

## ABR Dynamic Funds' Inflation Q&A

### ***Is an extended period of major inflation coming?***

We don't know. Ask us something about the past that we can attempt to answer with data.

### ***Based on historical data, has inflation been bad for equity allocations?***

Inflation hasn't been as bad as the gold bugs in the financial media would have us believe, for the S&P 500 on the whole.

We used four possible measures of inflation, although the first one is more about changes to inflation than persisting environments. None of them is perfect. We have heard the criticisms leveled at them, some of which have merit. However, there are several reasons to include these four measures. They are simple, not prone to data mining or overfitting when simply sorted into quartiles, and they have data going back to 1970. Further, by using four, we have a somewhat more robust picture of inflation that may mitigate some of the criticisms of any one of them.

The following four charts show the average 12-month S&P 500 Index total return during periods in which the following four measures of inflation were in each quartile of their ranges from 1970 to the present:

- 12-month change in the US 10-year interest rate
- 12-month change in the CPI
- 12-month change in the US Dollar Index
- 12-month average US 10-year interest rate

Without further ado, here are the results. In each chart, quartile 1 is most deflationary (or least inflationary), and quartile 4 is most inflationary.

<b><u>Equities and the Change in the US 10-Year Rate - 1970 through April 2021</u></b>		
<b>Quartile</b>	<b>12-Month Change in US 10-Year Rate</b>	<b>Avg. Corresponding 12-Month S&amp;P 500 Index Return</b>
1	-4.3% to -0.8%	14.8%
2	-0.8% to -0.1%	9.1%
3	-0.1% to +0.6%	11.5%
4 (most inflationary)	+0.6% to +4.0%	11.6%

<b><u>Equities and the Change in the CPI - 1970 through April 2021</u></b>		
<b>Quartile</b>	<b>12-Month Change in CPI</b>	<b>Avg. Corresponding 12-Month S&amp;P 500 Index Return</b>
1	-2.1% to +2.1%	11.1%
2	+2.1% to +3.1%	16.3%
3	+3.1% to +4.6%	12.5%
4 (most inflationary)	+4.6% to +14.8%	7.1%

### Equities and the Change in the US Dollar - 1970 through April 2021

Quartile	12-Month Change in US\$ Index	Avg. Corresponding 12-Month S&P 500 Index Return
1	+29.8% to +6.4%	9.7%
2	+6.4% to -0.2%	14.2%
3	-0.2% to -6.7%	12.4%
4 (most inflationary)	-6.7% to -28.3%	10.6%

### Equities and the US 10-Year Interest Rate - 1970 through April 2021

Quartile	12-Month Average US 10-Year Rate	Avg. Corresponding 12-Month S&P 500 Index Return
1	+0.8% to +3.9%	11.4%
2	+3.9% to +6.2%	7.9%
3	+6.2% to +8.0%	12.2%
4 (most inflationary)	+8.0% to +14.3%	15.8%

Based on the above charts, in much the same way that the prices of many things have gone up during inflation, the prices of fractional ownership shares of companies have also generally fared OK during inflation.

One important side note on equities before turning to gold:

We do want to note that inflation may not be the biggest concern right now, for ~10-year horizons. In other words, this note should not be read as an endorsement of maximum equity allocations at the time of this writing. The following graph of the S&P 500 Cyclically Adjusted Price-to-Earnings (CAPE) ratio may be considerably more concerning to equity investors than the prospect of inflation. CAPE ratios at these levels have historically been associated with approximately zero return over the next decade in the S&P 500. Of course, as the graph illustrates, it's a small sample at these extremes. Although that fact may add uncertainty, it probably isn't comforting.



Source: multpl.com

***Let's get to gold already. I still want to look for inflation help, even if equities haven't been terrible during inflation. Should I look to gold?***

Traditionally, yes. Conventionally, yes.

Here are the same four charts, but this time for the change in the gold spot price.

