OMNIGENCE
ASSET MANAGEMENT



Preparing for a Second Wave:

Inflation sensitivity across asset classes, and what it means for the balanced portfolio

Q4 2026

EXECUTIVE SUMMARY:

US inflation has fallen from its 2022 peak but remains above target, and several of the conditions behind the last shock are still in place: high and rising public debt, pressure on central bank independence, volatile trade policy and new geopolitical supply risks. Equity valuations suggest markets see little danger. Bond markets are less sure.

The clearest sign of the change is the stock and bond correlation. Between 1986 and 2020 the correlation between annual S&P 500 returns and annual 10-year Treasury returns was −0.11. Between 2021 and 2025 it was +0.77. When inflation rather than growth is the dominant shock, stocks and bonds fall together and the bond allocation stops protecting the portfolio.

Across the high-inflation regimes since 1972, our estimates place long-duration Treasuries at the bottom of the real-return hierarchy, at roughly −6 percent a year, and large-cap equities at roughly −3 percent. At the top sit energy, broad commodities, farmland, infrastructure and lower middle market private equity, although the private-market figures are estimates.

In recent AQR research, a hypothetical portfolio with modest allocations to commodities, trend following and inflation-linked bonds would have reduced a global 60/40 portfolio's loss in the 2022 inflation shock from 15.2 percent to 8.9 percent, at similar expected risk. For investors who can accept longer lock-ups and less liquidity, certain private real assets offer a complementary route to the same resilience.



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TWO REGIMES:

Table 1 shows how far the relationship has moved. The correlation between annual stock and bond returns swung from −0.11 over 1986–2020 to +0.77 over 2021–2025, and an all-bond portfolio went from a 6.99 percent annual return to a loss of 2.44 percent a year.

Table 1: Stock and bond behavior by regime, annual returns, percent

	1986 to 2020		2021 to 2025	
	Return	Risk	Return	Risk
Stock/bond correlation		−0.11		+0.77
100% bonds	6.99	9.10	−2.44	9.83
60 stocks / 40 bonds	10.17	10.15	8.52	14.86
100% stocks	12.29	16.46	15.83	19.35

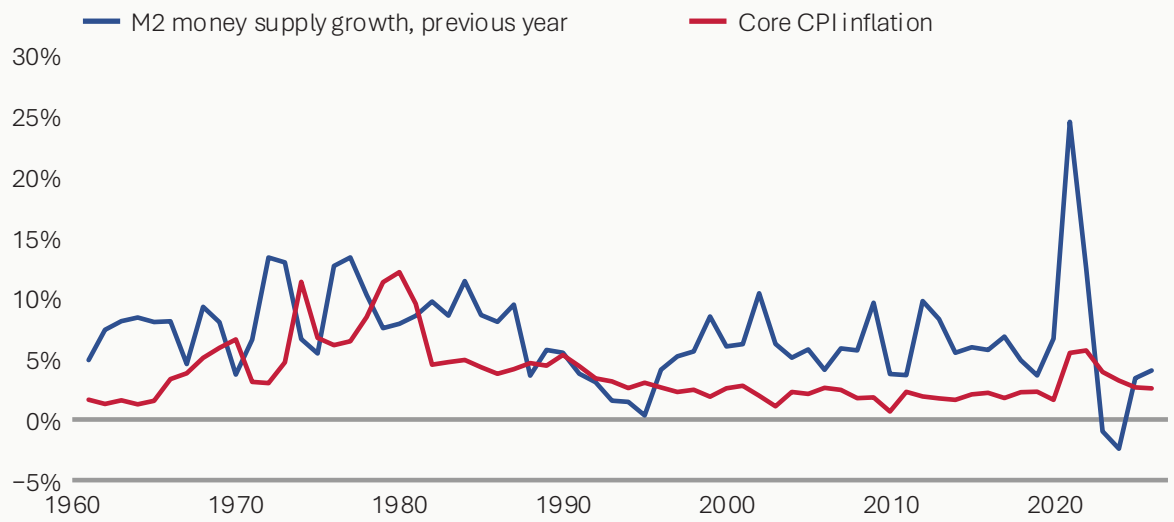
Source: Annual S&P 500 and 10-year US Treasury total returns, Aswath Damodaran, NYU Stern, January 2026 update. Omnigence calculations; see Omnigence, The End of the Bond Hedge (September 2026). Risk is the standard deviation of annual returns.

