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Market Insights

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Are Stocks a Good Inflation Hedge?

Investors often wonder whether investing in stocks will protect them against inflation. While stocks have historically outperformed the rate of inflation, they are not a true hedge simply because they are too volatile.

Why Worry About Inflation?

Inflation is not something only economists worry about. Even moderate inflation can affect your retirement savings and even current income. For example, if inflation averages out to the Federal Reserve's long-term inflation target of about 3 percent over the next 30 years, $100,000 would be worth just $40,000 in today's dollars. If inflation were higher, say at 7 percent, the purchasing power of $100,000 would fall to just $17,000 in today's dollars.

Stocks as a Hedge?

Historically, stocks have outperformed inflation and seem to have provided some protection from rising prices. From January 1926 through July 2009, the S&P 500 Index returned 9.7 percent while the U.S. Consumer Price Index (CPI), which tracks inflation, had an annualized return of 3 percent.

Despite the evidence, stocks are not a true hedge against inflation. For one, the long-term monthly correlation between the two is slightly negative. That means that over the long run, there has not been a significant relationship between stock returns and inflation. Furthermore, stocks do not always outpace inflation, especially in down years. Looking at annualized returns over the past 10 years (August 1999 to July 2009) reveals that while the S&P 500 lost 1.2 percent, the CPI increased by 2.6 percent. Investors who relied on stocks to hedge their inflation risk not only did not keep up with inflation, they actually lost significant purchasing power.

In terms of total returns, the S&P 500 lost 11.3 percent. Since cumulative inflation was 29.2 percent, the real total return to stocks was –40.5 percent. That is one reason the recent bear market seemed so painful. The real loss was far greater than the nominal loss.

What stocks do provide is a risk premium. In other words, the reason stocks have outperformed inflation over the long run is due to the greater risk inherent in stocks. While holding stocks will increase volatility in a portfolio, the risk premium allows for an investor to outpace inflation when realized. But that is compensation for risk, not an inflation hedge.

Summary

Even though stocks are not a true hedge against inflation, holding stocks during times of high inflation might be better than holding just nominal bonds. Since stocks have a higher expected return than bonds due to the risk premium, stocks may provide a better chance at beating inflation. Unexpected inflation can significantly impact fixed coupons and principal payments. Staying short term on nominal bonds should protect an investor against increases in inflation, but the real rate will fluctuate. The best protection against inflation is to purchase Treasury inflation-protected securities (TIPS), which lock in a real rate of return (one that tracks inflation).

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