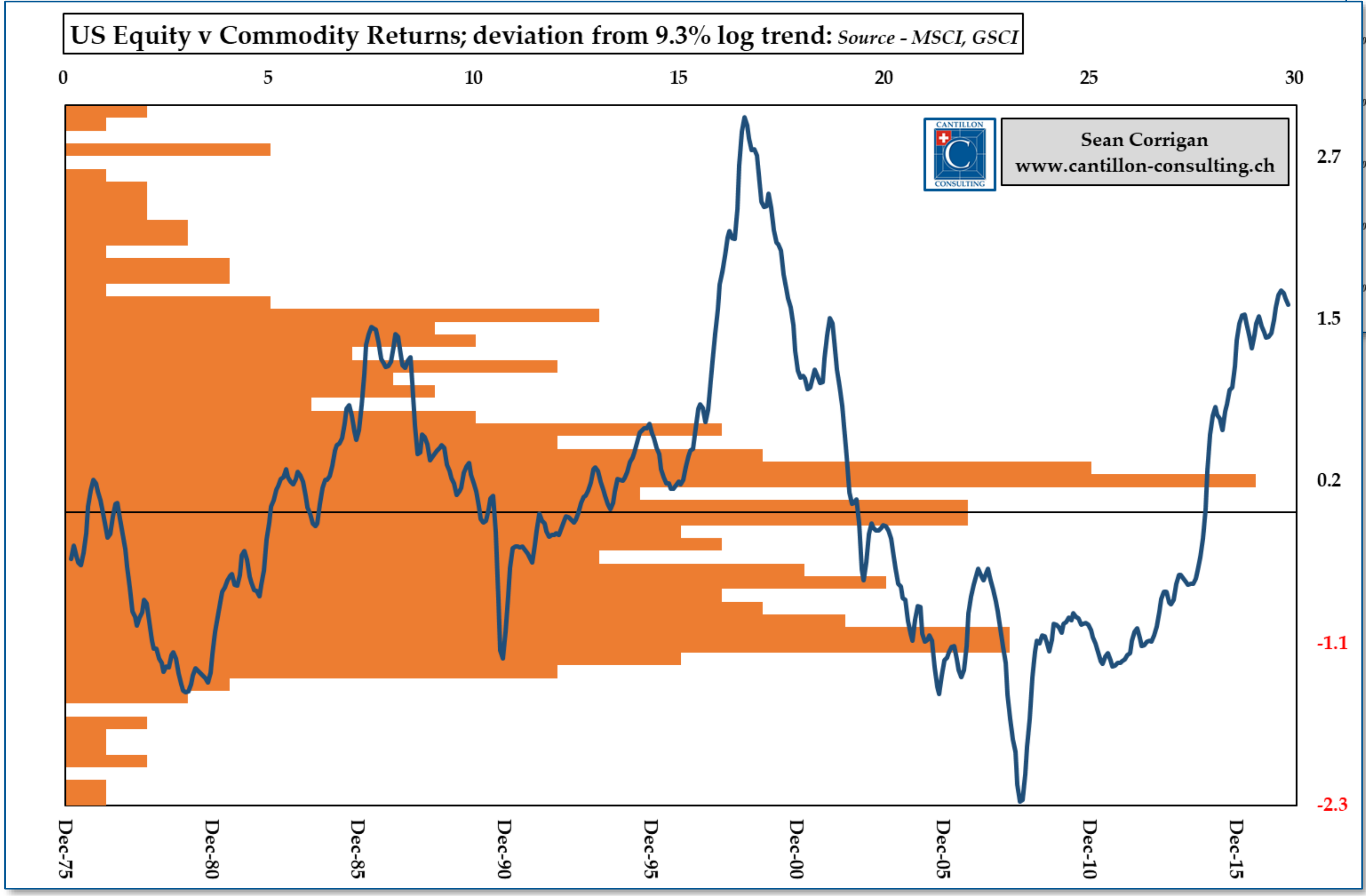
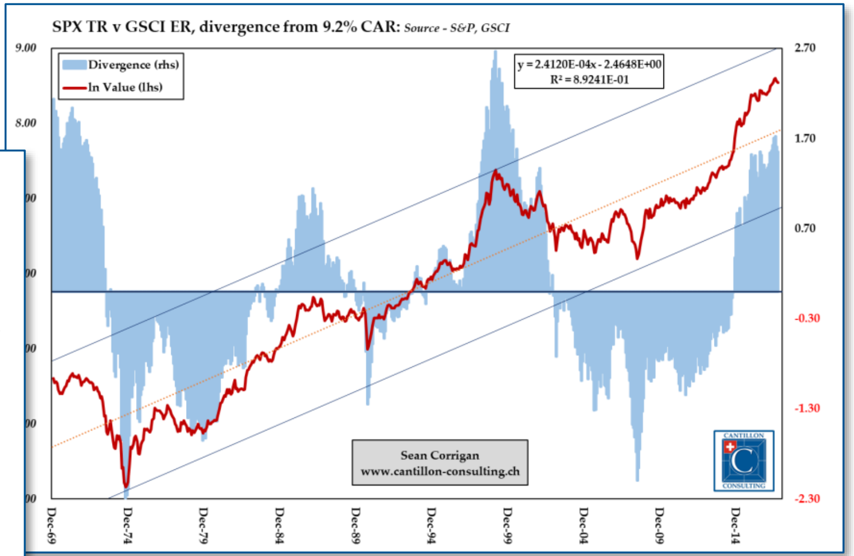
CANTILLON CONSULTING

