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Which Asset Classes Perform Best as Inflation is Driven Lower?

Since 2021, the economic discourse has focused on inflation, its broader implications, and the Federal Reserve's response to it. The Fed prefers the Personal Consumption Expenditures Index (PCE) as its gauge for inflation, but the Consumer Price Index (CPI) is still the more widely recognized measure of inflation.

After digesting July's 2.89% CPI print combined with Fed Chair Jerome Powell's remarks at Jackson Hole, it seems we are well on our way to the 2% inflation target that the Fed set out when it began raising rates back in 2022.

As the Fed's prolonged bout with inflation nears its end, the narrative has shifted towards anticipation of the first rate cut since 2020, signaling a possible pivot from emphasizing price stability to fostering full employment.

With the Fed beginning its pivot, this white paper was created to explore the frequency of a 2% CPI and, more importantly, the sustainability of controlled prices for a 12-month period. It also examines which asset classes have historically flourished under such conditions. To ensure the analysis was relevant to our current situation, we prioritized looking at periods when inflation was ***falling*** into the Fed's preferred inflation range.

Methodology

The Federal Reserve targets a PCE inflation range of 1.5% to 2.5% (2% target "midpoint"). In our analysis, we observed an approximate difference of 0.4 percentage points between the average CPI and the PCE. Considering this offset, we focused on a 12-month average CPI range of 1.9% to 2.9% to align with the Fed's preferred inflation measures.

The Federal Reserve's formal adoption of a 2% inflation target in January 2012, as outlined in its "Statement on Longer-Run Goals and Monetary Policy Strategy (updated in August 2020)," marked the resolution of debates stretching back to the mid-1990s.

Although the 2% target was only publicly announced in 2012, the Fed had been informally aligning around this figure in closed-door FOMC meetings since July 1996, when Janet Yellen, then a member of the Federal Reserve's Board of Governors and later Chair in 2014, indicated that there was diminishing opposition to establishing a target inflation range.

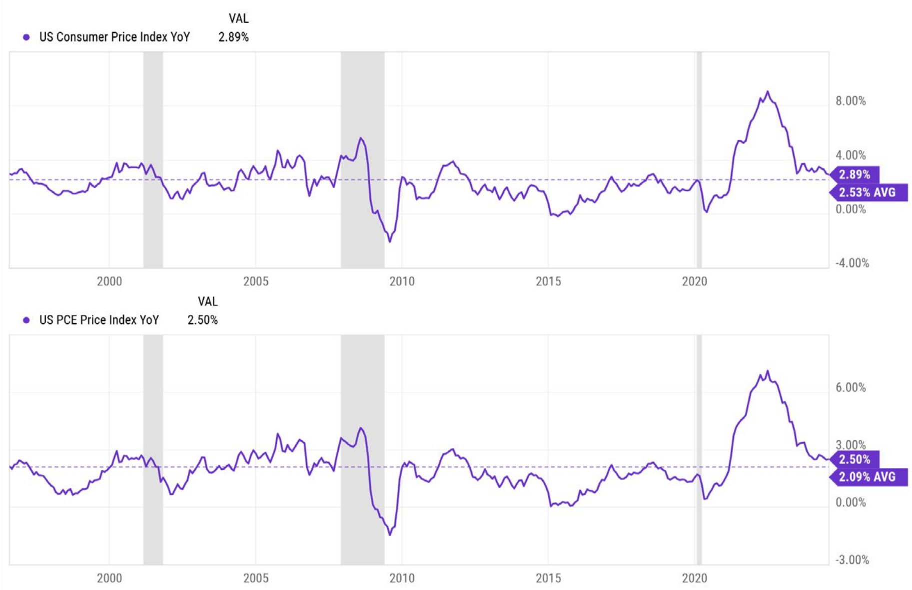
With the Fed using that 2% target internally since that July 1996 date to identify if inflation was "in range," we exported CPI data from YCharts from July 31, 1996, to the present. We then calculated the forward 12-month average CPI for each data point, identifying periods where the CPI fell within the 1.9% to 2.9% range (equating to the 1.5%-2.5% PCE target range as noted above).

To ensure that our analysis provided some timely takeaways, we applied the following process:

- First, we identified two-month "transition" periods: the reported CPI in month 1 was above 2.9% (the upper limit of our range), while the CPI in month 2 fell below that threshold.

- Next, we tracked to ensure the subsequent 12-month average CPI stayed within our target range.

This methodology helped us pinpoint periods similar to today: CPI was above the target range but declined into it. While there's no guarantee that inflation will stabilize in the Fed's target range, that would be the goal of the policy. As such, "benchmarking" against a 12-month average that was in the target range made intuitive sense for the purposes of this piece. Throughout the piece, when these "evaluation criteria" are met, they will be referenced as such.



Date Range: 07/31/1996 - 07/31/2024

Sources: BLS, BEA

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Key Takeaways

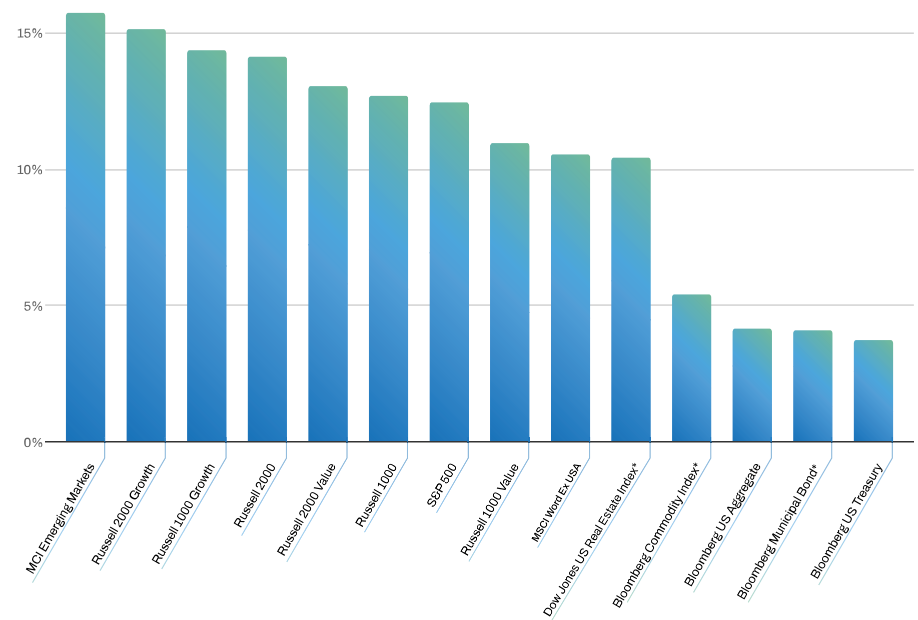
Overview of 12-Month Average CPI Trends

- **"In Range" CPI:** During the analyzed period, which spanned from July 31, 1996, to July 31, 2024, this CPI range occurred in 105 out of 326 12-month periods, accounting for 32.2% of the time.

