

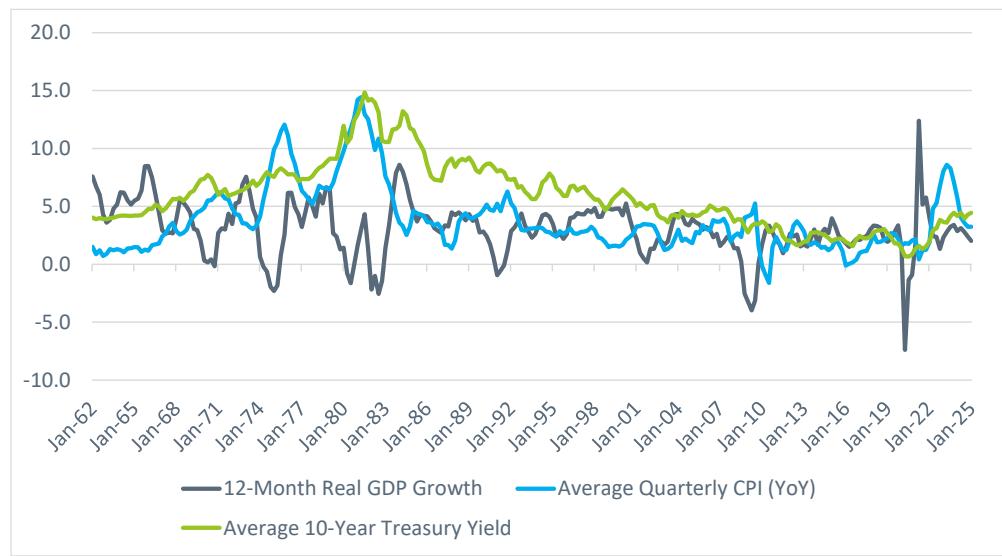
Constrained Economic Growth, Stubborn Inflation

An economic regime marked by stagnant real growth, persistent inflation above targets, and rising unemployment poses a unique challenge for investors. This type of environment can be a difficult challenge for multiple asset classes as high inflation erodes purchasing power, while stagnant growth and high unemployment can suppress consumer demand and corporate earnings. Drawing from historical precedent, economic theory, and current market insights can be important inputs into asset allocation, rebalancing decisions, and asset class structuring when presented with these coincident market factors. This piece explores past market cycles when these conditions were encountered and asset classes with potentially beneficial characteristics during future periods.

Historical Context

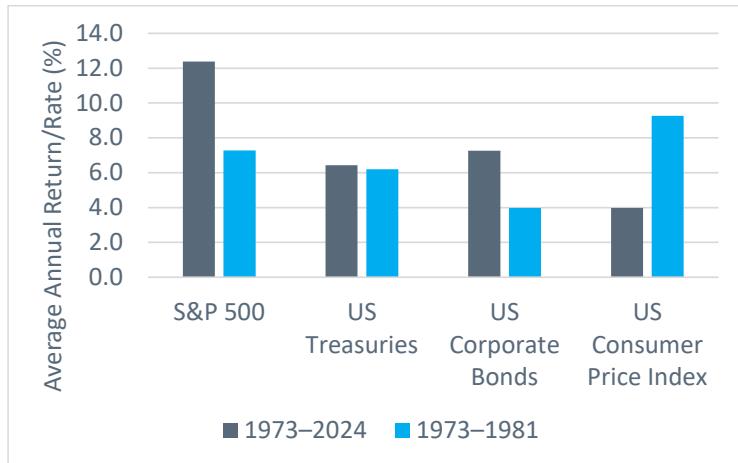
Many will refer to the type of environment described above as “stagflation”—although there are varying degrees of severity and each occurrence will be unique with idiosyncratic drivers. The term gained prominence during the period spanning approximately 1973–1981, when oil shocks and policy missteps led to a prolonged period of economic malaise in the United States and other developed economies. Stagflation of this magnitude is not common, but even less extreme cases can cause challenges for investors. As displayed in the following chart, Real GDP Growth declined and the Consumer Price Index (CPI) rose concurrently starting in the early 1970s, prompting an eventual policy and market response represented by the rising 10-Year Treasury yield.

Figure 1: Real GDP Growth, Inflation, and Treasury Yields (%)



Source: FRED, Federal Reserve Bank of St. Louis.

Figure 2: US Equity and Fixed Income Returns During Stagflation



Source: S&P Dow Jones, Bloomberg, FRED, Federal Reserve Bank of St. Louis.

Policy Dilemma and Market Impact

As previously noted, the ultimate conditions that lead to stagflation should be expected to differ and will likely not perfectly mirror past cases. Weak economic growth and elevated inflation can coincide for multiple reasons beyond supply-side shocks, including factors such as the timing of fiscal spending, currency depreciation, or labor cost pressures. Traditional monetary and fiscal tools do not necessarily remedy these conditions in quick fashion or without cost. Raising interest rates to combat inflation can slow growth even further and worsen unemployment, while stimulus to boost growth can fuel increased inflation. This policy dilemma makes asset allocation during these periods especially complex.

Unlike typical recessions, both equity and fixed income returns can be negatively impacted simultaneously, leaving traditional safe havens, such as fixed rate debt, as a less-than-optimal hedge for the situation. Equities can suffer from an investor preference for assets with lower volatility, valuations pressured by high interest rates, and margins squeezed by inflationary pressures. As for fixed rate debt, inflation can erode the purchasing power of fixed coupons; rising rates can depress current bond prices; and credit risk can rise within corporate bonds, widening spreads and depressing values. As shown in Figure 2, the returns from equities and debt were well below the average annual inflation experienced during the 1973–1981 period, a stark difference when compared to the returns generated for the expanded 1973–2024 period.