<b><u>Gold and the Change in the US 10-Year Rate - 1970 through April 2021</u></b>		
Quartile	12-Month Change in US 10-Year Rate	Avg. Corresponding 12-Month GOLD Return
1	-4.3% to -0.8%	7.6%
2	-0.8% to -0.1%	5.3%
3	-0.1% to +0.6%	11.8%
4 (most inflationary)	+0.6% to +4.0%	19.2%

<b><u>Gold and the Change in the CPI - 1970 through April 2021</u></b>		
Quartile	12-Month Change in CPI	Avg. Corresponding 12-Month GOLD Return
1	-2.1% to +2.1%	5.1%
2	+2.1% to +3.1%	6.2%
3	+3.1% to +4.6%	10.5%
4 (most inflationary)	+4.6% to +14.8%	21.2%

<b><u>Gold and the Change in the US Dollar - 1970 through April 2021</u></b>		
Quartile	12-Month Change in US\$ Index	Avg. Corresponding 12-Month GOLD Return
1	+29.8% to +6.4%	-4.5%
2	+6.4% to -0.2%	4.1%
3	-0.2% to -6.7%	23.7%
4 (most inflationary)	-6.7% to -28.3%	20.7%

<b><u>Gold and the US 10-Year Interest Rate - 1970 through April 2021</u></b>		
Quartile	12-Month Average US 10-Year Rate	Avg. Corresponding 12-Month GOLD Return
1	+0.8% to +3.9%	7.2%
2	+3.9% to +6.2%	12.4%
3	+6.2% to +8.0%	14.8%
4 (most inflationary)	+8.0% to +14.3%	9.2%

Remembering that quartile 4 is the most inflationary, the charts look encouraging. Of course, there's a "but" coming, in 2 parts:

1. Much of the view of gold as an inflation hedge seems to be based on the late 1970s to early 1980s.

The data on gold shown above are heavily influenced by this time period, which, in a sense, is a sample of one period of inflation with extreme, perhaps outlier, data. To illustrate, here are the same four charts, but this time the data begin in late 1981. Specifically, the included data in the following charts begin after CPI year-over-year changes were less than +10%.

### **Gold and the Change in the US 10-Year Rate - November 1981 through April 2021**

Quartile	12-Month Change in US 10-Year Rate	Avg. Corresponding 12-Month GOLD Return
1	-4.3% to -0.9%	8.3%
2	-0.9% to -0.3%	5.0%
3	-0.3% to +0.4%	6.2%
4 (most inflationary)	+0.4% to +3.0%	2.1%

### **Gold and the Change in the CPI - November 1981 through April 2021**

Quartile	12-Month Change in CPI	Avg. Corresponding 12-Month GOLD Return
1	-2.1% to +1.7%	5.6%
2	+1.7% to +2.7%	6.9%
3	+2.7% to +3.5%	2.5%
4 (most inflationary)	+3.5% to +6.3%	6.2%

### **Gold and the Change in the US Dollar - November 1981 through April 2021**

Quartile	12-Month Change in US\$ Index	Avg. Corresponding 12-Month GOLD Return
1	+25.1% to +6.5%	-3.1%
2	+6.5% to +0.5%	3.7%
3	+0.5% to -6.8%	6.3%
4 (most inflationary)	-6.8% to -28.3%	14.8%

### **Gold and the US 10-Year Interest Rate - November 1981 through April 2021**

Quartile	12-Month Average US 10-Year Rate	Avg. Corresponding 12-Month GOLD Return
1	+0.8% to +3.0%	3.2%
2	+3.0% to +5.0%	19.7%
3	+5.0% to +7.4%	-1.6%
4 (most inflationary)	+7.4% to +13.4%	0.0%

This time, gold only shows an encouraging pattern for help with inflation in the third chart, the 12-month change in the US Dollar Index. The other three charts no longer appear encouraging.

Proponents of gold will say that it is not fair to remove a period of major inflation and solid results for gold from the data when evaluating gold's potential value in periods of inflation. *They are correct.* That was not the point of this post-1981 exercise. The point was to illustrate the extent to which the conventional view of gold as an inflation hedge may be dependent on one instance of extreme data. Because of that feature, we find it hard to draw data-based conclusions with confidence.