- **Above CPI Range:** The CPI fell above range, meaning the forward 12-month CPI was above 2.9%, 30.7% of the time (100 out of 326 periods).

- **Low Inflation:** the 12-month average CPI was under 2%, 37.1% of the time (121 out of 326 periods).

Average Index Performance When Stable Prices are Sustained



** - Denotes an asset class benchmark without total return performance data for the full evaluation period. Past performance is no guarantee of future results. You cannot invest directly in an index.*

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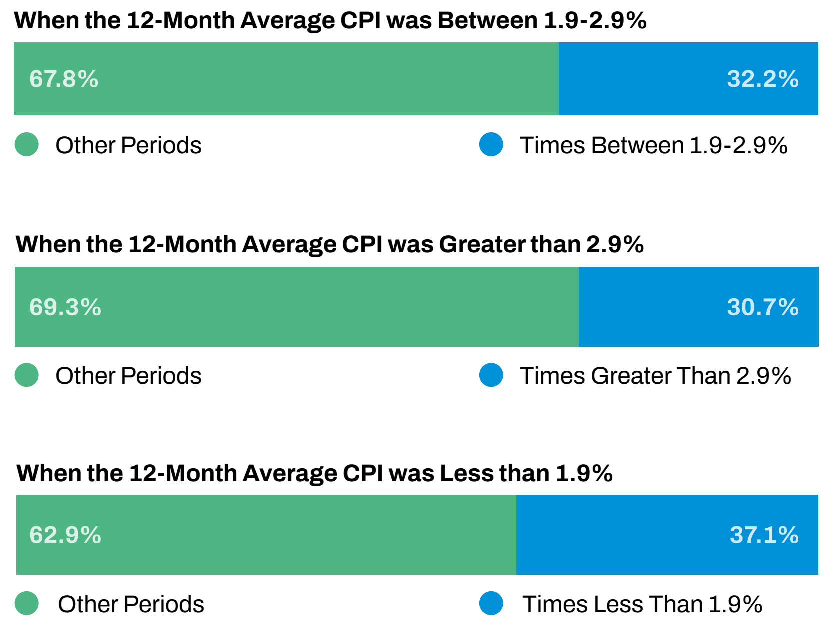

Observation Period: July 1996 to July 2024.

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Limited Sample Size for Comparable Scenarios: Across our dataset, we identified only six instances where the CPI exceeded 2.9% in the previous month, followed by a subsequent monthly CPI that fell within the designated range, and then maintained an average CPI within this range over the ensuing 12 months.

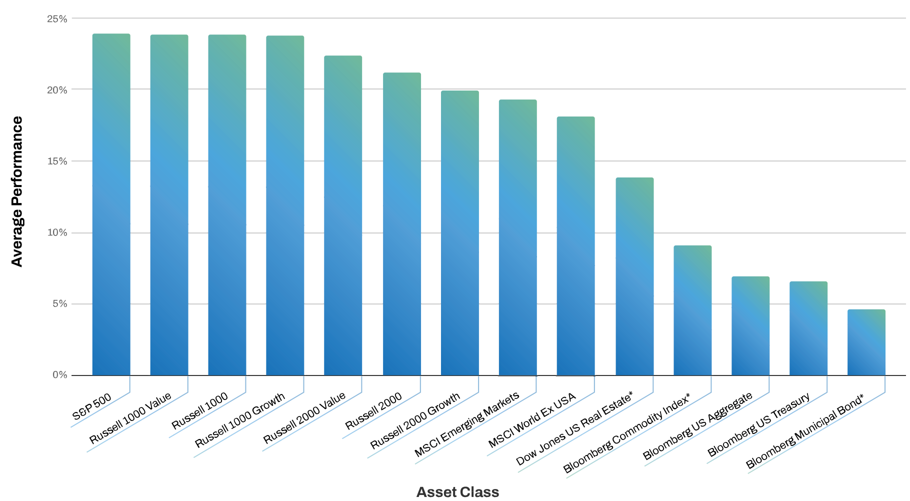
Asset Performance Under Controlled Inflation

Top Performers: During the six periods when inflation fell into and stayed in the target range, the S&P 500 and the Russell 1000 Value nearly matched performance, averaging returns of 23.9%. Following closely were the broader Russell 1000 and Russell 1000 Growth indices, both of which generated average returns of 23.8%.

Frequent Leaders: In periods when inflation fell into and stayed in the target range, the MSCI Emerging Markets and Dow Jones US Real Estate led the pack most frequently, emerging as the top asset class two times each. The Russell 1000 Growth Index and S&P 500 followed closely, leading once apiece.

Consistent Top Performers: Emerging Markets, Real Estate, large-cap growth, small-cap value, and the broader S&P 500 and Russell 1000 each appeared as a top three performer twice. Six other asset classes ranked in the top three at least once.

Average Asset Class Performance When CPI Fell "In Range" and was Sustained



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Asset Class	First	Second	Third	Total Top 3 Appearances
MSCI Emerging Markets*	2	0	0	2
Dow Jones US Real Estate*	2	0	0	2
Russell 1000 Growth	1	1	0	2
S&P 500	1	0	1	2
Russell 2000 Value	0	1	1	2
Russell 1000	0	1	1	2
Bloomberg US Aggregate	0	1	0	1
Bloomberg Municipal Bond*	0	0	1	1
Russell 1000 Value	0	1	0	1
MSCI World Ex USA	0	1	0	1
Russell 2000	0	0	1	1
Russell 2000 Growth	0	0	1	1

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Comparison of Asset Classes & Strategic Implications for Investors

Small Cap vs. Large Cap Performance: Large-cap stocks generally shined in the "criteria" period, with the Russell 1000 outperforming the Russell 2000 in **4 out of the 6** periods examined and also had a higher average performance of 23.8% compared to 21.2% for the Russell 2000.

