

Investors moving out of cash may favor equities and short duration bonds

A vast amount of money is hanging over U.S. financial markets in money market funds and other short-term liquid instruments. Evidence from past economic cycles suggests that this strong liquidity preference will ease at some point, especially if the U.S. avoids a deep recession.

As concerns over a hard landing for the U.S. economy have receded, focus has shifted from recession risk to inflation risk. This will impact where investors seek to allocate their money. Historically, bonds—particularly longer-dated bonds—have been an excellent hedge against recession but a poor hedge against inflation. During rare periods when inflation has turned negative due to sharp economic downturns, bonds have outperformed stocks.

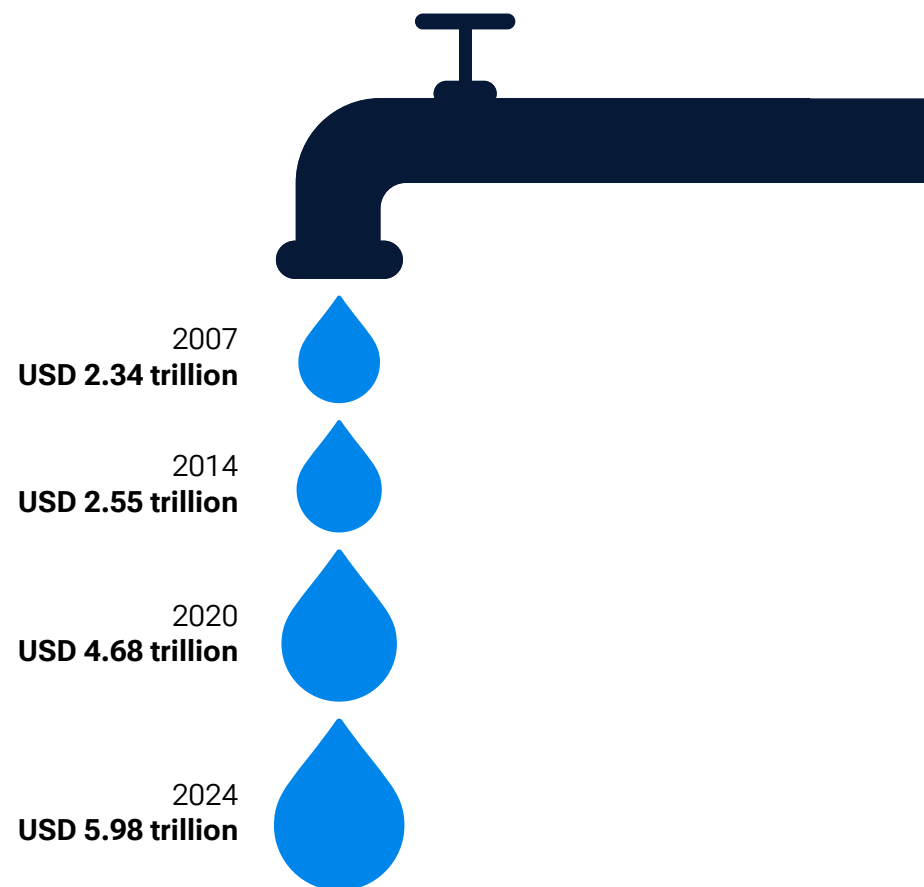
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Tim Murray, CFA
Capital Markets Strategist,
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U.S. investors are flush with liquidity

(Fig. 7) Money market fund assets are highly elevated



As of April 1, 2024.
Source: Investment Company Institute.

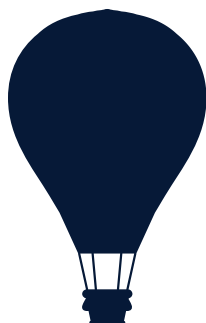
Energy stocks may offer best hedge against inflation

Stocks have tended to perform best during periods of low, moderate, or even slightly elevated inflation. But they have typically dipped sharply during recessions and have also weakened when inflation has moved to very high levels. However, energy sector stocks have historically performed quite well during periods of very high inflation. These patterns suggest that one way to hedge against inflation risk would be to tilt portfolios to stocks, with an emphasis on the energy sector and other commodity-oriented equities.

Investors are also likely to turn to shorter-term bonds given attractive yield levels available and the potential for price appreciation if yields move lower. Short-term bonds are highly valued during uncertain periods—such as the present—as they are less exposed to interest rate changes than longer-dated bonds. They also provide the potential for higher returns than cash while being almost as flexible. This flexibility may be useful given uncertain economic and market conditions.

Key takeaway

Commodity-oriented equities may offer an effective hedge against inflation risk.



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