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Inflation Protection Won't Be Simple

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With a strong economy and an incoming president promising tax cuts and tariffs, investors and economists are rightly worrying that inflation might make a comeback. Unfortunately, one of the standard ways to guard against it—buying commodities, especially oil—offers less protection than usual.

The twin inflation risks are well understood: supply shocks and demand surges. War in the Middle East has the potential to threaten energy supplies, while tax cuts into an economy with nearfull employment ought to lift prices.

The extra threats to inflation don't fit either model, though. Tariffs and deportations would both be likely to push up inflation, but would also hit the economy. "Commodities won't protect you from that," says Christian Mueller-Glissmann, head of asset allocation research at **Goldman Sachs.**

The problem has shown up in price moves since the election. The market measure of expected inflation over the next five years, known as the break-even, had its biggest jump in more than a year after the result, having risen as traders bet on Donald Trump winning.

Yet, gold, oil and copper are all down. Have they lost their ability to protect against inflation? To answer this, think about three different causes of inflation.

First, oil. Clearly, oil will still protect against one of the most common causes of runaway inflation: a soaring oil price resulting from strikes on oil facilities in the Middle East. Yet, that has become much less likely. Shocks to world oil supply are being damped by large stocks and excess production capacity, as well as by the U.S.'s status as a net exporter, a sharp change compared with the inflationary era of the 1970s. Far from soaring as Israel stepped up its fight with Iran's proxies and Iran itself, crude is stuck around $70 a barrel.

President-elect Trump's pledge to "drill, baby, drill" and his selection of a fracking

executive as nominee for energy secretary and oil prices suggest downward pressure on prices in the U.S., too.

Second, stronger growth. It should also raise inflation. Usually oil and copper are good ways to protect against growth-driven inflation as demand for both rises. But the decoupling of the U.S. and Chinese economies by tariffs might stymie this effect. China is the biggest source of demand for raw materials, but might not be helped much or at all by stronger U.S. growth.

Third, Trump's tariff and migrant-deportation plans. Both could increase inflation.

Tariffs have nuanced effects on inflation. The immediate impact is to raise prices, much like a sales tax, as well as pushing up the dollar. In the long run, they should slow the economy—again, like a tax rise—which should reduce inflationary pressure. The mixed effects show up in higher expectations for inflation in the near term, but little change in inflation expectations be-yond the next five years.

This sort of action is hard to protect against. Tariffs shouldn't help oil and industrial metals, and might hurt them as trade wars threaten a weaker world economy and so less demand. Gold could struggle as tariffs will push up the dollar,

tending to weaken the gold price and make interest- rate cuts less likely.

If the new administration manages to remove many millions of migrants who entered the country illegally, it would surely push up wages for the worst-paid as companies compete to replace low-cost workers. Since the poor tend to spend all their income, that ought to boost spending and feed through to prices both as companies try to make up for their higher costs and from the extra demand the higher spending creates. Again, this is the wrong sort of inflation for oil or copper.

The industry with the highest exposure to illegal migrant labor is farming, so this should have the biggest effect on food prices—potentially making agricultural futures a way to protect against this. But agriculture isn't a market for the fainthearted, with lots of volatility and a need to understand the details of each crop.

The one inflation hedge guaranteed to work is Treasury inflation-protected securities. TIPS promise inflationlinked returns. But they are only guaranteed to work if held to maturity. When sudden shocks lead to rate increases, as in 2022, TIPS are hit by higher after-inflation rates and can fall in value.

TIPS look better today than they did in the postpandemic inflation because they have much higher starting yields. But as Salman Ahmed, global head of macro and strategic asset allocation at Fidelity International, points out, TIPS are better at protecting against several years of higher inflation than they are at protecting against sudden inflation increases.

All this makes it hard to protect an otherwise-bullish portfolio against inflation. Some TIPS to hold to maturity make sense; gold might offer a cushion against stagflation, though recently it has been driven by demand from foreign central banks, nothing to do with inflation; and Ahmed says he likes having some energy company stocks as they could leap if there is a true oilprice shock.

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