Asset Allocation: Stocks, Bonds & Commodities

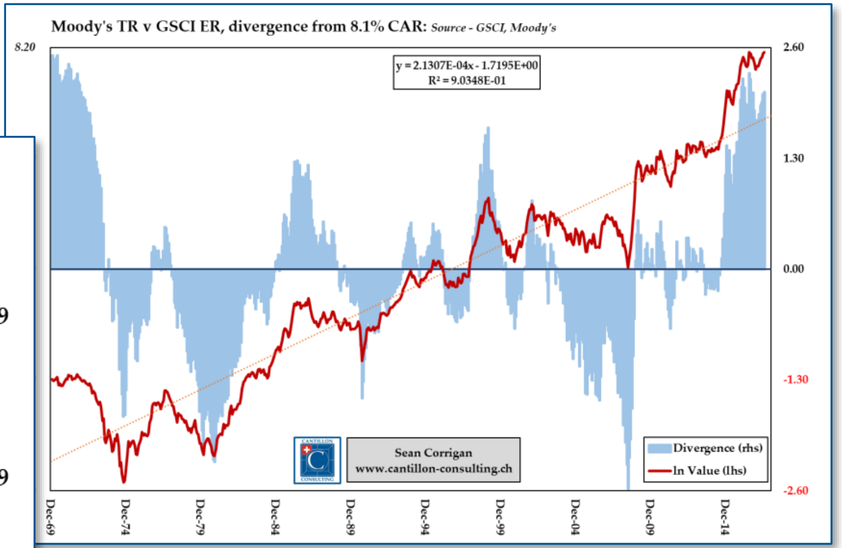
(expanded)

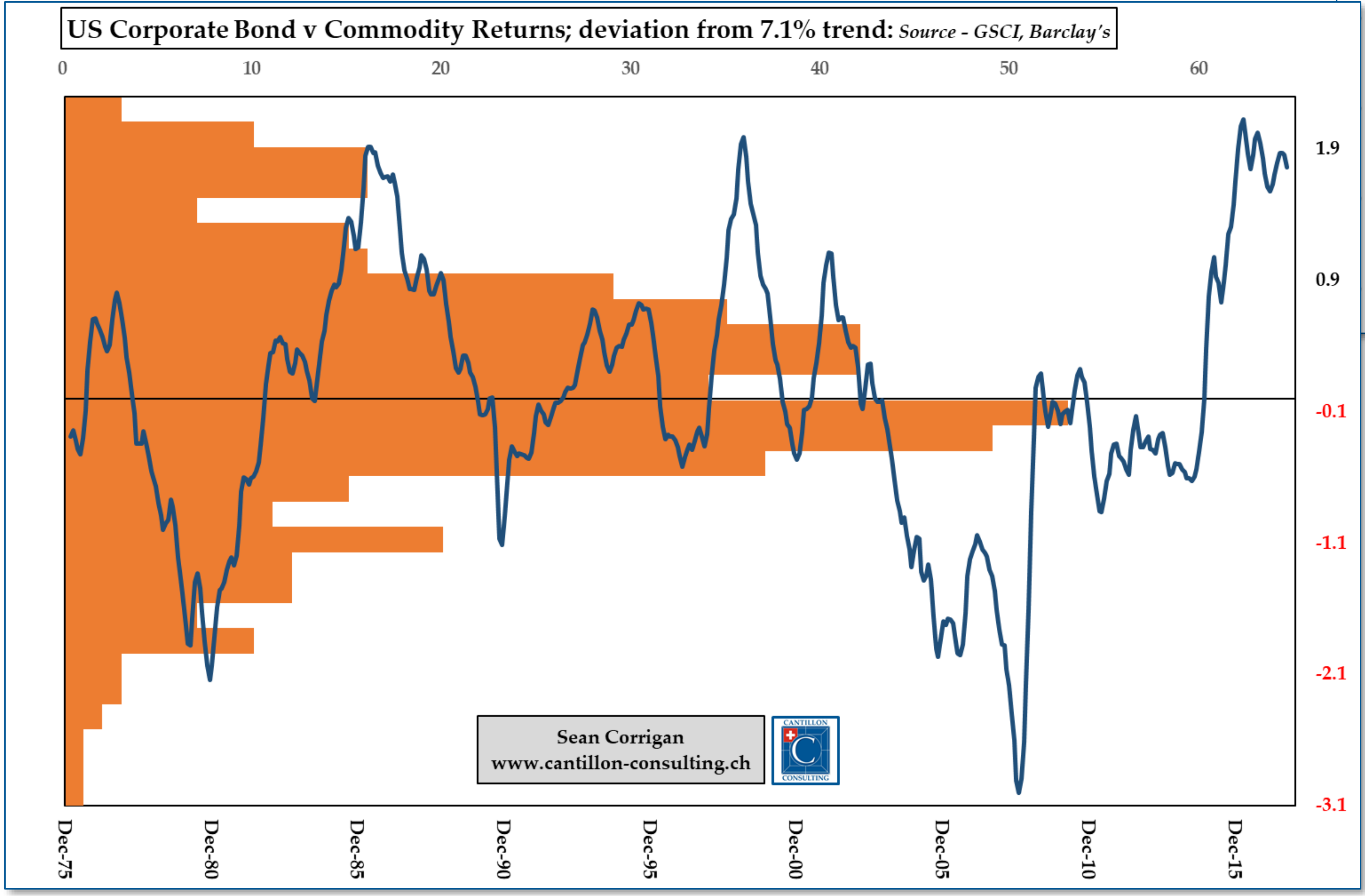




NB: All plots use total return for equities & bonds but <u>excess</u> returns for commodities

Even allowing for equities' trend appreciation in relation to commodities, they have only ever been comparatively more expensive at the height of the Tech Bubble, around the turn of the millennium





Similarly, US fixed income has enjoyed an extreme period of relative outperformance over this same, four-decade horizon. A reversion to the mean is hardly inconceivable, therefore.