Potentially Beneficial Asset Classes During Stagflation

Precious Metals

Gold has historically been one of the most reliable assets in these types of conditions. As a tangible, finite resource with intrinsic value, gold is not tied to any single economy or currency. During the 1970s stagflation, gold prices soared, reflecting its role as a hedge against both inflation and systemic risk. In 2025, gold continued to serve as a store of value amid economic uncertainty leading to notable price appreciation.

Silver offers similar inflation-hedging properties, with the added benefit of industrial demand. Its dual role as a precious and industrial metal has the potential to enhance portfolio diversification. Platinum and palladium may also benefit from supply constraints and industrial use cases. Of course, while precious metals are potential stores of value, investments in precious metals can lag the performance of asset classes that produce reliable cash flows for extended periods of time and an optimal entry point would be prior to the onset of stagflationary conditions.

Energy and Agriculture Commodities

Commodities have the potential to provide the most direct protection against inflation. In some past cases, supply-side shocks (e.g., energy crises, geopolitical tensions) can drive commodity prices higher, even as economic growth stalls. Other inflationary factors—such as fiscal policy efforts, currency depreciation, labor cost pressures, or entrenched expectations—can also lead to persistent inflation above normal target ranges. Depending on the situation, the specific commodity allocation most likely to guard against inflation can differ.

Energy prices tend to rise during inflationary periods, especially when supply is constrained. For example, oil prices surged in the 1970s, delivering significant returns to investors in energy assets in an otherwise unrewarding investing environment. Agriculture commodities may also be a consideration for investors, as food prices often rise during inflationary periods.

Inflation-Protected Bonds

Treasury Inflation-Protected Securities (TIPS) are US government bonds indexed to inflation. Their principal increases with CPI, ensuring that real returns are preserved even as inflation rises. TIPS may be particularly attractive during stagflation because they have historically offered government-backed safety, inflation-adjusted income, and a low correlation with equities. However, TIPS may underperform in deflationary scenarios or if real interest rates rise sharply. Gaining exposure to TIPS with lower duration could be beneficial for investors if a regime of rising rates to combat inflation is expected in the near term. Other countries also issue inflation-linked bonds, such as the UK's Index-Linked Gilts or Eurozone's OATi. These can diversify inflation protection across geographies.

Floating Rate Debt

Floating rate debt (such as bank loans, CLOs, or floating rate notes) typically resets coupons to a reference rate (e.g., SOFR) plus a spread. Should central banks raise policy rates to fight inflation, this will likely directly increase the coupons of floating rate bonds, boosting expected income for investors. In contrast, fixed-rate bonds typically lose real value because inflation erodes the purchasing power of the fixed coupons, as well as the expected capital depreciation hit from rising rates on higher-duration assets. Notably, most private credit is also floating rate in nature. While less tested in prior environments and subject to credit risk, private credit may behave in similar fashion to other forms of floating rate debt.

Importantly, for both the public and private assets, confirming that an investment manager is closely monitoring default risk and avoiding lower-quality issuers can be essential should higher interest rates be necessary to combat inflation given that servicing floating rate debt can become more burdensome for companies in this situation.

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Defensive Equities and Dividend Stocks

While broad equity markets often struggle during periods of constrained growth, certain sectors and companies have the potential to outperform relative to the general market. While idiosyncratic factors—affecting both return and risk—vary across investing eras, these sectors generally offer positive carry and the potential for growth.

Consumer Staples: Companies that produce essential goods—food, beverages, and household products—tend to maintain demand even during economic downturns. These firms often have pricing power, allowing them to pass on inflation costs to consumers.

Utilities: Utilities provide essential services and often operate under regulated pricing structures. Their stable cash flows and high-dividend yields make them attractive during volatile periods.

Healthcare: Healthcare demand is relatively inelastic. Pharmaceutical and medical device companies can often maintain earnings even in weak economic conditions.

Infrastructure and Real Estate

Infrastructure offers predictable cash flows and protection against inflation, making it a potentially attractive allocation for investors concerned about stagflation. In many cases, the long-term contracts tied to reputable or regulated counterparties will include payment adjustments based on inflation. Private real estate can offer inflation protection through rising rents and property values; however, their performance during stagflation is likely to be mixed. High interest rates can hurt valuations, especially in cases where elevated leverage is utilized. In both cases, focusing on private assets over their publicly-traded counterparts can help mitigate the equity risk associated with these investments.

Hedge Funds

Certain hedge fund strategies—such as global macro, managed futures, and commodity trading advisors (CTAs)—can thrive in volatile, inflationary environments. These funds often use derivatives and leverage to profit from macroeconomic trends.

Conclusion

No single asset class offers a perfect solution when the challenges of constrained economic growth, persistent inflation and rising unemployment coincide. Importantly, while any economic regime can persist for an extended period, investors should continue to build asset allocation frameworks able to withstand multiple types of economic regimes inclusive of assets that offer lowly correlated cash flow sources or value stability with different expected sensitivities and portfolio roles. Building out a portfolio solely to weather a single set of economic conditions can be suboptimal for investors with long investment horizons and liabilities or return targets to consider. However, investors could consider emphasizing or introducing asset classes noted in this paper, provided they also fit within a suitable asset class framework.

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