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Outperforming the market requires accurately estimating opportunities and risks: it's about identifying favourable odds through probability analysis. ***Percentage Play*** *offers high conviction calls based on our cutting-edge probability forecast models.*

THIS WEEK'S PLAY: SMART INFLATION HEDGING

THE SITUATION: President Trump's economic policies increase inflation risks, even if a further moderation in pricing pressures remains the most likely outcome. Adding some inflation protection to portfolios mitigates downside risk.

THE ACTION: Commodities and resource stocks often work well, but only a few offer a good entry point, and are robust to a supply-side spike in inflation (e.g. from tariffs). Battered private real estate and TIPS are also good alternatives.

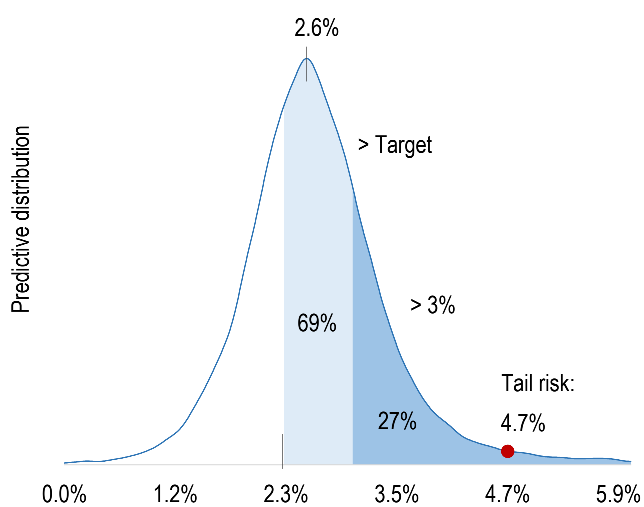
Better safe than sorry – US 10Y yields have risen 100 bps since the Fed pivot in mid-September. About one-third of this gain stems from higher inflation expectations in response to Trump's policy proposals. In particular, a combination of global tariffs, mass deportations and tax cuts could cause inflation to rise directly and via a tighter labour market.

Our models suggest these renewed inflation worries are likely excessive, with a 65% chance that inflation will average less than the 2.5% priced in by markets for the duration of Trump's presidency. This reflects a high probability of lower wage growth (as signalled by predictors like the quit rate) and a normalization in shelter inflation.

But while most drivers signal moderate risks, Trump's policy mix means we cannot discard adverse inflation scenarios. F1 shows our CPI forecast for 2025, which exhibits a clear right-tail skew: While there is only a 27% chance that inflation averages over 3%, it *could* jump close to 5%.

In this context, we suggest adding some inflation protection to investment portfolios. But which instruments would act as an effective hedge? For an asset to offer protection, it has to react positively to inflation shocks, and ideally deliver above-average returns during periods of high and rising inflation, compensating for losses elsewhere.

F1: While unlikely, high inflation may occur
US CPI inflation probability forecast - 2025

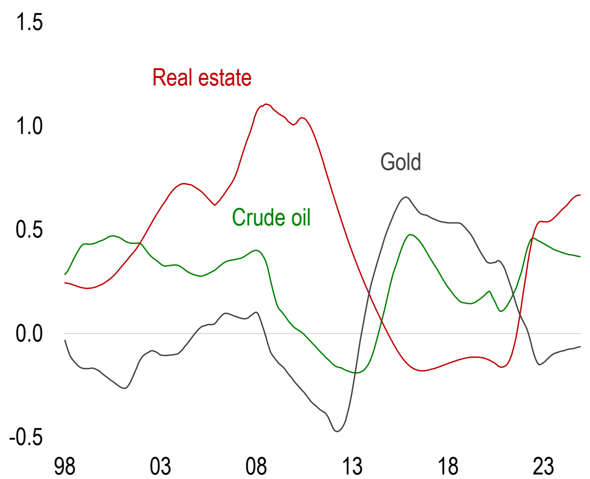


Note: There is a 69% chance that inflation exceeds target (2.3% on CPI) in full-year 2025 , and an 27% probability of >3% inflation. Should price growth pick up, the worst potential outcome is 4.7% inflation. Source: Numera Analytics.

We carried out an extensive exercise to assess the inflation hedging ability of 60 assets, including equities, commodities and even alternatives like real estate and hedge funds. Hard assets often deliver outsized gains during periods of high inflation, but some equities also outperform. At the country level, LatAm resource exporters and Canada are the best choices. Within the S&P, upstream energy (E&P) has the highest upside when inflation accelerates.

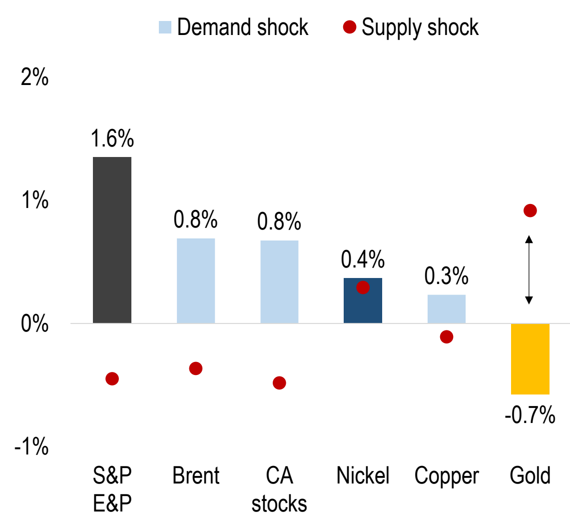
But while real assets may work as an effective hedge, their sensitivity to inflation surprises varies over time. F2 shows inflation 'betas' for oil, real estate and gold, when also controlling for activity. Unlike the first two, bullion offered limited protection during the 2022 inflation spike, as aggressive Fed hikes discouraged a rotation in investment flows.