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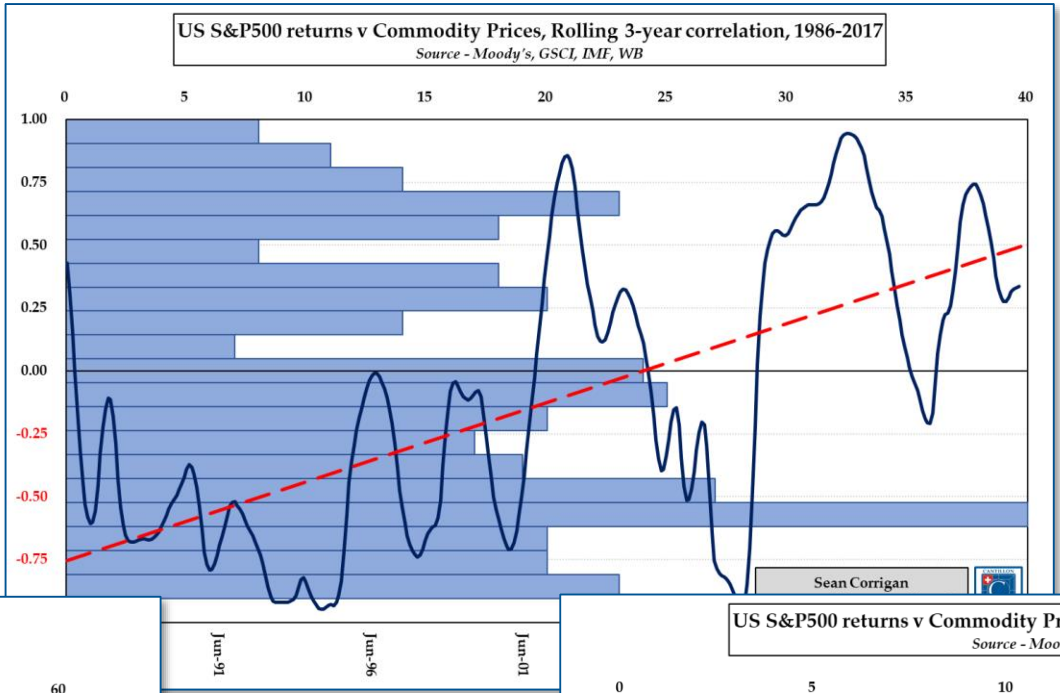
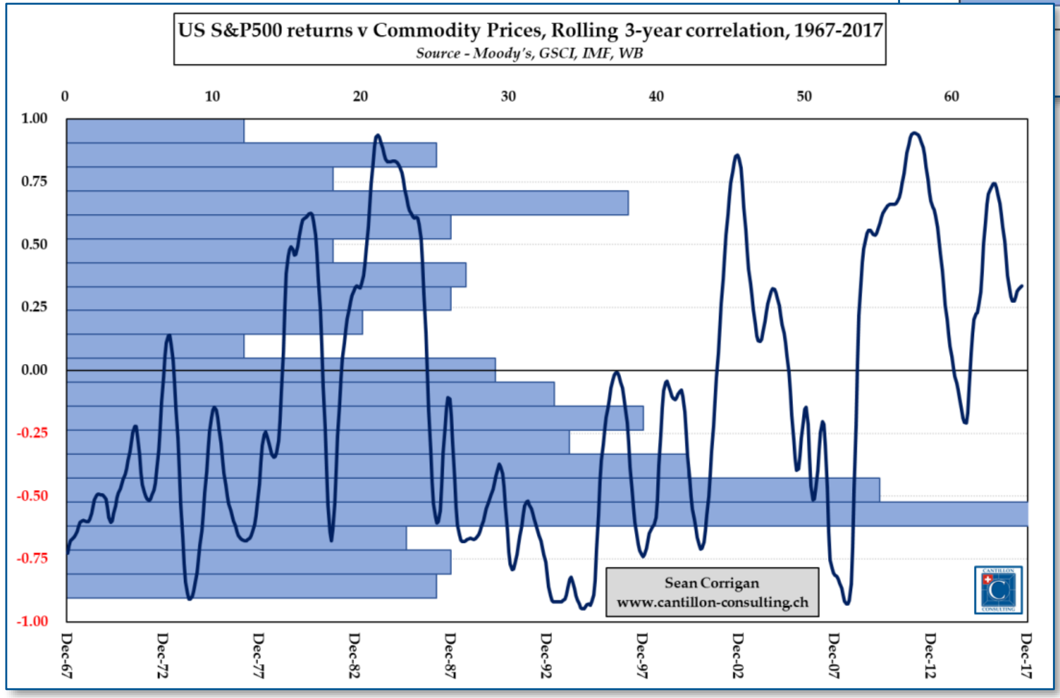
