# Commodities: An Inflation Hedge for All Seasons?

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**Anu Rajakumar:** Surging inflation is affecting consumers and businesses around the world. And while inflation could moderate from here, there are structural drivers that may cause it to stay elevated. From an asset allocation perspective, it's crucial for investors to take a deeper look into their portfolio, understand it's exposure to inflation, and if necessary, make modifications to avoid erosion. But this latest flavor of inflation is unlike what we've seen in almost half a century. So, do real assets like commodities still hold their weight in gold? Excuse the pun. Or does the current economic environment require a different approach? My name is Anu Rajakumar. And to help me break this down, I'm joined today by a couple of my colleagues from the multi-asset team. Here in New York, we have Hakan Kaya, Senior Portfolio Manager for Commodity Strategies, and Joe McDonnell, Head of Portfolio Solutions for EMEA, based in London. They're here to discuss inflation in the asset allocation context, and dig into the robustness of broad, diversified commodities as a potential inflation hedge. Hakan, Joe, thanks for being here and for coming back to the show.

**Joe McDonnell:** Hi, Anu. Thanks.

**Hakan Kaya:** Great to be here, Anu. Thank you.

**Anu:** It's the middle of the first quarter, 2022, and investors are grappling with the very high CPI prints that we've been seeing recently. Joe, you are a seasoned allocator. You've managed large pension fund portfolios before. So, let's go back to basics. How do most allocators think about inflation when they're designing their long-term strategic asset allocation? And how has that played out over the recent past?

**Joe:** Thanks, Anu. Yes. So, essentially, pension fund managers and other institutional investors haven't really had to focus, as you know, on inflation, for perhaps close to two decades. We've had a fairly benign environment, which has been pretty good for risk assets. But in reality, investors are very concerned about generating real returns because their liabilities are very often linked to inflation. That's certainly the case for UK and certain Dutch pension funds. And other types of investors are also very much focused on positive returns. It's not a great situation if your nominal returns are okay, but your negative returns on a real basis are poor. So, that's a big concern for investors. So, what we're seeing now from an asset allocation perspective is investors really thinking about scenario analysis in more detail. So, thinking about high inflation environments, high inflation, low growth, high inflation, high growth environments. And really testing their current strategic asset allocation to see just how robust it is under those different structures. But also within that, obviously calculating the inflation beta that they have in their existing portfolio and looking at ways to potentially increase that inflation beta.

**Hakan**: So, Anu, if I may add on top of what Joe is saying here, if I think about an asset allocation problem, the real problem we see here as asset allocators is– how do assets relate to each other? Because ultimately, when you buy an asset, you are buying a stream of cashflow. And you pay the discounted value of these future cash flows as priced today. So, what happens is these discounts, they need to be increased. Because first you are dealing with the, increasing rates going into the future. Also you also need to be dealing with these discounting with maybe inflation on certainly the premium. You know, that answer that they bring, debt requires an additional risk premium as well. So, all this mental accounting, what it does is, it ties all cash flow discounting assets together. So, all of the sudden you can expect your cash flows to increase. Perhaps that's true.

But if not, it's bad. But no matter what, when you are discounting all these things with higher rates because of inflation, that's making the correlations between all assets increase. So, when you think about, for instance, these 60-40, 70-30 stock bond splits, you may think that you are diversified because you have stocks and bonds that are different. But at the end you may be facing just one big inflation bet. And that diversification dies. What remains is the volatility that you will have to face now. And it's unpleasant.

**Anu**: Alright, so investors are dealing with a double whammy. They've got volatility coupled with a lack of diversification in their portfolios. What are their options from here, Joe?

**Joe**: The lack of diversification is more of a concern, as Hakan mentioned, as inflation feeds through. And therefore, it breaks the natural diversification you have between principal core asset classes with bonds and equities. The reason problem we have here is that investors can make certain changes from their existing asset allocations. So, they can adjust it, for example, their equity portfolio, to be more moving away from long-term secular growth to more value strategies, or equities which will have more pricing power potentially as well, and shorter duration. That can help, but that is just about optimizing within different asset classes like equities. So, really what an investor needs to do is probably think about more structural changes in their asset allocation. So, thinking about what combination of liquid and illiquid real assets do they have today. What the combination will be tomorrow, and what allocation weights that they need. Because at the end of the day, the emphasis needs to be about increasing beta of the overall portfolio. To make sure when we do have situations where inflation is above central bank targets that there's a robustness coming through into the portfolio as a whole.

**Anu**: Okay, so, Hakan, broad based commodities have historically been a good way to increase that inflation beta that Joe was speaking about. But we're dealing with inflation alongside potentially slowing growth, like stagflation. How might commodities fare in that environment?