F2: Hedging ability fluctuates over time
Time-varying betas to US inflation 'surprises'



Note: Chart tracks the time-varying link between asset price movements and US inflation surprises, controlling for activity. Betas are Kalman filter estimates from multivariate state-space models. Source: Numera Analytics.

F3: Source of change matters for hedging
Simulated impact of positive inflation surprise



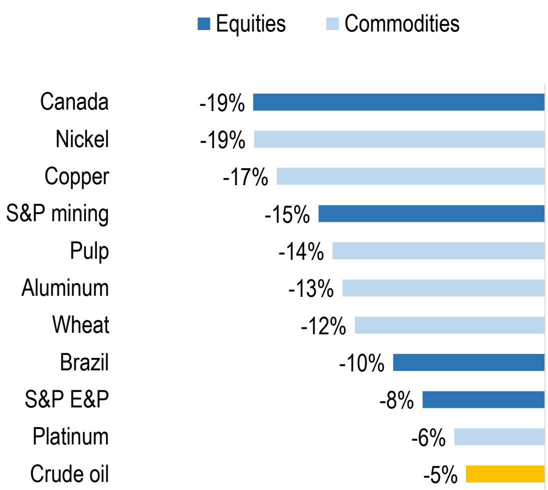
Note: 12M simulated response by asset to a positive US inflation surprise, triggered by demand and supply-side shocks. Source: Numera Analytics.

In choosing a hedge, this means it is important to understand the source of change. Unlike 1970s stagflation, high inflation in 2022 coincided with strong final demand and low and falling unemployment. Crucially, not every hedge works well in this context. To evaluate this formally, we built a structural model to disentangle if positive inflation surprises stem from demand or supply side factors. F3 shows our findings for a few competing assets.

Out of the 60 assets in our study, only eight react positively to inflation shocks irrespective of the trigger. Nickel appears to be the most effective, consistent with its strong showing during the 70s and in 2022 (although admittedly also aided by falling Russian supply). Energy and most industrial commodities fare well in overheating, but take a hit if the inflation spike is supply driven. The opposite applies to precious metals, since they are also 'safe haven' assets.

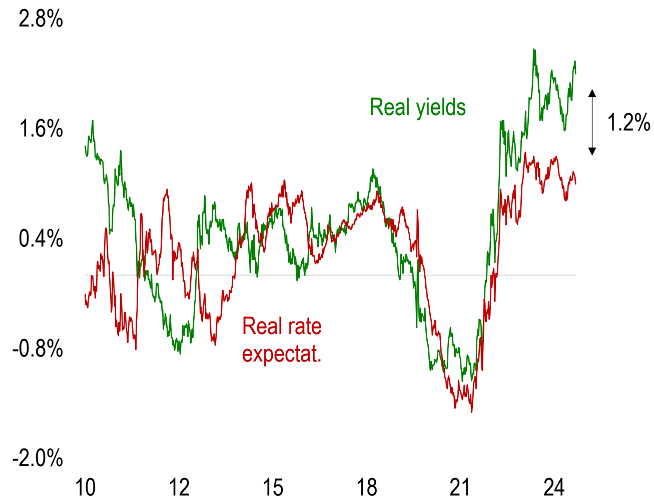
Besides the macro context, investors should also consider asset valuations. To evaluate the importance of the entry point, we looked at forward returns in periods of high and rising inflation, but only when asset prices trade well above their long-term trend. In most cases, the valuation effect dominates over an asset's inherent hedging properties.

F4: Entry point guides strategy success
Excess returns (inflation + high valuations)



Note: 12M forward returns vs. trend when US inflation is above target and rising, and assets were purchased at expensive valuations. Source: Numera Analytics.

F5: TIPS are an attractively priced hedge
10Y US real yields vs. expected real rates



Note: Chart plots 10Y US inflation-linked yields (TIPS) vs. expected short-term real rates over the next 10 years. Source: Macrobond, San Francisco Fed.

F4 compares 12M forward returns versus trend for the assets that based on our research have the best hedging properties. The valuation effect dominates, resulting in much weaker returns. In choosing a hedge, investors should then favour assets that are well priced, have a strong current inflation link, and are robust to the source of change.

On the equity side, Canada, E&P and metals & mining meet the first two criteria, but they are vulnerable to a supply spike that would hit activity (like tariffs). Oil, wheat, nickel, aluminium and pulp also meet the first two requirements. However, the non-energy commodities are robust to supply shocks, making them attractive choices. We also find that private real estate is a good alternative, with good supply-side protection and trading at a hefty discount.

What about inflation-linked bonds? TIPS are usually a worse inflation hedge than hard assets, because they are very sensitive to Fed hikes (TIPS fell 13% in 2022). Today, however, we find that OW TIPS improves risk-adjusted portfolio returns. The key reason is that real yields are much too high versus the level implied by fundamentals (F5). Alongside a high probability of slowing activity, this translates into an 80%+ chance of positive returns in 2025.

In case you missed it ...

- **Commodity Outlook** (21/12): Will commodities regain their shine in 2025?
- **US Asset Allocation** (23/01): Will spreads remain 'narrow for longer'?

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