Value vs Growth: When comparing Growth and Value performance across various periods, Growth outperformed Value **4 out of 6** times. However, while Growth led in most of the observed periods, Value and Growth's average performance was virtually identical. Value had a higher average return of 23.9%, narrowly surpassing the 23.8% for Growth. This indicates that while Growth frequently topped individual periods, Value produced more consistent performance over time.

Diversification Strategy: The data supports diversifying across asset classes, including equities and fixed income, to effectively balance risk and leverage economic conditions for growth. For instance, Emerging Market equities emerge as top performers twice, reinforcing the value of owning some non-U.S.-based assets. However, this comes with additional volatility. Diversifying across different market capitalizations and geographical regions may help mitigate volatility and present opportunities for capital appreciation.

Small Cap vs. Large Cap Performance:

Period	Russell 1000	Russell 2000	Better Performance
Aug. 2018 - Jul. 2019	4.4%	-8.4%	Large-Cap
Feb. 2012 - Jan. 2013	12.1%	12.8%	Small-Cap
Sept. 2006 - Aug. 2007	12.6%	10.4%	Large-Cap
Apr. 2003 - Mar. 2004	26.2%	49.6%	Small-Cap
Mar. 1997 - Feb. 1998	41.2%	36.4%	Large-Cap
Aug. 1996 - Jul. 1997	46.4%	26.1%	Large-Cap
Average	23.8%	21.2%	Large-Cap

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Value vs Growth:

Period	Russell 1000 Growth	Russell 1000 Value	Russell 1000	Winner
Aug. 2018 - Jul. 2019	5.1%	3.7%	4.4%	Growth
Feb. 2012 - Jan. 2013	8.3%	16.0%	12.1%	Value
Sept. 2006 - Aug. 2007	14.6%	10.6%	12.6%	Growth
Apr. 2003 - Mar. 2004	23.1%	29.4%	26.2%	Value
Mar. 1997 - Feb. 1998	43.7%	38.7%	41.2%	Growth
Aug. 1996 - Jul. 1997	48.0%	44.7%	46.4%	Growth
Average	23.8%	23.9%	23.8%	Value

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Aggregate Asset Class Performance When Inflation is Trending Down

As previously noted, since July 1996, there have been only six instances of inflation scenarios in which the CPI in the previous month exceeded 2.9%, subsequent monthly CPI fell within the designated range, and the CPI maintained this range on average over the next 12 months.

These periods include

- August 2018 - July 2019
- February 2012 - January 2013
- September 2006 - August 2007
- April 2003 - March 2004
- March 1997 - February 1998
- August 1996 - July 1997

During these intervals, the S&P 500 boasted the highest average return at 23.88%, closely followed by large cap value stocks at 23.85%. The Russell 1000 rounded out the top three with returns of 23.82%, with large cap growth stocks not far behind delivering an average return of 23.8%.

Asset Class Total Returns When CPI Falls "In Range"

Aug. 2018 - Jul. 2019	Feb. 2012 - Jan. 2013	Sept. 2006 - Aug. 2007	Apr. 2003 - Mar. 2004	Mar. 1997 - Feb. 1998	Aug. 1996 - Jul. 1997	Average
Real Estate 11.2%	Real Estate 16.5%	Emerging Markets 42.9%	Emerging Markets 67.3%	US Growth 43.7%	S&P 500 49%	S&P 500 23.9%
Aggregate Bonds 7.4%	US Value 16%	World ex US 19.6%	US Small Value 50.2%	US Large Cap 41.2%	US Growth 48%	US Value 23.9%
Muni Bonds 7%	US Small Value 15.6%	US Small Growth 15.6%	US Small 49.6%	S&P 500 40.8%	US Large Cap 46.4%	US Large Cap 23.8%
US Treasuries 6.7%	US Small 12.8%	US Growth 14.6%	US Small Growth 49.1%	US Value 38.7%	US Value 44.7%	US Growth 23.8%
US Growth 5.1%	US Large Cap 12.1%	US Large Cap 12.6%	World ex US 43.8%	US Small Value 37.6%	US Small Value 35.3%	US Small Value 22.4%
S&P 500 4.6%	S&P 500 11.9%	S&P 500 12.2%	Commodities 35.4%	US Small 36.4%	US Small 26.1%	US Small 21.2%
US Large Cap 4.4%	World ex US 10.4%	US Value 10.6%	US Value 29.4%	US Small Growth 35.5%	Emerging Markets 19.8%	US Small Growth 20%
US Value 3.7%	US Small Growth 10%	US Small 10.4%	US Large Cap 26.2%	World ex US 15.7%	World ex US 19%	Emerging Markets 19.3%
Emerging Markets .9%	US Growth 8.3%	Commodities 8.3%	S&P 500 24.8%	US Treasuries 11.9%	US Small Growth 16.6%	World ex US 18.1%
World ex US .1%	Muni Bonds 4.7%	US Small Value 5.6%	US Growth 23.1%	Aggregate Bonds 11.6%	Aggregate Bonds 10.9%	Real Estate* 13.9%
Commodities -3.7%	Aggregate Bonds 2.6%	US Treasuries 5%	Muni Bonds 5.2%	Emerging Markets -17%	US Treasuries 10.3%	Commodities* 9.1%
US Small Growth -7%	Emerging Markets 1.9%	Aggregate Bonds 4.3%	Aggregate Bonds 4.5%	Commodities N/A	Commodities N/A	Aggregate Bonds 6.9%
US Small -8.4%	US Treasuries 1.5%	Muni Bonds 1.6%	US Treasuries 3.9%	Muni Bonds N/A	Muni Bonds N/A	US Treasuries 6.6%
US Small Value -9.9%	Commodities -3.7%	Real Estate N/A	Real Estate N/A	Real Estate N/A	Real Estate N/A	Muni Bonds* 4.6%