**Hakan**: Ah yeah. So, what will happen here, Anu, is we're going to start seeing these late cycle dynamics in my opinion. So, we will be looking for this pricing scarcity, depleting inventory type of situations. So, what happened? How did we come here? We've had the speediest, perhaps, economic recovery that we have ever seen that particularly created that huge demand for everything. You know, cars, food, materials, lumber, you name it. Everything. Demand has been coming in such a volume that the supply, it just cannot catch up. And that's where we are today. Demand is making that very steep V recovery. But supply is coming up like an L. Not even like U. Just an L. And why is this happening? Because, you know, when you think about supply that needs to recover, you need that capital for it to supply the producers, and the miners, and everybody who would use, that productive capital to bring that supply. That money is not flowing at the speeds that we have been accustomed to like in previous cycles, Anu. And that's why, we are moving into that scarcity pricing regime. So, despite there will be economic slowdowns, and that's not going to be a big impact on the volumes – maybe at the margin. So, what we will be seeing is this supply is going to continue to be very, very limited. So in terms of thinking about why this supply is not coming, it's like a decade ago, you have seen in China. You have seen the shale projects in the aftermath of the global financial crisis. And the yields were mouthwatering. And at that time, you really saw that big capital moving to the commodity space created that interesting projects, and it persisted. A lot of the space, they got burned with these very, very poor returns. And what is coming back is just a deal flow. If you look at the debt, there is some debt flow happening in the space, but it's just for restructuring. It's not for venturing out for the oil field or opening up the next mine on borrowed capital. So, that's why supply is not coming. And inventories are continuing to dwindle, even if we will see potentially a slowing economy in the near future.

**Anu**: Yep. I think the scarcity aspect makes a lot of sense. Maybe looking at the demand side, the fed is tightening. No more stimulus checks. Isn't it likely that people are going to be consuming less, and that's going to affect the demand side of this equation?

**Hakan**: Yeah, I would say perhaps at the margin, it will impact. But what we need to understand here, Anu, you know, in commodities, the rate of growth, it really doesn't matter. You know, what happens in commodities, you need to think about the volume of demand and volume of supply. So as long as that volume of demand is above the volume of supply, you're in a deficit. You are chewing up that inventory. So, you know, perhaps yes, you are right. Maybe the world will not consume 1 million barrels of oil. Maybe we consume 100 million barrels of oil because of rate rises. But you got to understand, you cannot produce more oil. So, you are still chewing up those inventories. And that's what's causing that price spike, or the scarcity pricing. Despite there may be a slowdown in the economy.

And that's why I think commodities are really interesting, right? They are the only asset class with this kind of behavior, that really pay off in inflationary slowdowns. So, rate rises may happen. I think it's going to happen at this point, you know, tapering in the medium to short term. These may be impacting maybe the risk appetite. I don't think it's going to be a big impact on the commodities. Because at the end, it's always the volume of demand; and it's always the volume of supply. As long of the volume of demand is above the supply, you are shrinking that inventory. Making already scarce commodities scarcer, more valuable, and prices are going to adjust up.

**Joe:** I would just add to that, I think we have to be careful about equating rate rises to some sort of meaningful correction in real assets. Because essentially, of course, rates are rising hopefully in the backdrop of decent economic growth. But also, we need to recognize there has to be limitations about rate rising. Central banks are sitting on huge balance sheets.

They're incentivized to have inflation above long-term trend. Obviously, not substantially. But if you were targeting 2, 2 and a half, you're probably comfortable with 3, 3 and a half. So, if you're essentially allowing the economy to continual to run hot, obviously you have interest rate policy, which will help to curtail maybe some of the demand elements. But as Hakan mentioned, no impact on the structural supply issues. We just have to recognize that there will be limitations about rate hikes because central banks can't afford, with the size of their balance sheets, to deal with that liability.

**Hakan:** Yeah. I like to agree with Joe on this, I think there are too many zombie companies like this time. After the pandemic, the Fed decided to keep them alive. And you know, there's a lot of this debt load, both in the public and the private sphere. And potentially, we will be looking at this huge debt service threat. I think if Fed will have to choose between the red pill and the blue pill. The blue pill being forcing the economy into a recession with rate hikes, and all sorts of market and credit busts. Or if they think about having the red pill of above average inflation. I would think the fed will choose the red pill. I think they will accept above average inflation for a longer while. And let the markets rebalance themselves. I think the penalty for recession, or a mistake, is a lot higher for them. At the end of the day, recessions don't generation tax to pay for all those debt. I think the inflation may level off some from these very extreme levels, of past decades. But I think we are still looking for above average inflation for a long time.