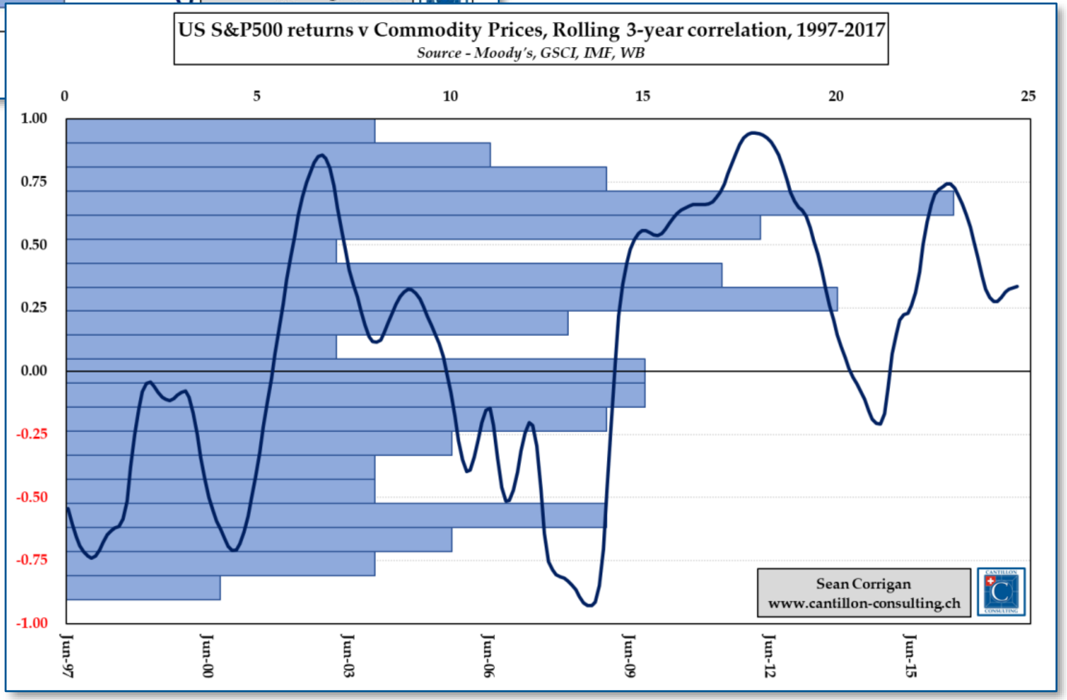
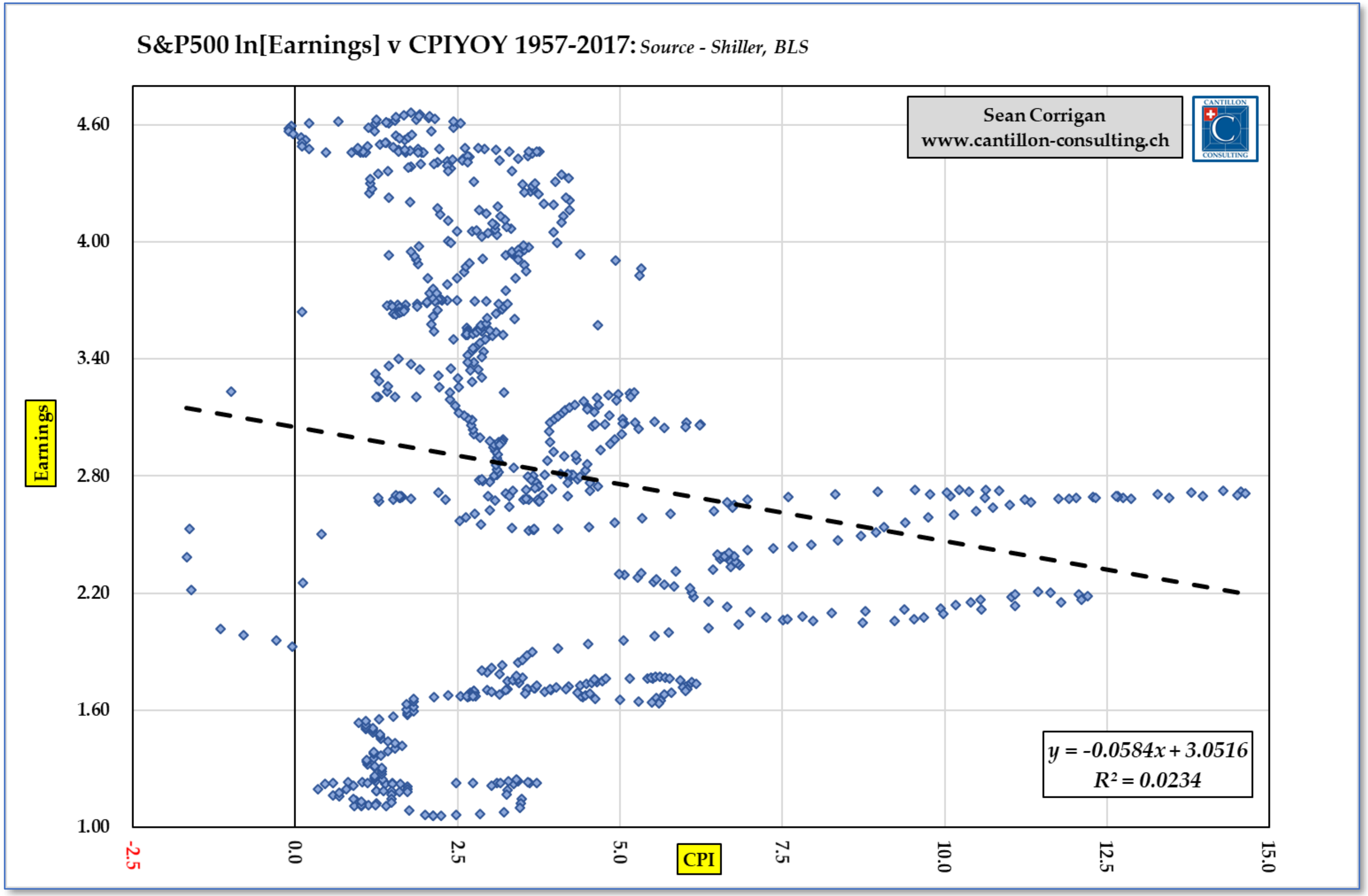
October 4th 2017