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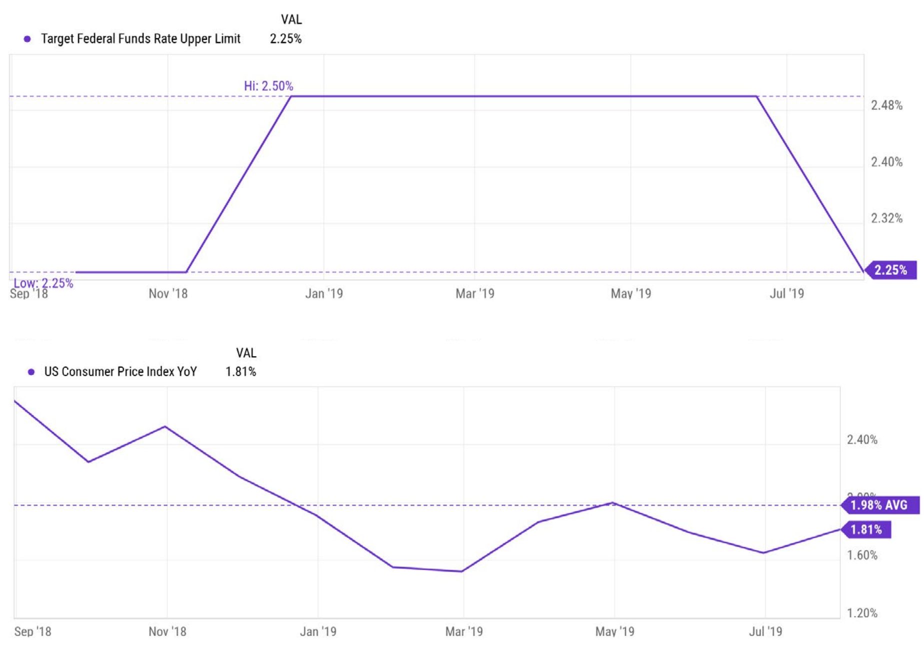
"In Range" Period Analysis:
August 2018 - July 2019

The most recent instance of inflation decreasing from above 2.9% to stabilizing within the 1.9-2.9% range for at least 12 months occurred from August 2018 to July 2019. During this time, the year-over-year CPI was recorded at 2.95% in July 2018 and dropped to 2.7% in August, with the average CPI over the following 12 months settling at 1.98%.

Concurrently, the Federal Reserve raised the upper interest rate limit by a quarter point from 2.25% to 2.50% in December 2018 and later reduced it back to 2.25% six months later in June 2019.

During this period, diversification into non-equity assets, aside from commodities, yielded the highest returns. Real Estate emerged as the top performer with an 11.2% gain. Fixed income assets also saw substantial returns: the Bloomberg US Aggregate delivered 7.4% returns, municipal bonds returned 7%, and US Treasuries provided a 6.8% return. Meanwhile, only the Russell 1000 Growth produced returns greater than 5% on the equity side.

This varied performance underscores the advantage of diversification in a portfolio.



Date Range: 08/31/2018 - 07/31/2019

Sources: Federal Reserve, BLS

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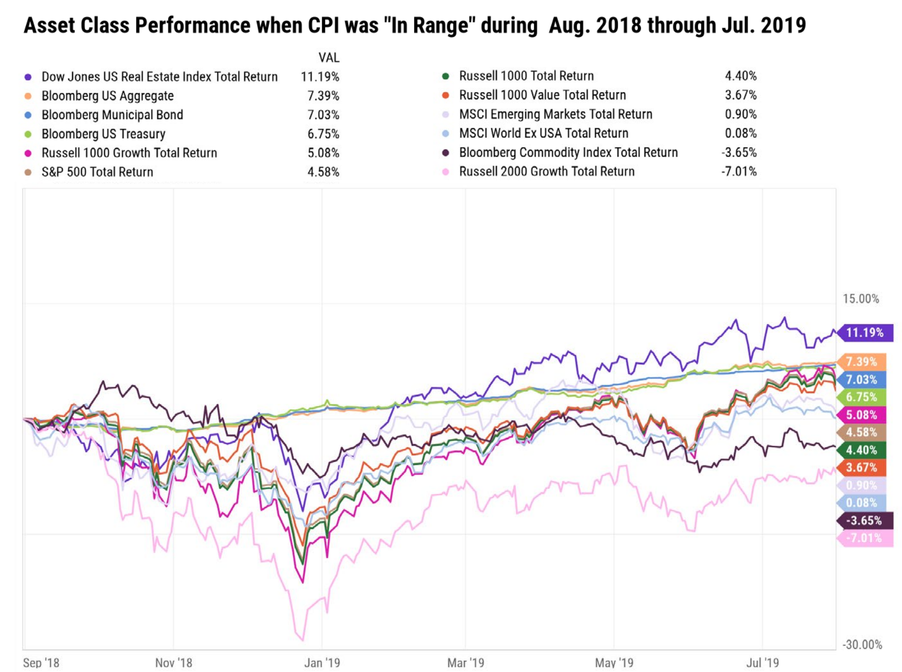

Date Range: 08/31/2018 - 07/31/2019

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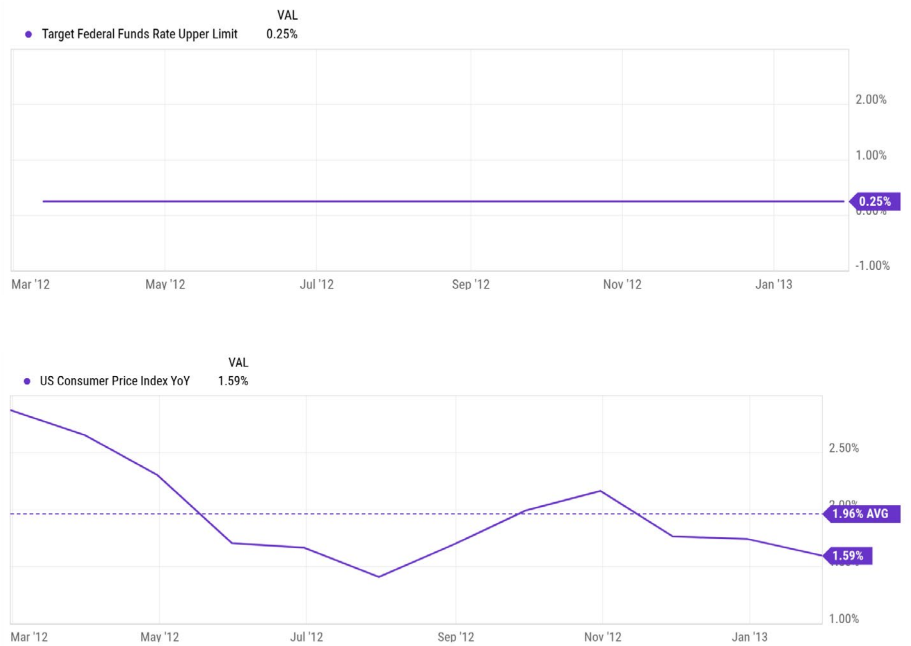
"In Range" Period Analysis:
February 2012 - January 2013

From February 2012 to January 2013, the Federal Reserve maintained the Target Federal Funds Rate Upper Limit at 0.25% as part of its Zero Interest Rate Policy (ZIRP). Inflation began this interval at 2.87% in February, slightly below the 2.93% recorded the previous month. The average inflation rate was 1.96% throughout this timeframe, reflecting moderate fluctuations within a relatively stable inflationary environment.

