

Inflation shocks and equity factor returns.



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Equity factors such as value, momentum, and quality are widely used by investors seeking repeatable sources of return. Over long horizons, these factors have demonstrated robustness across sectors, market capitalizations, and geographies. However, long-term averages can obscure meaningful regime-dependent behavior, particularly during periods of elevated and rising inflation.

As John Maynard Keynes famously observed, “In the long run we are all dead.” For investors concerned with portfolio positioning through inflation shocks, the short- and medium-term behavior of equity factors matters.

Executive summary

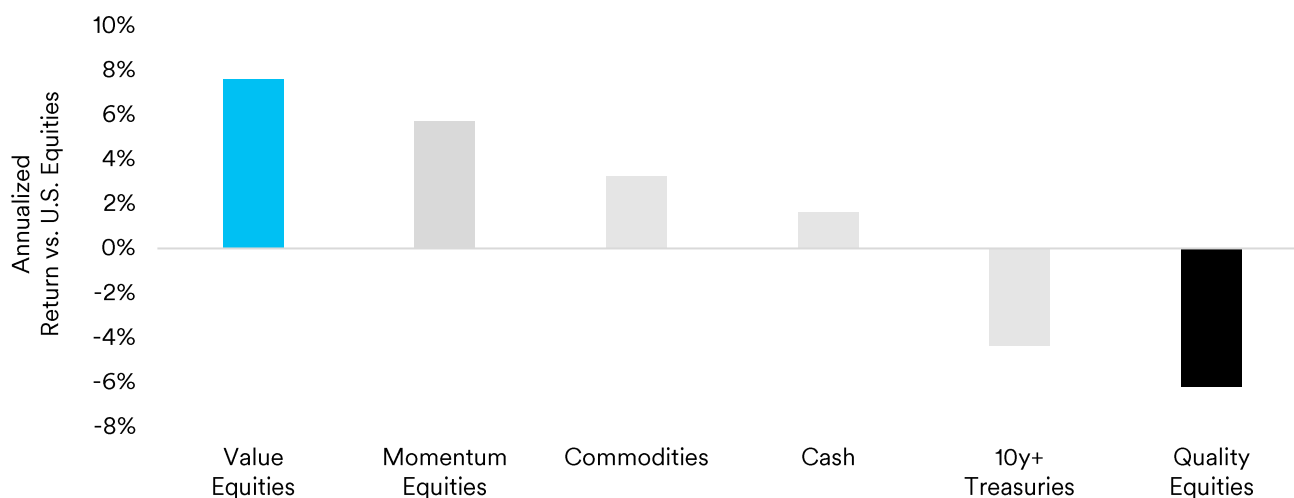
- Inflation shocks can impact the performance in various ways.
- With history as a guide, we expect the value factor to outperform the quality factor in the short- to medium-term.
- Value stocks tend to have shorter duration profiles, or less sensitivity to changes in interest rates, than quality stocks.
- Still, factor diversification, rather than reliance on a single factor, remains critical.

Lessons from the inflationary 1970s

The 1970s provide a useful historical reference point. This period was characterized by persistent inflation, rising interest rates, supply shocks, and weak economic growth. Equity market leadership shifted meaningfully during this regime.

As shown in Exhibit 1, **value-oriented equities** and **real assets** performed relatively well, while **long-duration assets**—including long-dated government bonds and quality equities—which are more sensitive to changes in interest rates, experienced significant drawdowns.

Exhibit 1: Factor and asset class returns versus U.S. equities 1971 to 1981



Source: SEI QiM. March 1, 1971, to September 30, 1981 period coincides with the bottom-to-peak move in US 10-year Treasury Yields. Value Equities: Top 30% ranked U.S. equities by book-to-market, from Kenneth R. French Data Library. Momentum Equities: Top 30% ranked 12-1 Price Momentum, from Kenneth R. French Data Library. Commodities: S&P GSCI Index, from Standard & Poor's. Cash: 3-month U.S. Treasury bill returns from Ibbotson and Associates Inc. 10y+ Treasuries as measured by the Bloomberg U.S. Treasury: Long Index. Quality Equities: Top 30% ranked U.S. equities by quality as defined in Asness, Frazzini and Pedersen (2014), "Quality Minus Junk"

Duration sensitivity and valuation effects

At a high level, the relative performance of value and quality during inflationary episodes can be understood through **duration** (sensitivity to movements in interest rates).

- **Value stocks**, typically characterized by lower valuation multiples, embed a shorter duration of cash flows. Their present value is therefore less sensitive to changes in discount rates.
- **Quality stocks**, often trading at higher multiples, derive a larger share of their valuation from cash flows expected further into the future. Rising inflation and interest rates increase discount rates, disproportionately compressing these valuations.

