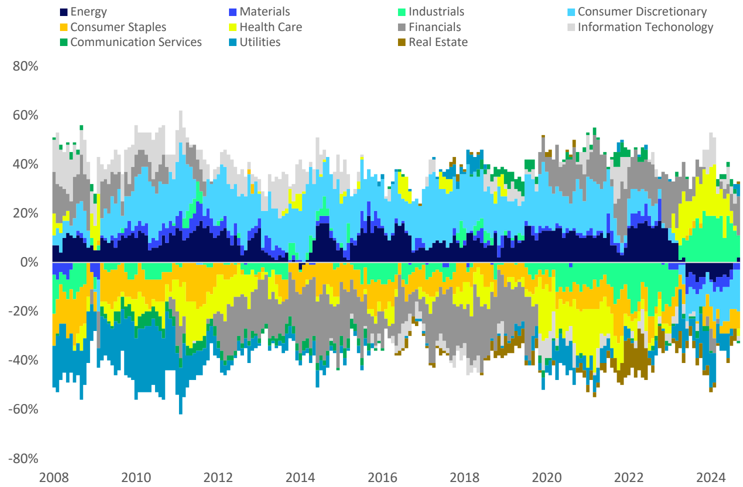
Stocks for Inflation Shocks

An adaptive data-driven strategy for navigating inflation shocks

Inflation presents a complex challenge for equity investors, with traditional research offering mixed conclusions on whether stocks can effectively hedge inflation. Sector playbooks and static "inflation hedges" often look persuasive in hindsight but prove inconsistent once regimes change. Some companies withstand inflationary pressures with surprising robustness, while others consistently falter. We introduce a new framework designed to reveal these asymmetries and translate them into meaningful, actionable insights.

Exhibit 1: Dynamic Sector Composition



Source: State Street Markets

We evaluate a stock's inflation robustness by comparing a collection of firm attributes—such as dividend yield, leverage, and volatility—to those of stocks that performed well or poorly during past inflation events. This method uses the Mahalanobis distance to capture nonlinear, conditional relationships between attributes and inflation sensitivity. In practice, this allows the score to change as the market's inflation narrative evolves: a balance sheet configuration that was effective in one period may not be in another, and the method is designed to reflect that rather than force a constant template.

The results speak to current market challenges. Through out-of-sample regressions across 65 inflation events from 2008 to 2025, the robustness scores significantly explain cross-sectional stock returns. A long-short portfolio based on these scores delivers 9.1% annualized outperformance during inflation events. The inflation robustness factor outperforms traditional attribute-based and sector-based portfolios. Even after controlling for sector and factor exposures, it remains statistically significant, indicating that it captures unique information beyond linear combinations of firm characteristics. Sector decomposition showcases its dynamic composition across time and macroeconomic regimes.

This adaptive methodology enables investors to construct inflation-robust portfolios with stocks, offering a more effective hedge against inflation than conventional equity benchmarks.

For more on this topic, see our 2025 working paper: **"Stocks for Inflation Shocks"** by Megan Czasonis, Ding Li, Grace (Tiantian) Qiu, Huili Song, and David Turkington.

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