During this period, Real Estate was again the top-performing asset class, with 16.6% total returns. However, investors were also rewarded across the equity style box. Large- and Small-cap value indices achieved 16% and 15.6% returns, respectively. Additionally, the Russell 2000 and Russell 1000 Value indices outperformed the S&P 500 and their respective growth-oriented counterparts.



Date Range: 02/29/2012 - 01/31/2013

Sources: Federal Reserve, BLS

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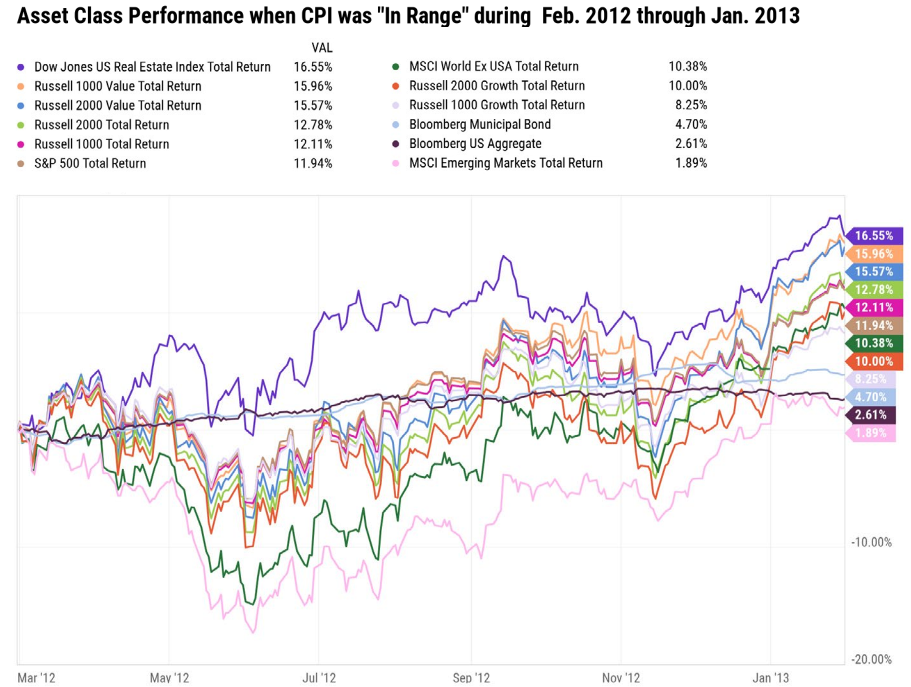

Date Range: 02/29/2012 - 01/31/2013

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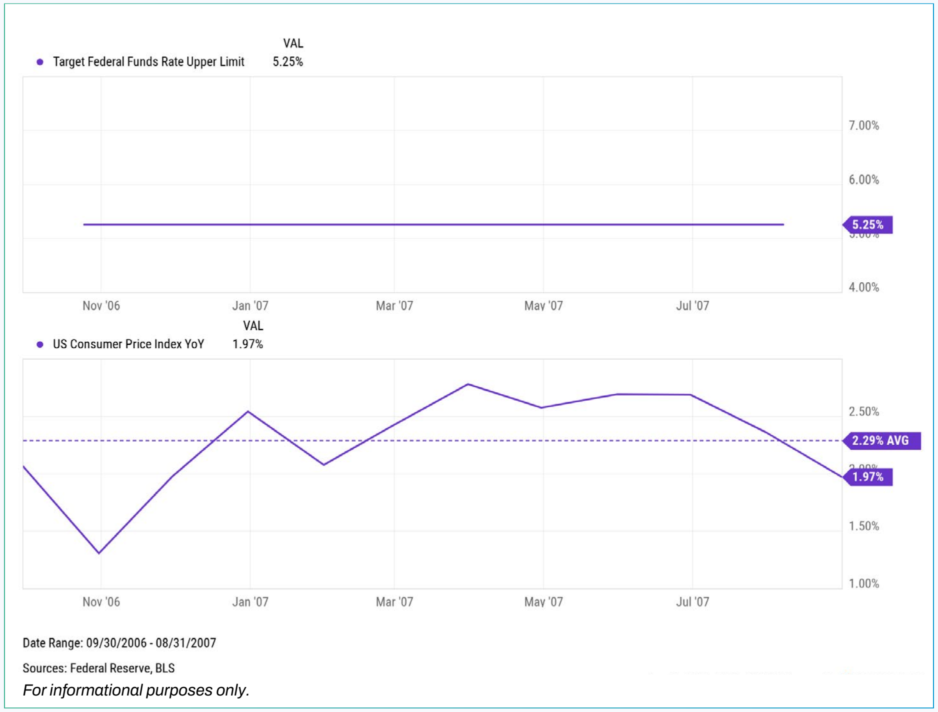
"In Range" Period Analysis:
September 2006 - August 2007

Throughout 2004 and 2005, the Federal Reserve implemented a series of rate hikes, culminating in a peak Federal Funds rate of 5.25% that was maintained during our evaluation period from September 2006 to August 2007.

August 2007 marked the culmination of this hawkish monetary stance, as the Fed began a rate-cutting cycle the following month. This shift was in response to growing concerns about the economic impact of tightening credit conditions, particularly on the housing market. The Fed's statement at the time highlighted these challenges: "The tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally. Today's action is intended to help forestall some of the adverse effects on the broader economy..."

That 5.25% level would stand as the highest Federal Funds rate for nearly 16 years until the more recent rate hike cycle pushed rates to 5.5%.

Backing up to the beginning of the observation period, in September 2006, the CPI recorded a significant decrease to 2.06%, down sharply from 3.82% the previous month. Over the subsequent 12-month period, the CPI averaged 2.29%, as prices were stable, but economic reckoning was around the corner.



