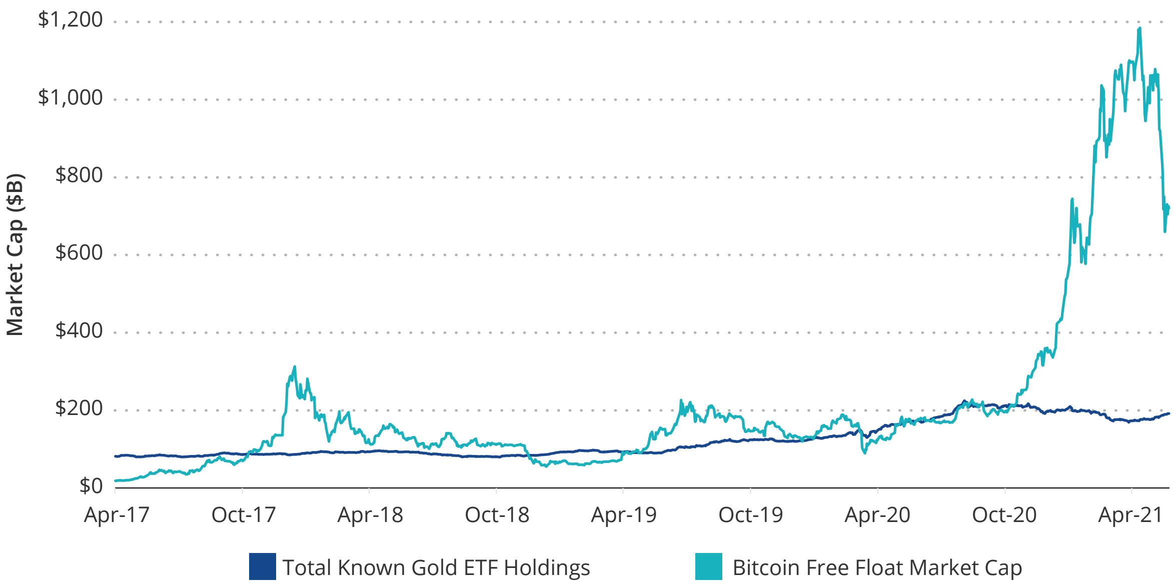

Source: Bloomberg. As of 5/31/2021

Over the past month, the price of gold has increased from $1,685 per ounce to hovering around the $1,900 level. No firm conclusions can be drawn yet from such a short period of time, but history does tell us that gold is likely to kick into overdrive if high inflation persists.

## The Prospects for Digital Gold

In the prior inflationary environments, gold was the primary, and most accessible, store of value asset available to retail investors. But things are changing. Bitcoin has been well adopted by both retail and institutional investors. Like gold, it is scarce, cannot be counterfeited and is easily exchangeable. These attributes have created competition between bitcoin and gold. The chart below illustrates the boom in market capitalization of bitcoin relative to gold ETFs (proxy for gold investment demand).

**Market Cap Comparison: Gold ETFs vs. Bitcoin**




Source: Bloomberg. As of 5/31/2021

The scarcity of bitcoin makes it a viable inflation hedge. There are only 21 million bitcoins that can be mined and there are approximately 19 million bitcoins that have been mined so far.[1] By comparison, gold mining increases the supply of gold by approximately 1.5% per year.[2]

Bitcoin is an evolving asset that needs to be handled with caution, but we do believe that it should be considered as a component in a basket of inflation fighting assets. The recent volatility and performance of bitcoin highlight both the risk and opportunity of the cryptocurrency. We believe this allows investors to risk a little (1-3% of their portfolios) to potentially gain a lot.

1 Source: https://www.cryptocompare.com/coins/btc/overview/USD
2 Source: https://www.gold.org/about-gold/gold-supply/gold-mining/how-much-gold

## Sizing a Portfolio Allocation for Inflation Protection

We have already established that real assets protect against high inflation. The question now is: how much of a portfolio should be allocated to real assets in order to sustain purchasing power in a period of high inflation? Going back approximately 50 years, the average annualized real return (adjusting for inflation) of the 60/40 portfolio has been 6%. However, the average annualized real return for the 60/40 portfolio during the high inflation periods of the 1970s and mid-2000s was 0.55%. For that same period, the average annualized return for the inflation protection portfolio (set at 50% commodities and 50% gold: based on data availability and for the sake of simplicity) was 15.97%.