WHY INFLATION RISK HAS NOT GONE AWAY:

When deficits are financed by expanding the money supply, inflation tends to follow. US M2 rose 24.5 percent in 2020, the fastest increase since the series began in 1959, and core inflation reached 5.7 percent by the end of 2022 (Chart 1). The 1970s followed the same sequence. Between 1980 and 2019 the link was looser, because money growth was moderate and, in later years, globalization held prices down: China in particular exported low-cost manufactured goods and recycled its trade surpluses into US Treasuries, restraining both US inflation and bond yields.

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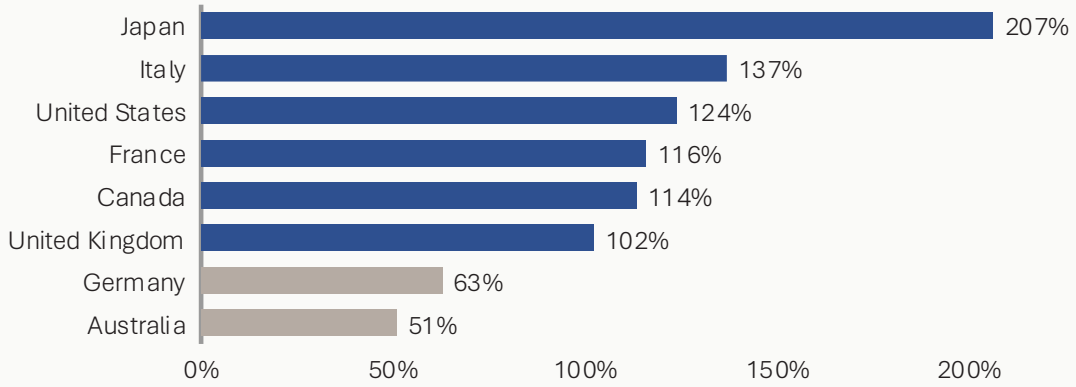
Chart 1: US money supply growth and core inflation, 1961 to 2026, percent



Source: Board of Governors of the Federal Reserve System, M2 (FRED M2SL); BLS core CPI (FRED CPILFESL); Omnigence calculations. December-to-December growth rates, with M2 growth shown in the year after it occurred. 2026 core CPI as of September.

Until recently, central banks had been largely unconstrained: after periods of monetary easing to generate growth, they could tighten policy to push inflation back down without endangering government finances. That freedom has gone. Gross government debt is now at or above 100 percent of GDP in 23 economies, including six of the G7, from 102 percent in the United Kingdom to 207 percent in Japan (Chart 2). Only Germany, at 63 percent, and Australia, at 51 percent, sit near or below the 60 percent level once treated as prudent.

Chart 2: General government gross debt, G7 and Australia, 2025, percent of GDP



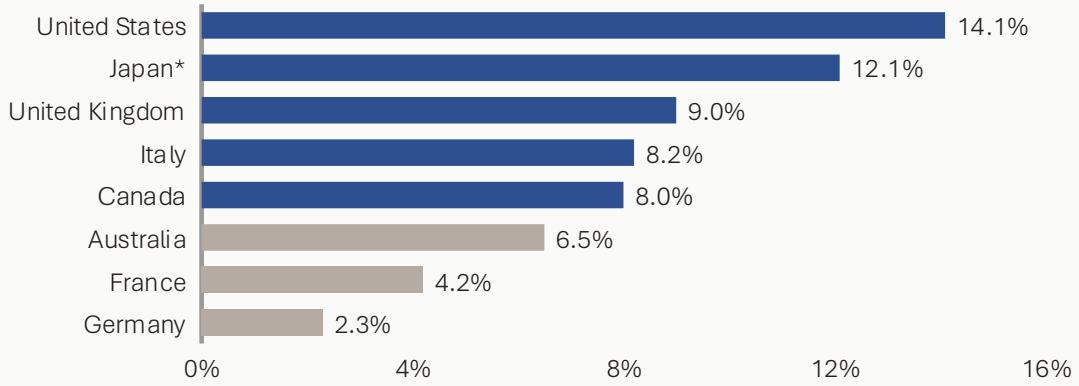
Source: IMF World Economic Outlook database, April 2026 (2025 values), general government gross debt. Japan reflects the IMF's revised consolidated face-value definition. Economies at or above 100 percent of GDP shown in blue.