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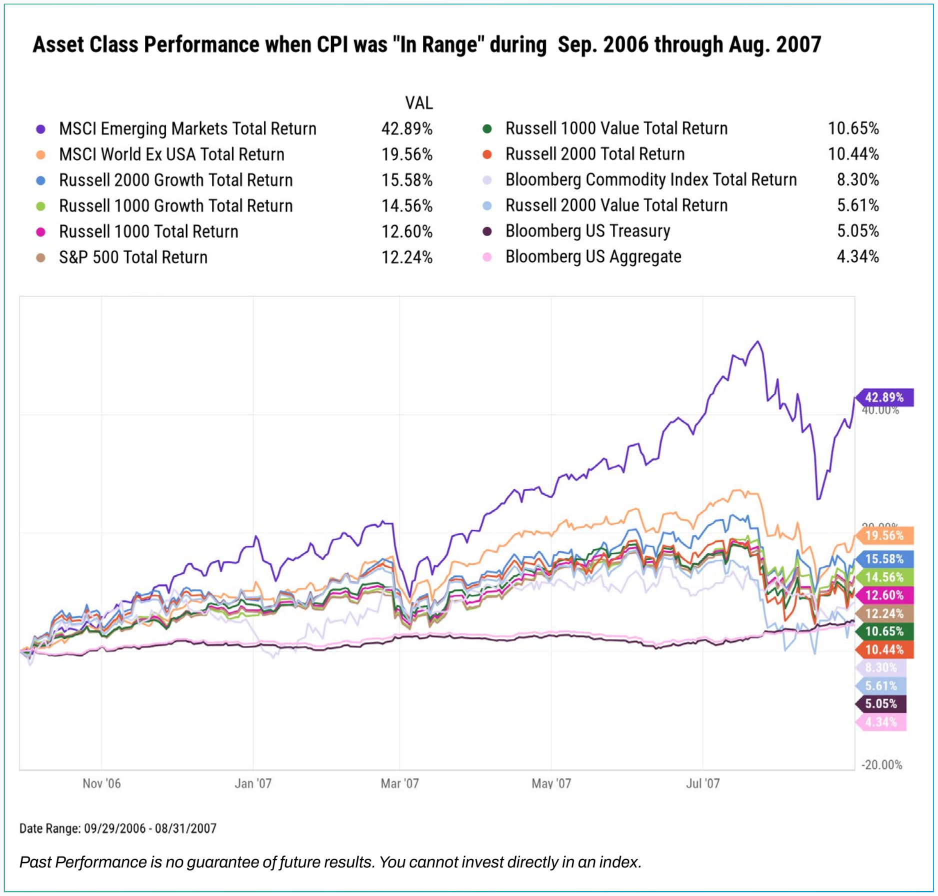
“In Range” Period Analysis:
September 2006 - August 2007 *(continued)*

From September 2006 through August 2007, Emerging Market equities significantly outperformed other asset classes, delivering a total return of 42.9%. The MSCI World Ex USA also showed strong performance, with a 19.6% total return, further highlighting the gains from the international markets during this time.

Within the U.S., the Russell 2000 Growth and Russell 1000 Growth indices demonstrated solid returns of 15.6% and 14.6%, respectively, showcasing the appeal of growth-oriented equities across market caps during this timeframe.

In contrast, the Russell 1000 Value and Russell 2000 Value indices posted more moderate gains of 10.7% and 5.6%, respectively, both underperforming the S&P 500, which delivered a 12.2% return. Moreover, the Bloomberg Commodity Index and Treasuries offered modest returns in the non-equity asset classes.



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Hard and Soft Landing Scenarios

Given the Federal Reserve's current shift towards a more dovish stance, it is timely to examine the outcomes of past monetary policy cycles, specifically the last hard and soft landings manufactured by the Fed.

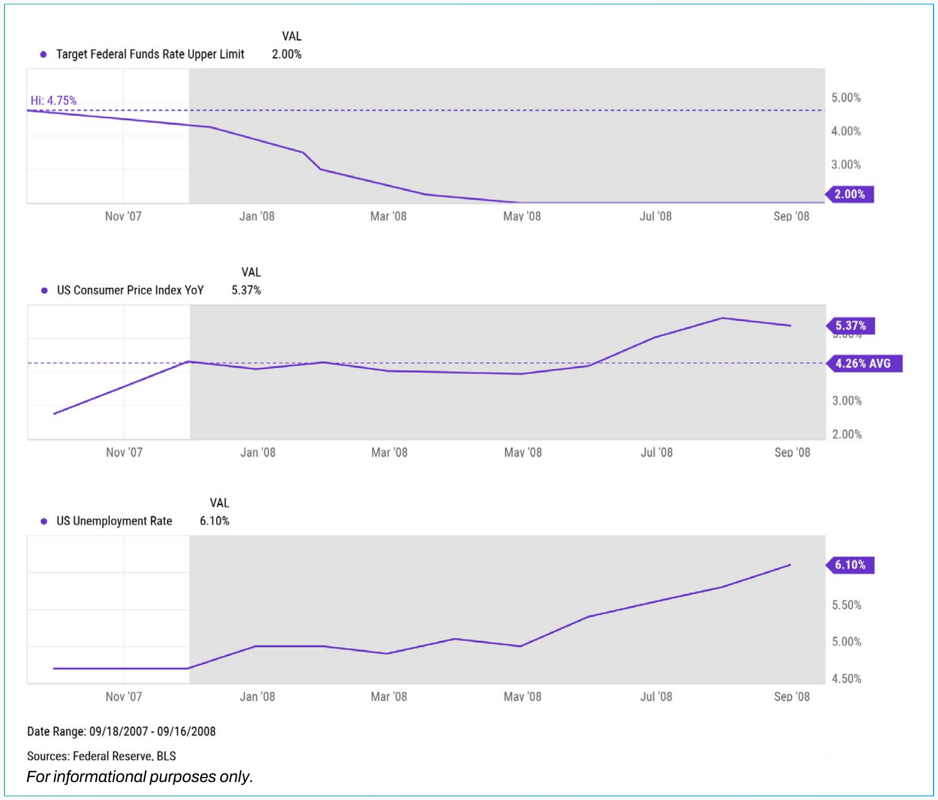
Economists typically review entire cycles of interest rate hikes and cuts to determine whether the Fed successfully achieved a soft landing or inadvertently triggered a hard landing. To align our analysis with the current monetary policy landscape and adequately capture market reactions to these policy shifts, we are examining data from one year after the initial rate cut. We'll start our analysis by exploring a "hard landing" example.