Showing the equivocal interplay of growth and inflation with both stocks and commodities, rolling correlations between prices of the latter and equity returns have been negative for less than 60% of the past half-century – and for less than 40% of overlapping 3-year samples in the last twenty years.

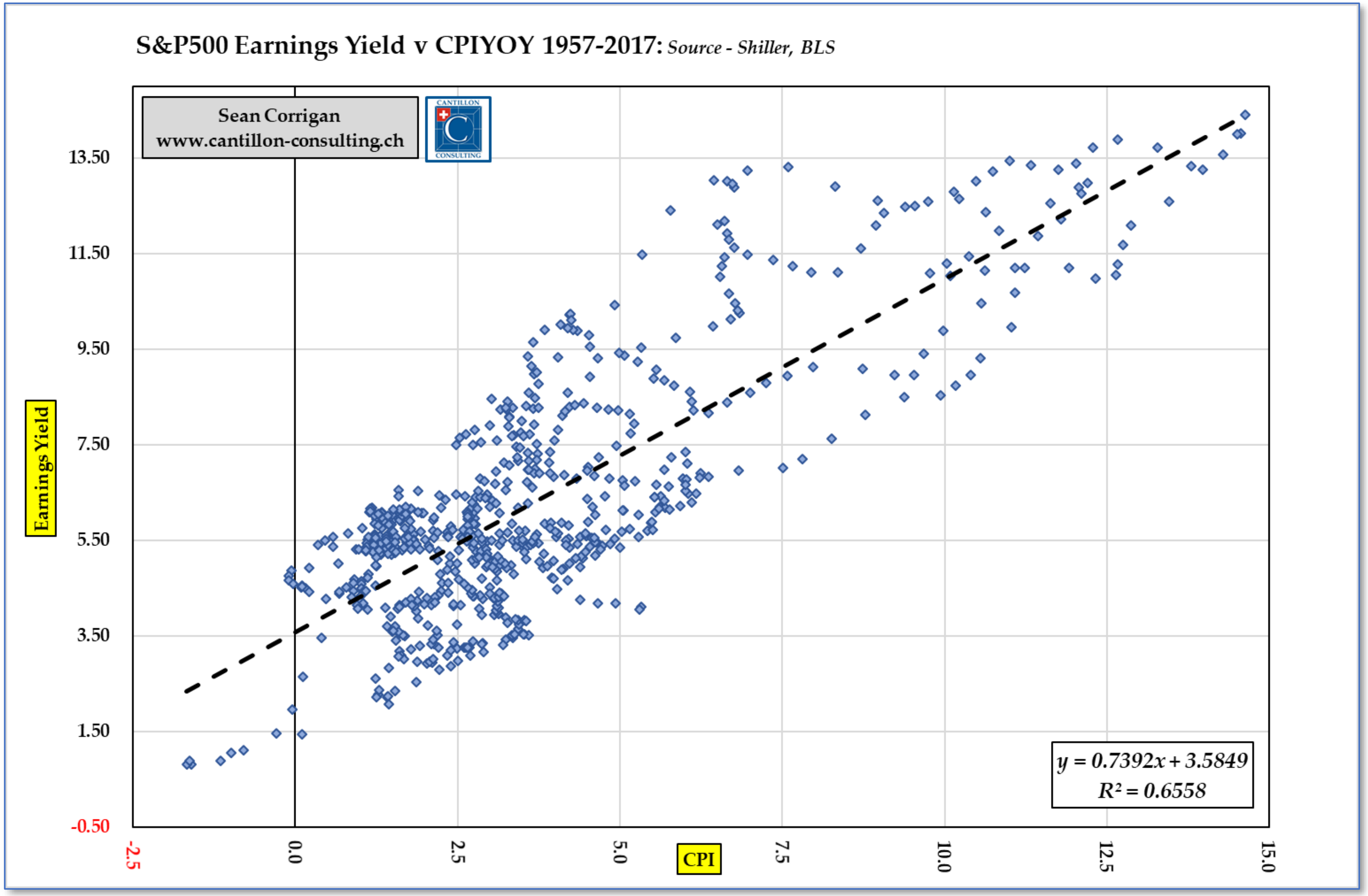






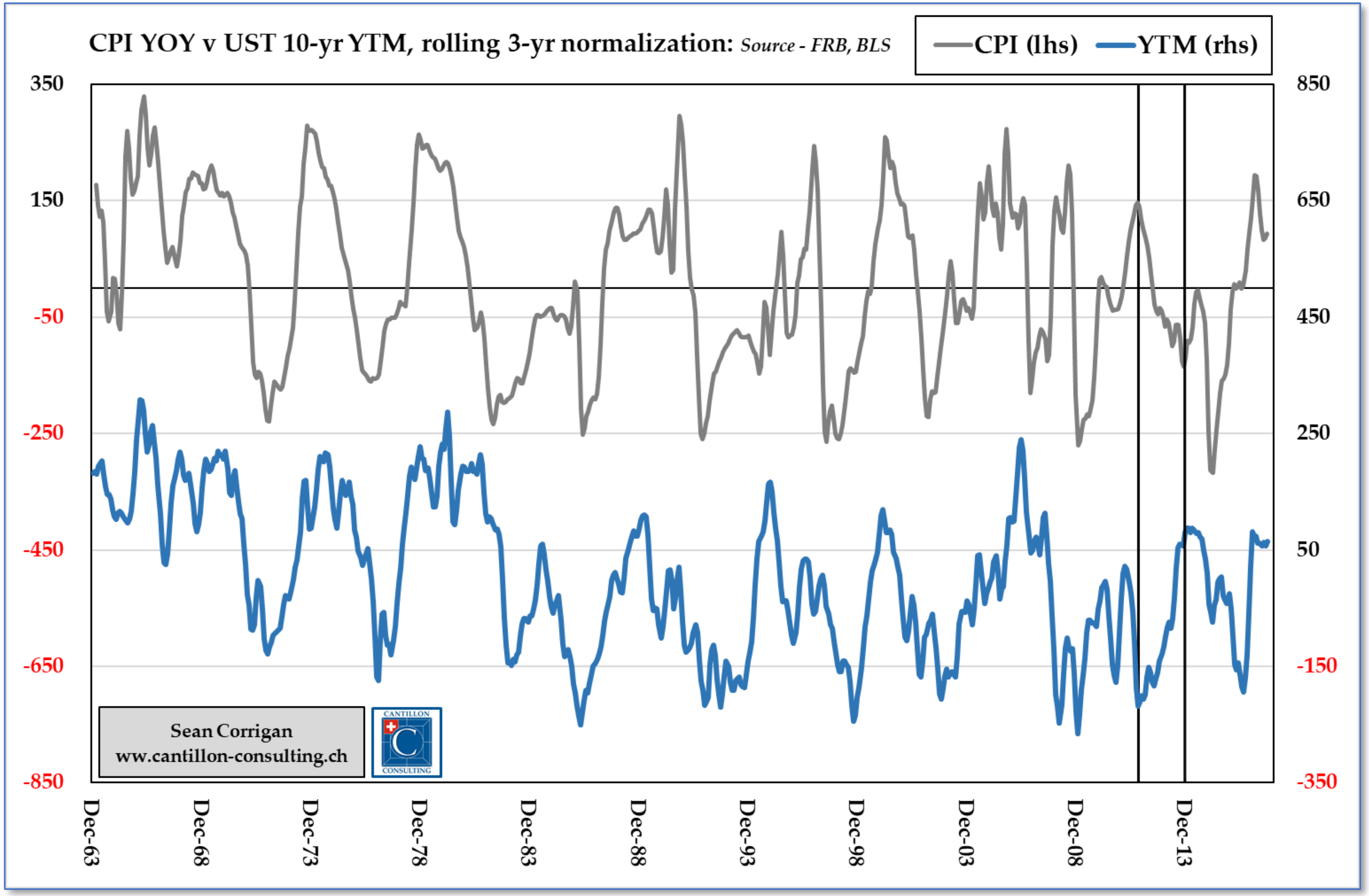


As we said, there is little clear relation between earnings and CPI changes but….