Debt at this scale changes the arithmetic of monetary policy. Each 100 basis point rise in rates feeds into interest expense as debt is refinanced, and gross interest already absorbs about 14 percent of US government revenue, 12 percent of Japan's central government revenue and 8 to 9 percent in the United Kingdom, Italy and Canada (Chart 3). US federal gross interest payments reached about $1.2 trillion in fiscal 2025, and deficits keep adding to the stock: the US ran a general government deficit of 6.8 percent of GDP in 2025, and the United Kingdom and France more than 5 percent (Chart 4). A central bank that raised rates far enough to crush inflation would push its government toward a fiscal crisis, and the 2022 to 2023 tightening, which nearly doubled gross interest on US

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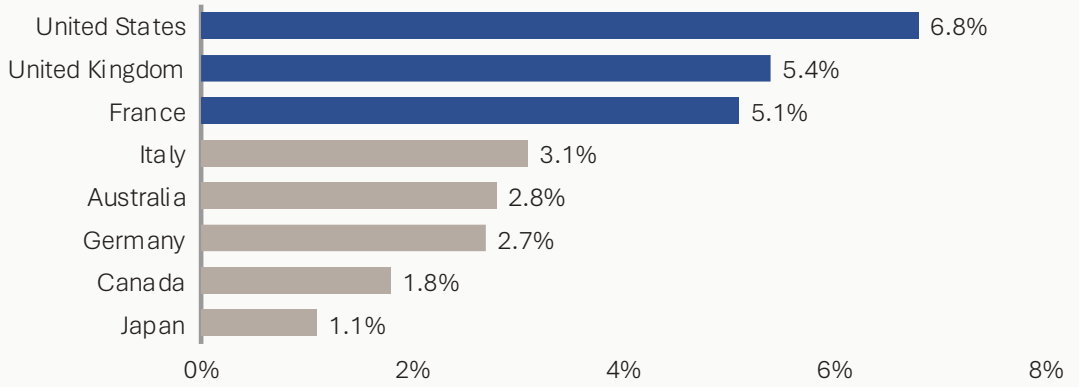
debt held by the public from about $500 billion in fiscal 2022 to about $1.0 trillion in fiscal 2025, shows how quickly that point approaches. Tightening becomes fiscally untenable before it becomes economically effective. This is fiscal dominance: when the level of government debt, fiscal deficits and interest payments means governments cannot afford higher rates, central banks lose the freedom to set them independently.

Chart 3: Gross interest payments as a share of government revenue, G7 and Australia, latest fiscal year, percent



Sources: IMF Fiscal Monitor, April 2026 (US general government interest and revenue, 2025; revenue for all economies); Eurostat interest payable, 2025 (Italy, France, Germany); OBR, 2024-25 (UK debt interest); Statistics Canada, consolidated general government, 2024; ABS Government Finance Statistics, 2024-25 (Australia); *Japan Ministry of Finance, FY2025 budget, central government interest over non-bond revenue. Omnigence calculations. Economies at or above 8 percent shown in blue.

Chart 4: General government fiscal deficit, G7 and Australia, 2025, percent of GDP