Hard Landing Period Analysis

As mentioned in the previous "in range" period analysis, "reckoning" was coming for the economy in the second half of 2007. And it did, culminating in the Global Financial Crisis (GFC), which coincides with the most recent hard landing period and ties to the September 18, 2007 rate cut.

By August 2008, the CPI year-over-year stood at 5.37%, signaling persistent inflationary pressures that were unusually high for a recessionary period. This punctuated the moderately high inflation during this period, where the CPI averaged 4.26% in the months leading up to and ending with the August 2008 report.

During this critical period, the Federal Funds Rate was aggressively reduced from a peak of 5.25% in August 2007 to 2.00% in an attempt to alleviate the burgeoning financial stress and prevent a deeper economic downturn. Despite these efforts, the unemployment rate escalated from 4.7% to 6.10%, reflecting growing economic instability and labor market challenges.



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Hard Landing Period Analysis *(continued)*

The elevated unemployment, coupled with high inflation and a substantial reduction in the Federal Funds Rate, underscores the complexities the Federal Reserve faced in managing a rapidly deteriorating economic landscape. The rate cuts, although aimed at fostering economic stability, coincided with significant financial market adjustments and increasing unemployment rates, which heralded the onset of the GFC. This scenario illustrates a hard landing, where despite attempts to control economic decline through monetary policy adjustments, the outcomes were ultimately characterized by severe economic contraction and upheaval.

During the period, asset class performance reflected the tumultuous financial environment triggered by the Global Financial Crisis.

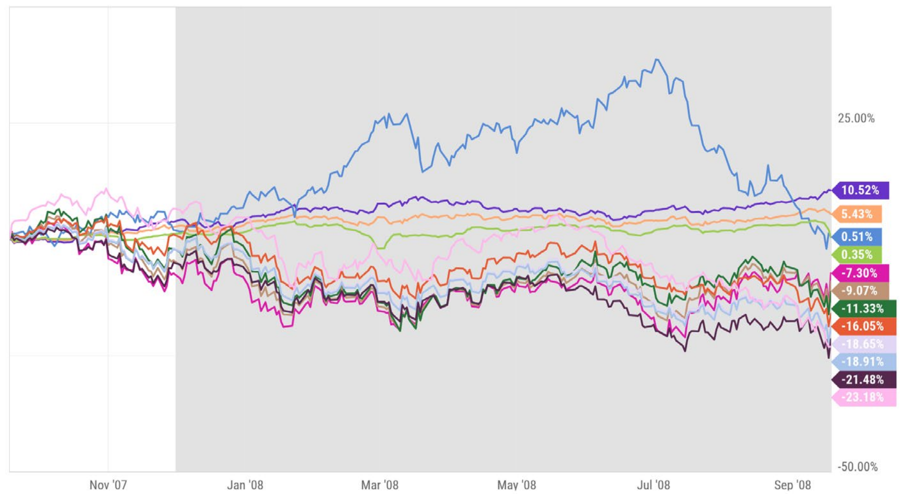
Notably, Treasuries securities significantly outperformed other asset classes, yielding a total return of 10.5% as investors sought refuge in the stability of government-backed securities. The Bloomberg US Aggregate Index also performed positively, with a 5.4% return, underscoring bonds' role as a defensive asset during market downturns.

In contrast, the equity markets endured substantial losses, with the S&P 500 and Russell 1000 indices declining by 18.9% and 18.7%, respectively. The Russell 2000 Index recorded a total return of -9.1%, while its growth and value segments experienced sharp declines of -11.3% and -7.3%, respectively.

Additionally, global equities, represented by the MSCI World ex USA, declined by 23.2%, and emerging markets (charted here) fell by 28.9%, indicating the widespread nature of the market corrections beyond U.S. borders.

Asset Class Performance 1 Year After the First Rate Cut During the Last Hard Landing

	VAL		
Bloomberg US Treasury	10.52%	Russell 2000 Growth Total Return	-11.33%
Bloomberg US Aggregate	5.43%	Russell 1000 Growth Total Return	-16.05%
Bloomberg Commodity Index Total Return	0.51%	Russell 1000 Total Return	-18.65%
Bloomberg Municipal Bond	0.35%	S&P 500 Total Return	-18.91%
Russell 2000 Value Total Return	-7.30%	Russell 1000 Value Total Return	-21.48%
Russell 2000 Total Return	-9.07%	MSCI World Ex USA Total Return	-23.18%



Date Range: 09/18/2007 - 09/18/2008

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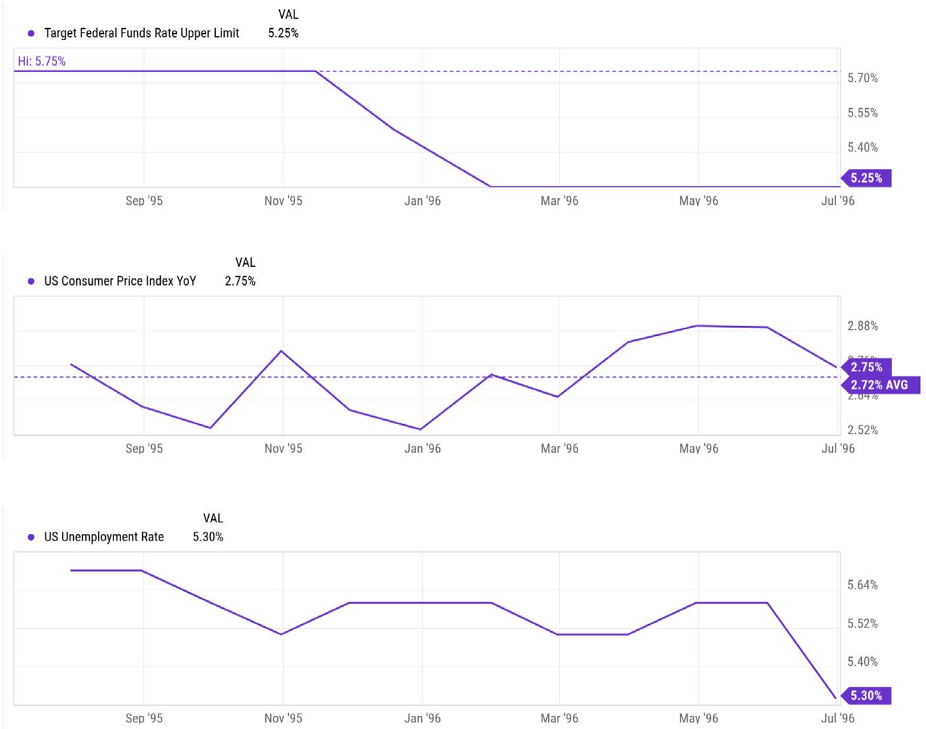
Soft Landing Period Analysis:

A soft landing, as opposed to the more distinctly measurable hard landing—typically marked by the onset of a recession—lacks a clear-cut definition. Alan Blinder, former vice chair of the Federal Reserve, contends that the Fed has achieved, or nearly achieved, a soft landing on six occasions. Among these, the period from 1994 to 1995 stands out as the most widely agreed upon instance among economists.