2. Perhaps gold's inflation hedging potential, to whatever extent that it may exist more recently, is based on the expectation, rather than the measurable fact, of inflation. If that is the case, perhaps its potential has already been partially or fully realized today. It is even possible that gold's potential has been more than fully realized, depending on how much inflation actually materializes.

Over the past two calendar years, 2019-2020, gold was up 48% (21.6% annualized) without major inflation by any of these measures. Might gold's potential to help with possible upcoming inflation already be realized? Might that explain why gold is slightly down since August 2020, when the US 10-

year rate began its modest climb? Is it that more inflation was already factored into the price of gold than we may yet be seeing? Does that mean gold is or is not a good inflationary holding from here?

Unfortunately, we cannot answer these questions based on historical data. We just think they may be worth asking before increasing gold allocations, based on conventional wisdom, at these levels.

Just one more caveat that didn't deserve its own number 3: regardless of what data are or are not included in the analysis, "hedge" is too strong a word. Gold has not reliably gone up when inflation has gone up with a very high correlation. "Diversifier" is a more accurate word, even for the biggest gold proponents. At best, gold has been a diversifier with some of its biggest help coming in a past period of major inflation.

### ***Where else might I look, regardless of my view of gold as a "diversifier with a focus on inflation"?***

One place to look may be conventional trend-following managed futures, as part of a well-diversified portfolio. The following excerpt comes from installment 22 of our series on portfolio construction (entitled "garbage in; garbage out"). From the series, so that it makes sense below, "SPY" was shorthand for equity exposure; "TLT" was shorthand for treasury exposure; "LV" was shorthand for long volatility strategy exposure; and "MF" was shorthand for managed futures strategy exposure:

#### *Inflation*

The last period of significant and extended inflation in the U.S. ended in the 1980s. Data since then may not be very useful for constructing a portfolio for an inflationary regime. In other words, "garbage in, garbage out."

For example, a "TLT" allocation may be a loser instead of a winner in periods of inflation. On the other hand, certain "MF" strategies, with the potential to utilize both long and short exposures to commodities, bonds, and currencies, *might* be able to benefit from the meaningful trends in those assets that *might* result from an extended period of significant inflation.

There is, of course, no reason to limit oneself to "SPY," "TLT," "LV," and "MF," both in general, and especially for an investor who has another preferred asset for inflation hedging.

The Credit Suisse Managed Futures Liquid Index (CSLABMF), chosen as an illustration or benchmark and not as an endorsement or recommendation, has ridden an uptrend in oil and downtrend in US Treasuries (among other trends) to a +20.7% return since August 2020, when the US 10-year rate began its modest climb, through the time of this writing.

Conventional trend-following managed futures strategies may offer help to investors who are worried about an extended period of major inflation, perhaps even as a result of a long gold allocation in some situations. In light of that potential help, we think it's worth asking if a long-term *static* allocation to gold really adds much value to *dynamic*, trend-following allocations, allocations not just to gold but also to a variety of other potentially inflationary trends.

It should be noted that following trends involves losing at turning points (i.e., trend changes), but that may be an acceptable price for investors who are concerned about inflation and aren't excited about a static allocation to gold at these levels.

We think another possibility may be to follow trends in volatility assets. Short exposures to some volatility assets have historically done well in times of rising equity markets, whether or not they were associated with inflation. Meanwhile, long exposures to some volatility assets have historically done well in times of crashing equity markets, also without regard for the cause. In other words, volatility trend-following, as a long-term allocation, may have the potential to help mitigate the risk of incorrectly guessing the direction, magnitude, and timing of major market moves, whether they are the result of inflation, a global pandemic, or something else entirely. As with other forms of trend-following, volatility trend-following should be expected to lose in turning points.

Disclosures:

- It is not possible to invest directly in an index or the spot gold price.
- Data sources are Bloomberg and multpl.com. This note should be viewed as an overview of the firm's thoughts on the issues covered and is not an absolutely thorough and precise assessment.
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