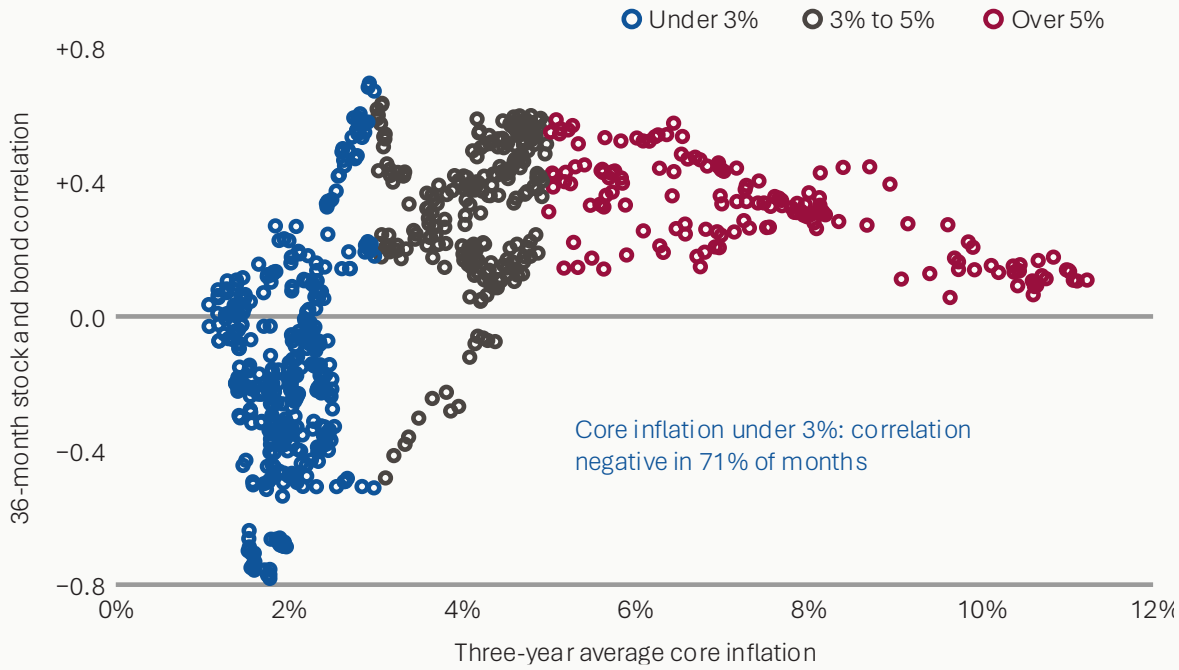
Source: IMF Fiscal Monitor, April 2026 (2025 values), general government overall balance. Deficits of 5 percent of GDP or more shown in blue.

The result is a structural bias to inflate. Central banks are more likely to cap yields at moments of stress, as Japan did explicitly with yield curve control, and to accept inflation above target rather than force spending cuts and tax rises. Inflation becomes the path of least resistance for reducing the real burden of debt, and it is the scenario most damaging for a portfolio that relies on government bonds as its only diversifier of equity risk, because it is the one in which bonds are likely to fall alongside equities.

INFLATION DETERMINES THE CORRELATION:

Chart 5 plots nearly 67 years of monthly data: the 36-month correlation of S&P 500 and 10-year Treasury returns against core inflation over the same three years.

Chart 5: Stock and bond correlation against core inflation, rolling 36 months, January 1960 to September 2026



Source: S&P 500 (Shiller), 10-year Treasury yield (FRED GS10), core CPI (BLS, via FRED CPILFESL). Rolling 36-month correlation of monthly total returns; Treasury returns estimated from yields. Omnigence calculations; see Omnigence, The End of the Bond Hedge (September 2026). October 2025 omitted (no CPI published).

The pattern has been strong. When three-year core inflation ran below 3 percent, the correlation was negative in 71 percent of months, and below 2 percent it averaged −0.26. Between 3 and 5 percent it was negative in only 6 percent of months, and above 5 percent it was positive in every month. The level of inflation, in other words, has largely determined the sign of the stock and bond relationship. Currently, three-year core inflation is 3.0 percent and the correlation stands at +0.22, right at the threshold above which bonds have historically failed to hedge equities. On the historical record, core inflation would need to settle back well below 3 percent before the traditional hedge could begin to be relied on again.

THE MECHANISM:

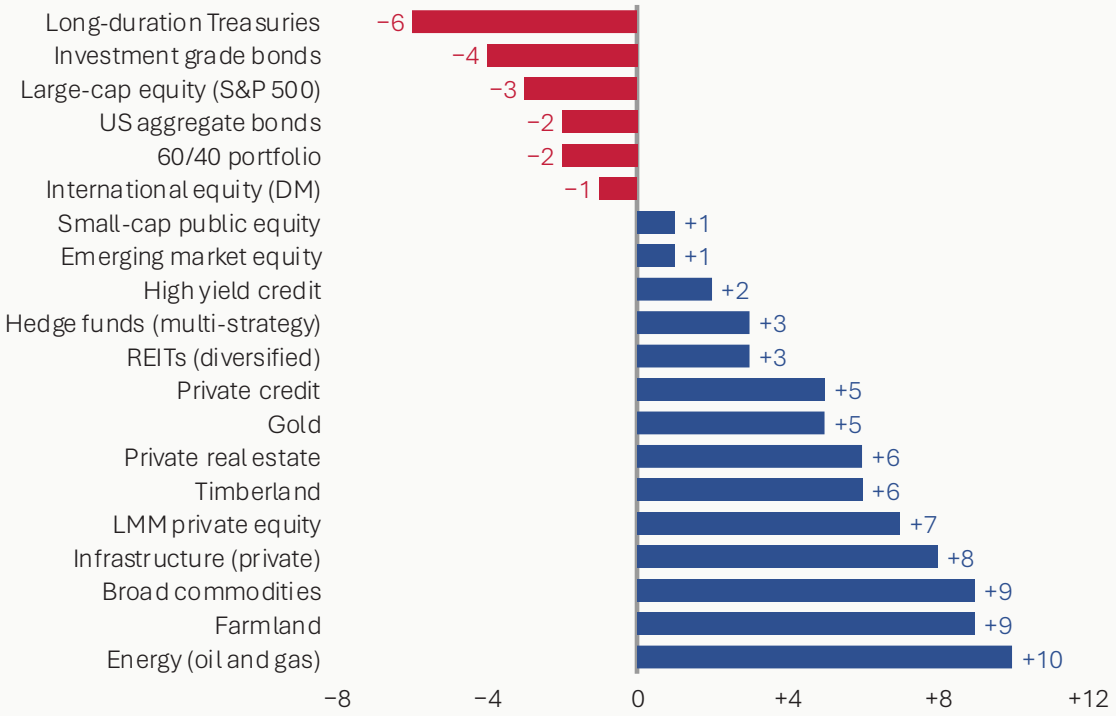
Why does inflation determine the stock and bond correlation? Stocks and bonds are priced off a common discount rate but respond to different shocks. A growth shock pushes them apart: weaker growth lowers earnings expectations and policy rates, so equities fall while bonds rally. An inflation shock pushes them together: higher inflation raises the discount rate applied to both, and both lose value. Which shock dominates decides whether the correlation is positive or negative, and the negative correlation investors grew used to was a feature of a regime dominated by growth shocks, not a permanent property of bonds.

THE INFLATION HIERARCHY:

Chart 6 ranks 20 asset classes by their estimated real return across the periods since 1972 in which US CPI exceeded 4 percent.

Long-duration bonds were the weakest hedge because their cash flows are fixed: unexpected inflation permanently erodes their real value. Public equities suffer from multiple compression as discount rates rise, even where earnings keep pace. Gold has protected in some episodes but not others, and its long-run inflation sensitivity is not statistically reliable.

Chart 6: Estimated real return in high-inflation periods, percent per year



Source: Omnigence, Inflation Performance by Asset Class (July 2026), from NCREIF Farmland and Timberland indexes, NAREIT, Bloomberg Commodity Index, FRED CPI and published inflation-regime research. Regimes: CPI above 4 percent in 1972 to 1982, 2007 to 2008 and 2021 to 2023. Real return is nominal return less concurrent CPI. LMM private equity, private infrastructure and private credit are illustrative estimates.

THE LIQUID ROUTE: COMMODITIES AND TREND FOLLOWING

Recent research measuring the inflation sensitivity of major liquid assets from 1972 to 2026 finds that commodities, inflation-linked bonds and trend-following strategies are among the few with positive exposure to inflation news. In the January to September 2022 bear market, commodities, trend following and long/short value delivered the strongest returns. Trend following is notable because it can go long or short and has tended to outperform in large shocks in either direction. Table 2 summarizes that research's hypothetical optimization, which starts from a global 60/40 portfolio and adds inflation-linked bonds, commodities and trend following under constraints on volatility, tail losses and relative underperformance.

Table 2: Global 60/40 versus a hypothetical inflation-aware portfolio

	Global 60/40	Inflation-aware
Expected return (geometric)	6.1%	6.8%
Expected volatility	9.8%	9.2%
Global Financial Crisis return	−24.5%	−24.5%
2022 inflation shock return	−15.2%	−8.9%
Inflation sensitivity	−0.23	−0.02
Tracking error to 60/40	0.0%	3.1%

Source: AQR Portfolio Solutions Group, Inflation Redux? Real Solutions for Real Returns, Alternative Thinking 2026 Issue 3, Exhibit 11 (robust optimized portfolio). Hypothetical, based on AQR's forward-looking assumptions. GFC: November 2007 to March 2009. 2022 shock: January to September 2022.