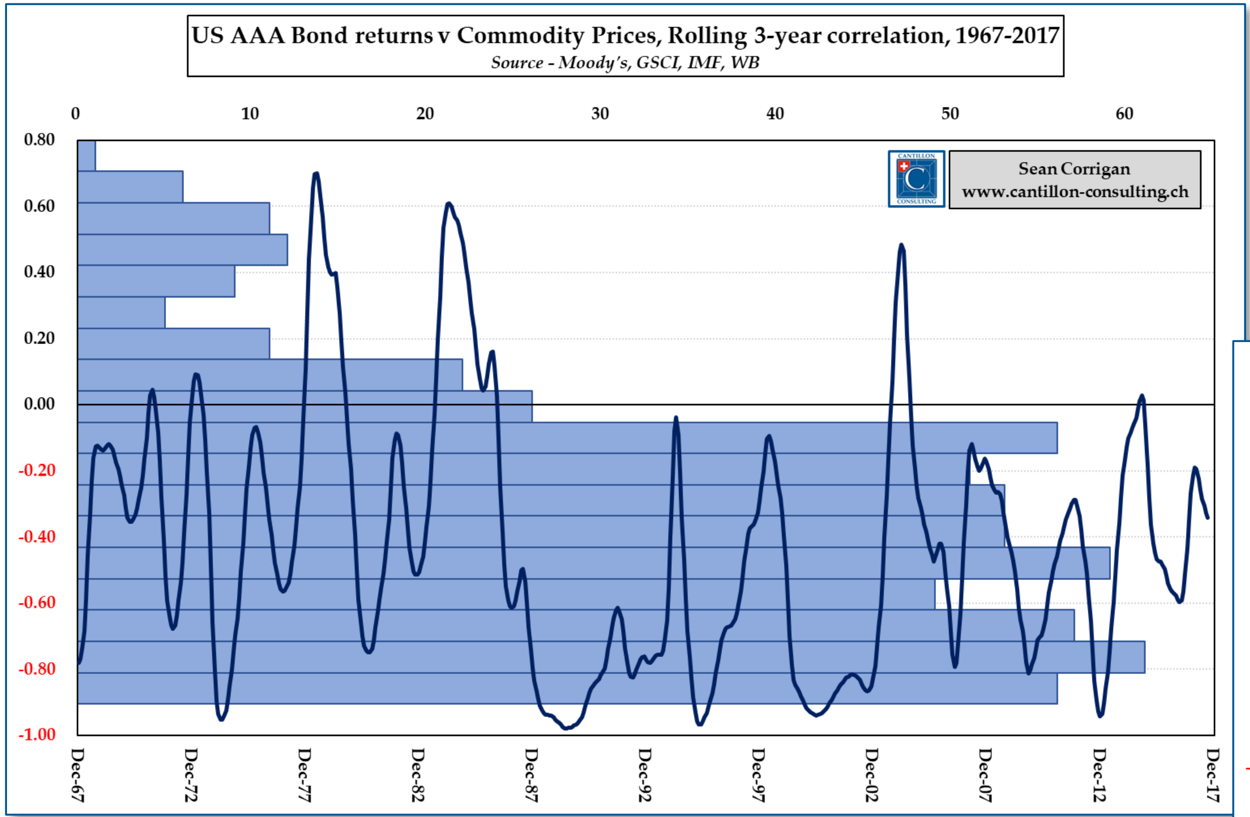


…there is a much clearer impact on the multiple attached to such earnings as are made.

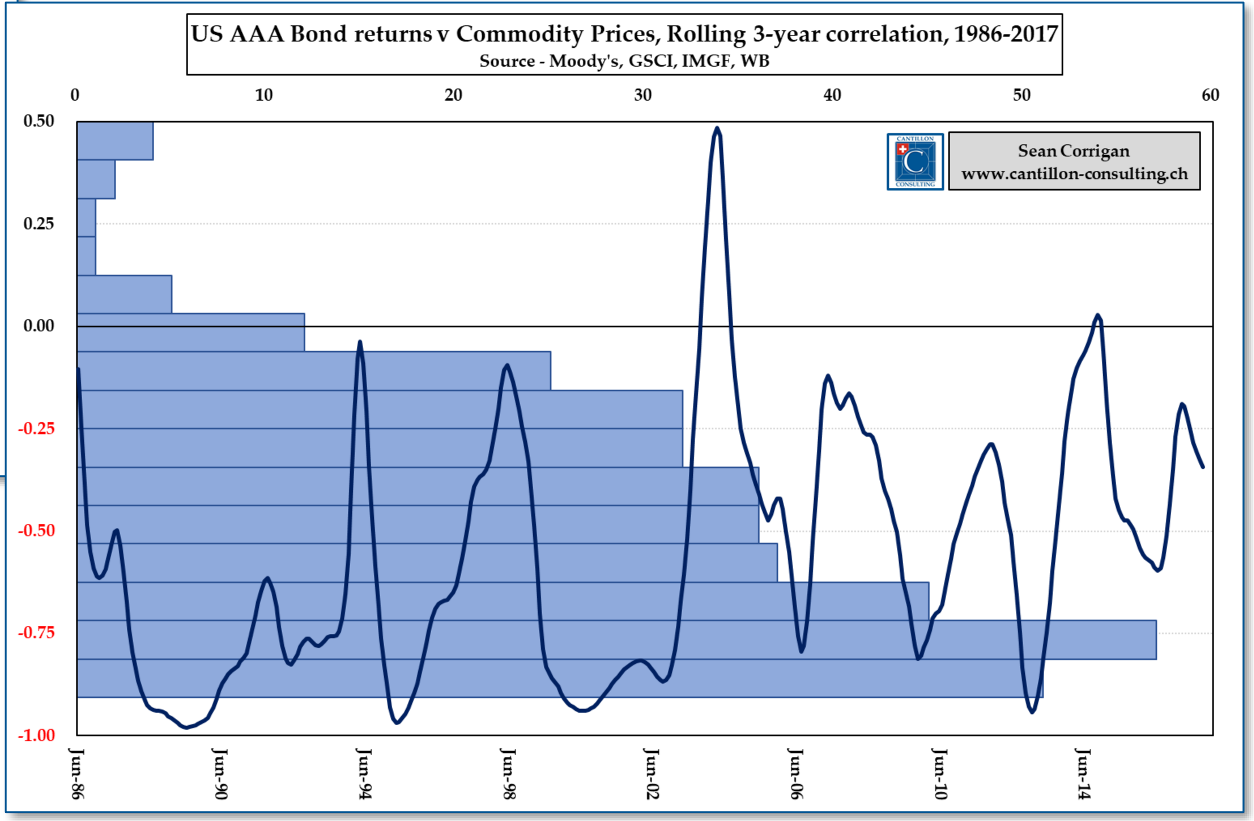
Inflation robs contractual obligations of clarity about the future, hence discount factors must be raised and/or the error bars associated with them must be widened (which amounts to much the same thing)