The Federal Reserve initiated a series of rate hikes in early 1994 in response to the elevated inflation rates observed during 1992 and 1993. Our analysis, just as with the hard-landing scenario, focuses on the subsequent rate-cutting cycle, which commenced on July 6, 1995, with an initial reduction in rates from 6% to 5.75%. By the same date the following year, rates had decreased further to 5.25%.

Over this period, the average CPI was 2.72%, and the unemployment rate significantly improved to 5.3%, down from the mid-6% range seen at the beginning of the rate-hiking cycle in early 1994. This shift indicates a successful tempering of inflation pressures while supporting a recovery in employment levels.



Date Range: 07/06/1995 - 07/02/1996

Sources: Federal Reserve, BLS

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Soft Landing Period Analysis: *(continued)*

Following the initial rate cut on July 6, 1995, the performance across various asset classes over the next year was strong.

The Russell 1000 Growth Total Return led with a notable increase of 22.8%, indicative of strong investor enthusiasm for growth-oriented equities. This was closely mirrored by the Russell 1000 and Russell 2000 indices, which posted returns of 21.6% and 20.3%, respectively, showcasing widespread optimism across small & large-cap companies.

The S&P 500 index also recorded a significant rise, achieving a total return of 21.5%. Value-oriented stocks similarly experienced substantial gains, with the Russell 1000 Value and Russell 2000 Value indices appreciating by 20.4% and 18.7%, respectively. These performances underline a healthy appetite for a range of equity investments during this period of monetary easing. Internationally, the MSCI World Ex USA Total Return index increased by 21.5%, reflecting positive sentiment in global equity markets as well.

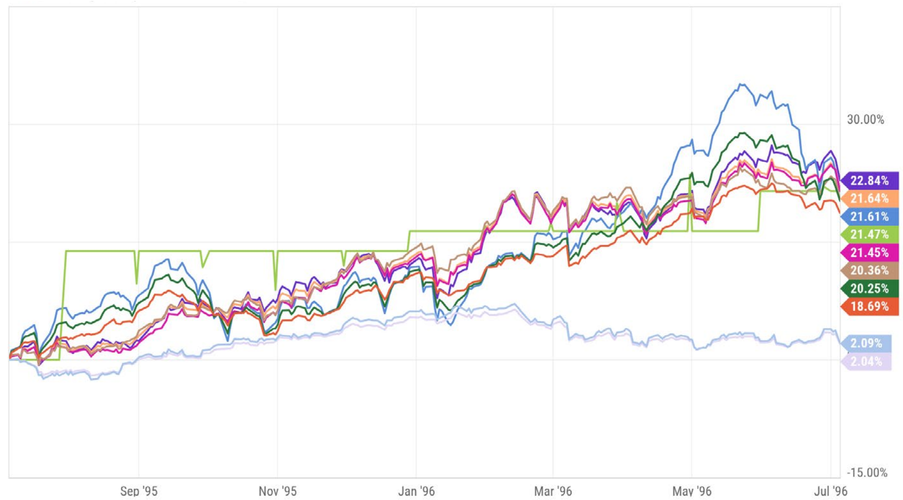
Contrasting with the exuberant equity market, fixed-income assets like the Bloomberg US Treasury and Bloomberg US Corporate indices posted more modest gains of 2% and 2.1%, respectively.

This period of equity gains coupled with steady fixed-income returns underscores the Federal Reserve's adept handling of monetary policy. The combination of initial rate hikes followed by timely rate cuts successfully stabilized and subsequently stimulated the market, achieving a stable and growing economic environment absent any financial crisis.

Looking at the present, the Federal Reserve is again attempting to navigate the economy toward another soft landing.

Asset Class Performance 1 Year After the First Rate Cut During the Last Soft Landing

	VAL		
Russell 1000 Growth Total Return	22.84%	Russell 1000 Value Total Return	20.36%
Russell 1000 Total Return	21.64%	Russell 2000 Total Return	20.25%
Russell 2000 Growth Total Return	21.61%	Russell 2000 Value Total Return	18.69%
MSCI World Ex USA Total Return	21.47%	Bloomberg US Treasury	2.04%
S&P 500 Total Return	21.45%	Bloomberg US Corporate	2.09%



Date Range: 07/06/1995 - 07/05/1996

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Conclusion

This white paper highlights the importance of diversification, particularly amidst fluctuating inflation trends and evolving Federal Reserve policies. Historical performance illustrates that various asset classes have outperformed during specific inflationary conditions, underscoring diversification's broader benefits. Financial advisors can leverage the insights and visuals in this white paper to provide tangible examples to clients of how diversification can not only enhance potential capital appreciation but also mitigate risk.

Furthermore, advisors can use tools like YCharts' Report Builder, Model Portfolios, and Proposals to effectively communicate the advantages of incorporating a balanced mix of asset classes—such as fixed income, domestic and international equities, and emerging markets—in their investment strategies. These tools help clearly illustrate complex financial concepts and strategies, making it easier for clients to understand and appreciate the importance of diversification in achieving stable and desirable investment outcomes.

Note on performance periods *- certain asset class benchmarks did not have total return performance data available for the full evaluation period. Those without a full performance record are noted below, with the earliest available performance date listed and the "in range periods" they were excluded from:*

Dow Jones US Real Estate Index TR: *08/02/10*
(Periods: Aug '96-July '97, Mar '97-Feb '98, Apr '03 - Mar'04, Sept '06 - Aug '07)

Bloomberg Commodity Index TR: *08/20/01*
(Periods: Aug '96-July '97, Mar '97-Feb '98)

Bloomberg Municipal Bond Index TR: *12/11/00*
(Periods: Aug '96-July '97, Mar '97-Feb '98)

** - Denotes an asset class benchmark without total return performance data for the full evaluation period.*