Another important aspect of this, Anu, is decarbonization. And it's mega, mega change in the sector. And this has a huge impact on inflation. You know, first of all, Fed cannot do anything about it. It's a policy choice, that was made before, and it's ongoing. It's a giant demand source for commodities as well, and a very structural one, too. And it also is a bonus. It solves for these redistribution issues, right? At the end of the day, we are right. These days we think about rate hikes, tapering, in the near term. But I think it's important not to be myopic to these very big shifts and themes in the grand scheme of things. I think these will shape up the economic history. And they are very commodity friendly.

**Joe:** Yeah. I would just add to that, actually over a century there are very few, irreversible trends. So, major events which mean the way we look at things changes. And we look at certain assets' changes as well. So, underpinning bond markets. That trend's been intact for that length of time. It'll be intact for another 20, 30 years. So, the truth is, 4 or 5 years ago, no one was really talking about zero carbon and the implications of that, in the same way as they are today. But with companies and governments making 20, 30-year commitments, and they're not going to roll them back, that just seems to me as an essentially an irreversible trend and the epicenter of that is commodities. So, even if the short-term gyrations in markets, which of course is going to be, because commodities as an asset class is volatile, you have these massive impacts on the supply and demand dynamics which are going to be present for the next 20 years and weren't present 5 or 10 years ago.

**Anu**: Yeah. You know, very interesting topic, and certainly one that lots of investors are focused on, particularly as they think about ESG issues, they're certainly emphasizing these environmental issues and emissions levels. In commodities, it seems like it's a little bit challenging give that, even in broad-based, diversified commodities, a large portion are what you'd consider sort of the quote-unquote dirty, old economy assets, the oil refineries, mining, etc. But on the other hand, there could be this big inflection point. And frankly without some of these key commodities, the green revolution's maybe just wishful thinking. So how should investors think about that dilemma? How do you see that changing in the future?

**Hakan**: Yeah, maybe I take that, Anu. So, what is happening is, like Joe said, there is a transition that's going on in the minds of investors. And their transition, it's mostly forcing investors towards divestment away from commodities, those old economy, dirty type of industries, right. And what that divestment is doing is killing the power of price signals. What we are doing is we are collectively saying as investors, you producers, you shall not produce. We don't want them to produce. The collective is kind of against the production. And will the wisdom of the crowd be right at the end? Perhaps yes, for the good reasons. But what happens in the meantime in the real economy among the producers? I can give you an example.

If I'm like the CEO of an energy company, and if I'm not seeing investment in my company, and I cannot borrow at the rates that the tech companies are borrowing, and in 5 years I may be thinking that we will all be driving electric vehicles anyways, why would I invest big money in production? Why would I go out and venture out for shale resources, the new fields? So, I probably don't have much appetite for that. And all I'll be focusing on is focusing on the current production and just keeping the cash flow secure for my investors. So, that's why what is going on, is despite all these steep rallies that we've seen last year, last 18 months, there is no meaningful increase in production. What we will be seeing is this price elasticity of supply's very, very, very low right now. And this wasn't the case before. And that's changed. I think that's a big change that was, in my opinion, driven by the investor reluctance, you know, both due to the poor returns. I understand. But also, now like you said, the ESG as well. The other part of this story is – you are making these policy choices that kind of are unfortunately ill-timed. But now you got to have to put that geopolitics in the equation as well. So now, we will have to deal with what Russia will be doing with their natural resources. And Iran. And all the uncertainties around it. I think at the end of the day, I don't think we

are leaning in that nice, cozy, globalizing one hegemon world. We need to build in these risk premiums in prices. It's probably what we will be seeing in commodity prices as well.

**Anu**: Right. Well, I think I'm going to have to go double check my energy bill after this recording, from what you've just said Hakan. Maybe bringing this back to asset allocation, I would like for you to share your view on how you think investors should consider approaching a commodities investment. And maybe touch on passive versus active management within this asset class.

**Hakan**: Yeah sure. So within the commodities investing, usually passive meant looking at only a few benchmarks. And in my opinion, you know, these benchmarks are no good. So, unlike in equity, or in the bond markets, here in the commodities space are very expensive and they have a lot of biases. One thing to mention here, Anu, is, in my opinion, there is no such thing as a passive benchmark in commodities anyways. In my opinion, everything is an active strategy. Just when you look at the Bloomberg Commodity Index, or the Goldman Sachs Commodity Index, you know, you know, let me ask you this question. Do you think you can guess the tracking error between these two indices?