This liquid route has costs. Popular commodity indices are concentrated in energy, so implementation choices matter. Commodities lose in growth shocks. Trend following brings tracking error and long stretches of underperformance in calm markets, which demand organizational patience.

THE PRIVATE ROUTE: REAL ASSETS

The alternative to hedging with liquid assets is to add private assets whose cash flows tend to keep pace with inflation. Two examples are farmland, a true real asset, and lower middle market private equity, which shares some of its characteristics:

- Over the 20 years to 2024, the NCREIF US Farmland Index returned 10.2 percent a year, with a correlation to US equities of about 0.05.
- Lower middle market companies with low capital intensity can be insulated from, and even benefit from, inflation if they can pass cost increases through to customers. Bought at 6 to 8 times EBITDA against roughly 12 times for the median buyout and approximately 18 times for the S&P 500 (October 2026), they also carry less exposure to the multiple compression that hits public equities when rates rise.

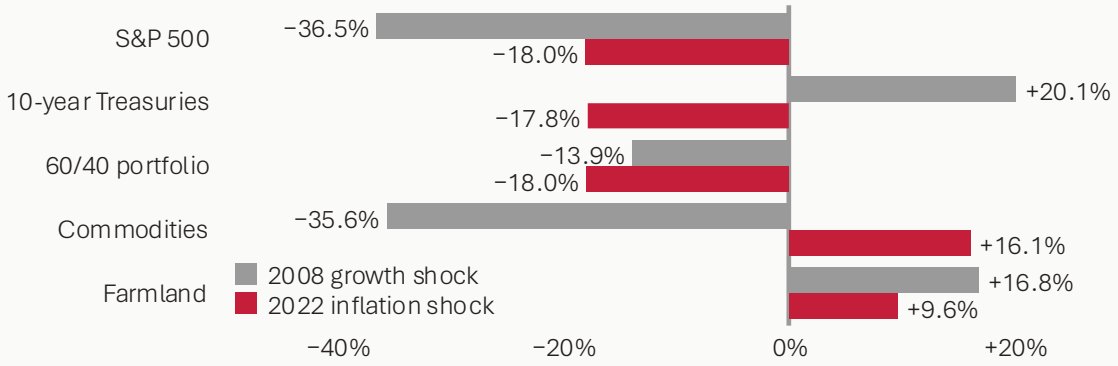
These assets have their own limitations. They can be illiquid, and their historical inflation records rest on fewer and less transparent data points than public markets. They are perhaps best viewed as a complement to the liquid diversifiers, not a replacement for them.

CONCLUSION:

Three implications follow for allocators who rely on a stock and bond mix for diversification:

- **Stress-test both kinds of bear market.** Stress tests should include an inflationary bear market as well as a growth-shock bear market (Chart 7). Frameworks calibrated to the Global Financial Crisis, a growth shock, will tend to favor nominal bonds and under-allocate to assets that protect in an inflation shock such as 2022.

Chart 7: Returns in a growth shock (2008) and an inflation shock (2022), percent



Sources: S&P 500 and 10-year Treasury returns (Damodaran, NYU Stern); Bloomberg Commodity Index; NCREIF Farmland Index. 60/40 rebalanced annually.

- **Resilience does not have to cost return.** Research indicates that a portfolio hedged with certain liquid assets can carry a higher expected return than the starting 60/40, and the real-asset hierarchy in Chart 6 suggests the same can be true of a portfolio augmented with real asset alternatives.
- **Plan for fiscal dominance.** Sustained fiscal dominance should be treated as a serious risk, driven by high debt and large deficits financed in part by money creation, a combination seen in the 1940s and, in milder form, the 1970s, when the resulting inflation persisted for a decade. That would be a multi-year problem, not a 12-month shock.

Investors do not need to forecast a second inflation wave to prepare for one. The shift in the stock and bond correlation since 2021 has already eroded the protection that balanced portfolios depended on for more than

three decades. Rebuilding that protection means owning assets that diversify equity risk better than bonds do when inflation is the dominant shock.



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