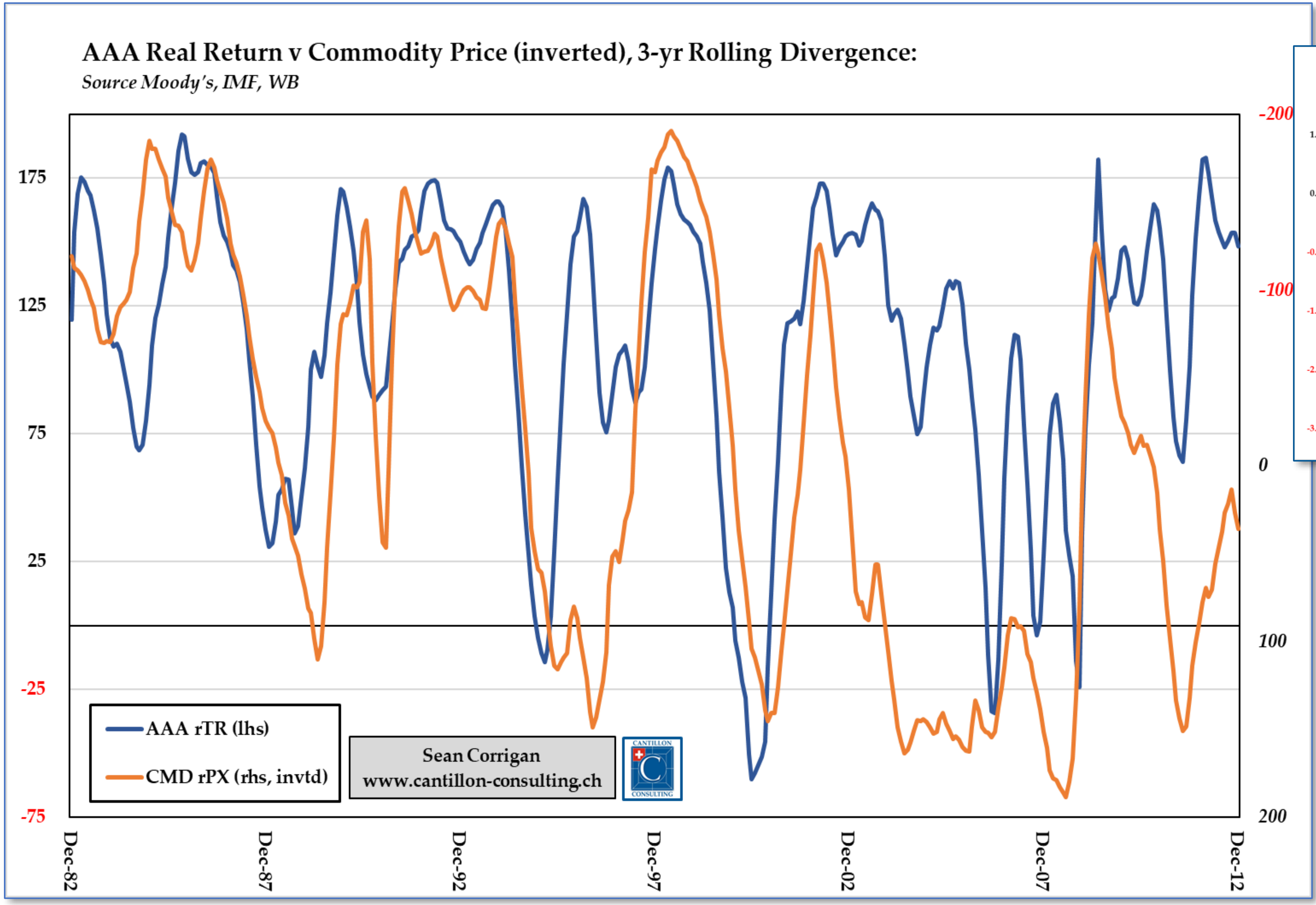
A similar reasoning applies here. Changes in the pace of CPI relative to what has been the recent norm bring about similar changes in bond yields

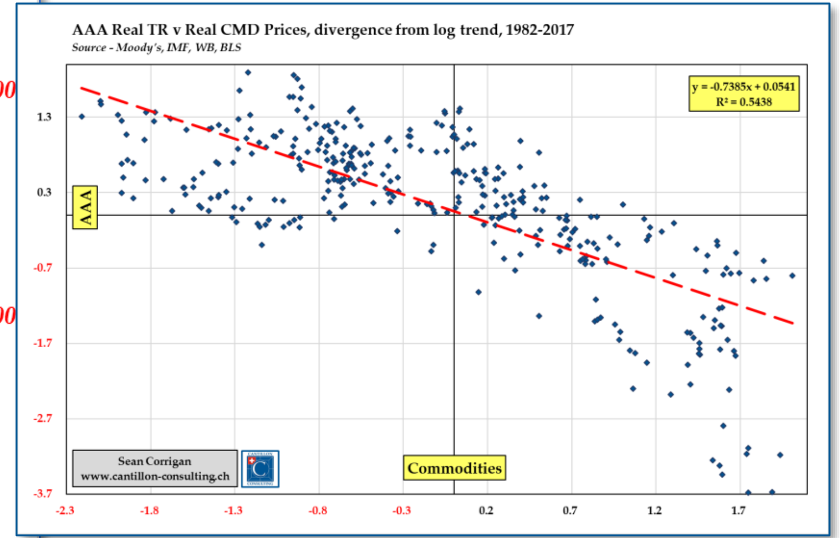


By contrast with equities, in same half-century we considered above, rolling three year correlations between bond returns and commodity prices have been negative for around 85% of the time, a proportion which increases to around 95% during the past three decades' subset.



Commodities should therefore be primarily be used to hedge FIXED INCOME portfolios, especially since bond durations are sensitive to divergences of CPI from trend, occurrences obviously closely associated with developments in raw material prices.





To re-emphasise the point, a plot of deviations from recent (rolling 3-year) norms shows broad co-movement of real commodity prices and bond returns

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