**Anu**: Oh, gosh. The tables have turned. So, let's see. Well, in equities, enhanced index fund tracking error's usually around 1%. So, probably something similar. A tracking error of around 1%, 100 basis points between the Bloomberg Commodity Index and Goldman Sachs. Pretty close? [laughs]

**Hakan**: [laughter] Don't get shocked. But I hate to say the tracking error between these two indices is like 11%. One thousand one hundred basis points. When you buy for example, Goldman Sachs Commodity Index, you are holding that 1,100 basis points tracking error against the income, and vice versa. So, everything, everything, is very active in the commodities space. People just like thinking about these passive vehicles. And they are driven to it. But I think passive investing may not be what investors may be thinking about in equities or fixed income.

**Anu**: Alright, so the takeaway here is that when you select a passive index from these two, the question – it's an active decision about which one you actually choose. There's an active decision to be made there as well.

**Hakan**: That's right.

**Joe**: Yeah, and I would just add just on this as well, because these indices are dominant, insofar as most investors will try to align even an active strategy against them. Only passive strategy linked to them can be picked off by an active manager, insofar as they'll have very strict balancing frameworks. So, we kind of know when they're in the market, and when they're rebalancing. We probably – we can work out which contracts they're in as well in size. So, that gives an active manager, you know, some information that's valuable. From a management cost perspective, they're fairly similar, active and passive management.

Obviously, an active manager can challenge the core allocation, which is the composition of those indices which has Hakan mentioned, is, they're more production-led not scarcity led. So, they seem a bit biased to obviously the energy complex. So, that's important as well. An active manager can build a better core portfolio. Obviously can exploit short-term tactical opportunities by assessing individual commodity markets. Make more informed contract selection decisions, and of course manage cash more efficiently. So, the opportunities there in the active management space is very high. While the transparency that you get with ETF is actually quite negative. So, that's something that investors need to be conscious of.

**Anu**: Terrific. I think we're covered a lot of really good material here. As we start to wrap up, Hakan, what are a few key takeaways that you want our listeners to walk away with from this episode?

**Hakan**: So, first of all I think it's time for commodities, right? Inflation is kind of getting to a level it looks unanchored. And commodities are good for that. I think it's also importantly, like Joe has been saying, and I'll be saying, it makes sense to be active in this space. And value investing in commodities is chasing scarcity not production like the benchmarks or the passive indices are doing. So you really don't want to be in markets where there are players who are obligated to buy commodity futures at whatever the price, making them expensive for investors to gain exposure to. So, what I'd like to say is yes, you can be very, very right about your commodity bets. But when you execute that bet using a passive, rule-based product, you may end up being with a subpar performance. That's unfortunately the experience with the passive benchmarks in past cycles. And I humbly say I recommend going against automation here, you know. Being a little bit more forward looking to these changing themes like greenification, electrification, metallization of the world. I think at the end of the day, finding such solutions that give you smart exposure to commodities is not that difficult. You just need to look beyond passive implementations.

**Anu:** Great. Excellent. Thanks so much, Hakan. Now, I can't let you both go without a quick bonus question. So, we all know that inflation takes its toll over the years. Just over 100 years ago, in 1915, a movie theater ticket cost about 10 cents. Today that is closer to, it's about 10 dollars on average in the US, or about 10 pounds in the UK. So, my question for the two of you is, maybe starting with you, Hakan. What is one of your favorite movies?

**Hakan**: Oh, one of my favorite movies. I guess it's The Usual Suspects. And I would say, think it's The Usual Suspects because I like to relate it to the commodities. I think commodities, that's the one asset class you wouldn't expect come to your savior at the end with a big surprise. But when stocks and bonds are decreasing these days, at the same time commodity's coming up. You know, getting that big surprise on the upside. Yeah. Maybe it's not The Usual Suspects. You should be looking at interesting things like commodities.

**Anu**: Alright, Joe. I'm not sure if you can top that. That was pretty good with the commodities-related rationale. But what about you, Joe?

**Joe**: I don't know. I'm trying to think of all the movies that are commodity related I know. There was Blood Diamonds. I'm a bit older, so Roger Moore did one about gold in the late '70s.

**Anu**: It doesn't have to be commodities related, to be clear.

**Joe**: Okay. My favorite movie is probably Michael Collins. Which has nothing to do with commodities whatsoever. But it's about an independence leader. That's not interesting.

**Anu**: That's perfectly fine. Thank you very much. Well, Joe, Hakan, it was a pleasure speaking with you today. Inflation is, of course, a concern for all kinds of clients. And here at Neuberger Berman, we are actively searching for solutions that are robust, intuitive, scalable. And commodities seem to check a lot of these boxes. Though, as Hakan said, they can be volatile at times. But importantly, they can be a hedge against inflation, particularly in this environment. Thank you again, Joe and Hakan.

**Joe**: Thank you.

**Hakan**: Thanks for having us, Anu.

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