The chart below demonstrates the allocation targets per real return hurdle. This demonstrates that, during periods of high inflation, a minimum allocation to the inflation protection portfolio of 15% is needed to achieve a reasonable real return, which we have defined as 3%. A more diversified inflation protection portfolio, which may include natural resource equities, infrastructure, REITs and possibly even bitcoin, would likely yield even better results.

### Allocation Targets Per Real Return Hurdle


Source: Bloomberg. As of 5/31/2021

## Conclusion

Inflation is here, and it is time to do something about it. Most portfolios are best positioned for a low inflation environment. For stocks, the growth sectors, which benefit from lower inflation, now dominate the weightings of major equity indices and the once dominant classic value sectors, such as energy and related areas of the market, are practically nonexistent.

Successful investing is all about managing risks–do not ignore this one! We believe that a minimum allocation of 15% to a diversified portfolio of assets that provide inflation protection is needed to keep a portfolio generating the returns required of it.

### Inflationary Tidbits

- The State of Connecticut is offering unemployed residents $1,000 to get back to work.
- Semiconductor supply issues is causing widespread shortages of basically everything that requires either a plug or battery.
- Walmart and Amazon, the two largest employers in the U.S., will raise wages to attract and retain employees to keep up with demand.
- Wawa is temporarily closing some stores due to staffing issues as it attempts to hire thousands.
- The National Owners Association, an independent group of McDonald's franchisees, suggests that higher pay and higher prices are on the menu. One franchise owner is offering $50 to anyone who sits for an interview.
- Lumber prices are up 180% since last year and, on average, increased the cost of a new single family home by $24,386.
- Semi-conductor, seating foam and plastic supply issues lead to new car shortage, increasing the demand for used cars and sending the average price of a used car to an all-time high of $25,463.
- There is a chicken wing shortage due to an increase in demand and labor shortages of production workers. Tyson Foods is also blaming the roosters.
- The national average of gasoline price at the pump this year jumped over 30%, from $2.25 per gallon to nearly $3 per gallon now.
- According to data from FactSet, 47 S&P 500 companies have mentioned inflation on their earnings calls for Q1 2021—more than during any other quarter in the last 10 years.
- A recent survey from TripAdvisor finds that over two-thirds of Americans are planning to travel this summer.

DISCLOSURES

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**Index Definitions**

**CPI – US CPI Urban Consumers YoY NSA**

**Commodities** – Bloomberg Commodity Index is made up of 23 exchange-traded futures on physical commodities, representing 21 commodities which are weighted to account for economic significance and market liquidity.

**Gold** – Gold spot price in U.S. dollars per troy ounce

**Equities** – S&P 500 Index is a free-float weighted measurement stock market index of 500 of the largest companies listed on stock exchanges in the United States. Prior to January 4, 1988 the index is Total Return, and after it is Price Return.

**Fixed Income** – U.S. Generic Government 10-Year Treasury yield assuming a constant 7 year duration to approximate a generic U.S. Government Treasury return

**Natural Resources** – S&P Global Natural Resources Index includes 90 of the largest publicly-traded companies in natural resources and commodities businesses that meet specific investability requirements, offering investors diversified and investable equity exposure across 3 primary commodity-related sectors: agribusiness, energy, and metals & mining.

**Infrastructure** – S&P Global Infrastructure Index is designed to track 75 companies from around the world chosen to represent the listed infrastructure industry while maintaining liquidity and tradability. To create diversified exposure, the index includes three distinct infrastructure clusters: energy, transportation, and utilities.

**REITS** – Dow Jones Equity REIT Index is designed to measure all publicly traded real estate investment trusts in the Dow Jones U.S. stock universe classified as equity REITs according to the S&P Dow Jones Indices REIT Industry Classification Hierarchy. These companies are REITs that primarily own and operate income-producing real estate.

**Inflation Expectation** – median one year ahead expected inflation rate

**60/40 Allocation** – real return for a 60/40 allocation in 60% S&P 500 Total Return and 40% in 10-Year U.S. Treasury Total Return

**Real Asset Allocation** – real return for a 50/50 allocation in Bloomberg Commodity Index Total Return and Gold Spot



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666 Third Avenue | New York, NY 10017

vaneck.com | 800.826.2333