Ukraine Crisis: What Does It Mean For Asset Allocation?

The risk of stagflation favors potential inflation hedges such as commodities and gold.

Russia's invasion of Ukraine has increased the risk of stagflation (slowing economic growth but high inflation). How should investors prepare for this possible scenario? Our analysis reveals which asset classes may be likely to outperform if it comes to pass.

Inflation in Each Phase of the Business Cycle

In general, there are four different phases of the business cycle based on the evolution of output: recovery, expansion, slowdown, and recession. The table below shows the average real (inflation-adjusted) total return of major asset classes for each business cycle phase during high-inflation environments.

Annualized Real Returns In High Inflation Environments (%)

	Global Equities	US 10-Year Treasuries	US T-Bills	Commodities	Gold
Recovery	-6.2	-1.9	-0.1	8.2	-18.4
Expansion	7.4	-2.1	-1.7	16.6	6.6
Slowdown	-0.6	6.4	-0.2	16.7	19.3
Recession	-28.1	4.0	-0.1	-1.6	5.5

Past performance does not guarantee future results. Data from May 1988 to December 2021. Notes: real returns are in excess of US Consumer Price Index (CPI, defined by the Bureau of Labor Statistics as a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services). High inflation is defined as US CPI annual inflation above the 10-year average. See page 2 for representative index definitions. Source: Schroders Economics and Strategic Research Unit.

Historically, the slowdown phase has favored investing in traditional potential inflation-hedges such as gold (+19.3%) and commodities (+16.7%). This makes economic sense: Gold is often seen as a safe-haven asset and tends to appreciate in times of economic uncertainty. Commodities, such as raw materials and oil, are a source of input costs for companies as well as a key component of inflation indices. So, they'll also typically perform well when inflation rises (often because they are the cause of the rise in inflation).

In comparison, the slowdown phase has proved very challenging for equities (-0.6%), as companies combat falling revenues and rising costs. Keeping your savings in cash (-0.2%), proxied via T-Bills, hasn't been a better strategy.

Although US Treasury bonds have performed well in the past (+6.4%), they should be treated with caution today. In theory, they should benefit from falling real rates, driven by declining growth. However, rising inflation eats into their income, putting upward pressure on yields and downward pressure on prices.

Key Points

- The Russia-Ukraine crisis has increased the odds of a high-inflation/low-growth environment.
- A leadership change may be in store; riskier assets such as equities could wind up out of favor.
- Central banks are between a rock and a hard place trying to manage inflation without sending the global economy into recession.

Insight from sub-adviser Schroders Investment Management

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In practice, the extent to which this harms bond returns will depend on their duration[1] and starting yields (higher yields provide a larger cushion to absorb rate rises).

What Are the Key Takeaways for Asset Allocation?

Last year, the reflation environment favored investing in risk assets[2] such as equities and commodities, while gold suffered. This is consistent with what we would expect using our previous analysis.

However, if we're on the cusp of a period of stagflation, then a shift in performance leadership may be on the way. In this scenario, equity returns may become more muted while gold and commodities may outperform. This is exactly what has manifested so far in 2022.

Meanwhile, central banks are stuck between a rock and a hard place. Hiking interest rates too quickly could send the global economy into recession. But keeping rates low for too long could send inflation spiralling out of control.

Taken together, the outcome for bonds is uncertain and will depend on the tug-of-war between inflation and growth sentiment.

If we're on the cusp of a period of stagflation, then a shift in performance leadership may be on the way.

Talk to your financial professional to help you stay focused during volatility.

[1] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[2] Risk assets (such as equities, commodities, high-yield bonds, real estate, and currencies) have a significant degree of price volatility.

Global Equities are represented by the MSCI World Index, a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.

10-Year US Treasuries are represented by the US 10-Year Datastream Index.

US T-Bills are represented by the US 3-Month Fed Index.

Commodities are represented by the S&P GSCI Commodity Total Return Index, which consists of 24 commodity futures on physical commodities across five sectors: energy, agriculture, livestock, industrial metals, and precious metals.

Gold is represented by the spot price of gold in dollars per ounce.

Indices are unmanaged and unavailable for direct investment.

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