Inflation and corporate fundamentals

Beyond valuation mechanics, inflation also affects companies through the income statement.

Quality businesses—defined broadly as firms with high and stable profitability—often rely on durable competitive advantages, or “economic moats.” These may stem from brand strength, network effects, scale, or regulatory barriers. While such advantages can be long-lasting, they are rarely permanent.

During inflationary periods, these businesses can face a **double headwind**:

- **Input costs rise**—pressuring margins.
- **Consumers face real income erosion**—limiting pricing power.

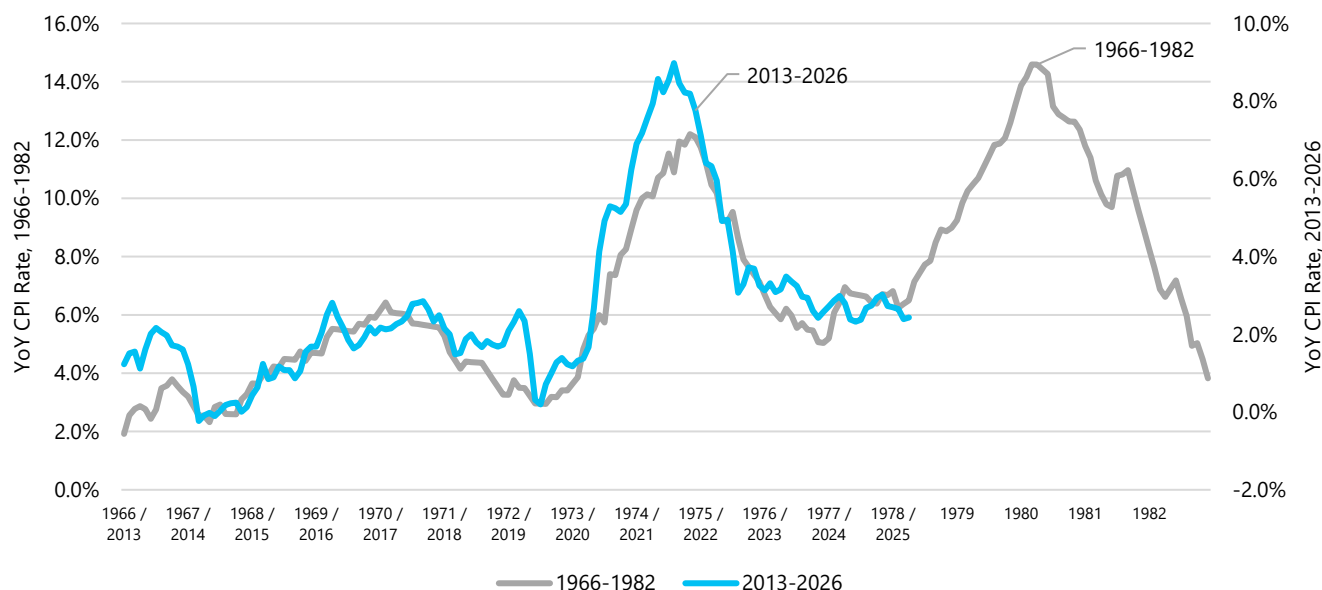
The result is often a combination of **margin compression** and **valuation derating**, reinforcing the negative impact on the quality-style returns during inflation shocks.

Is this time different?

Each inflationary episode is shaped by its own catalysts. Nevertheless, history suggests that when inflation and interest rates rise, **factor leadership can shift in predictable ways**.

Across inflationary regimes, assets and styles with **shorter duration characteristics**—including value equities and real assets—have tended to fare better than long-duration growth and quality exposures.

Exhibit 1: Year-over-year (YoY) U.S. inflation rate comparison, 1966 to 1982 versus 2013 to 2026



Notable periods:

12/76 - OPEC announces price increases

02/79 - Iranian Revolution

05/81 - Fed hikes 100 basis points (1%) to a record 14%

Source: SEI QiM; data from FRED. Conceptual framing is inspired by work discussed by Niall Ferguson, Hoover Institution.

Portfolio implications

For equity investors navigating inflation uncertainty, the key takeaway is not to abandon quality entirely, but to **recognize regime sensitivity**:

- Valuation discipline matters more when discount rates are rising.
- Exposure to shorter-duration cash flows can improve portfolio resilience.
- Factor diversification, rather than reliance on a single style, remains critical.

Inflation regimes challenge long-held assumptions. Understanding how factor returns behave under these conditions can help investors position portfolios more deliberately without relying on the hope that the long run arrives quickly.

Glossary and index definitions

For financial term and index definitions, please see: <https://www.seic.com/ent/imu-communications-financial-glossary>

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