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Impact of Inflation on Investment Portfolio Returns: A Review of the Literature

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Abstract

This paper outlines the relationship between inflation and investment returns, and looks at how nominal and real returns differ. It also considers whether financial assets like equities are a good inflation protection. According to the Fisher hypothesis, nominal interest rates will increase to roughly offset expected inflation, so real interest rates are broadly the same. However, empirical research has shown that there is often a negative relationship between inflation and stock returns in the short-term. This can be due to the proxy hypothesis, fiscal and monetary policy and behavioural inflation illusion. There is also evidence to show that the relationship varies between investment horizons, countries, sectors and firm characteristics. Commodities have offered some inflation protection historically but are subject to roll yield, collateral return and period of analysis. This paper considers some research done in India looking at the impact of recession, financial stress from the pandemic, entrepreneurial finance, accounting practices and financial services marketing. Whilst this gives useful context, it does not directly look at inflation protection. This paper concludes that equities are at best a conditional partial protection and more empirical research is needed in India.

***Keywords**: Inflation, Nominal Returns, Real Returns, Fisher Hypothesis, Equity Returns, Inflation Protection, Commodities, India.*

Introduction

When asking a retired schoolteacher from Udaipur about the impact of inflation on her fixed deposit, many textbooks would not give as practical an answer as she may. A 7% deposit earning with 6% inflation on grocery and medical prices will not lead to much of an increase in purchasing power. In fact, after tax the real return could be negative. This paper considers the difference between nominal and real returns and how different financial assets can be protection from inflation.

Despite seeming like a simple question, there is not one clear answer from the literature. Fisher (1930) argued that nominal interest rates will increase roughly in line with expected inflation to leave expected real interest rates unchanged. When looking at equities it may seem logical to assume this applies. However, early empirical research by Bodie (1976) and Fama & Schwert (1977) found a negative relationship between stock returns and inflation. Research has since been done to look at what causes this relationship.

This paper will look at the international evidence and how this can be applied to India. Some research has been done in India looking at the impact of recession, financial stress from the pandemic,

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financing constraints, accounting practices and financial services marketing. Whilst this does not directly look at the impact of inflation on portfolio returns, it does provide useful context as investors in cities like Jaipur and Pune may be facing different macroeconomic conditions than many classic US samples.

This paper is split into 6 sections. Section 2 looks at the theory behind this topic. Section 3 considers the empirical evidence. Section 4 looks at how the evidence can be summarised. Section 5 looks at the limitations and future research. Section 6 concludes.

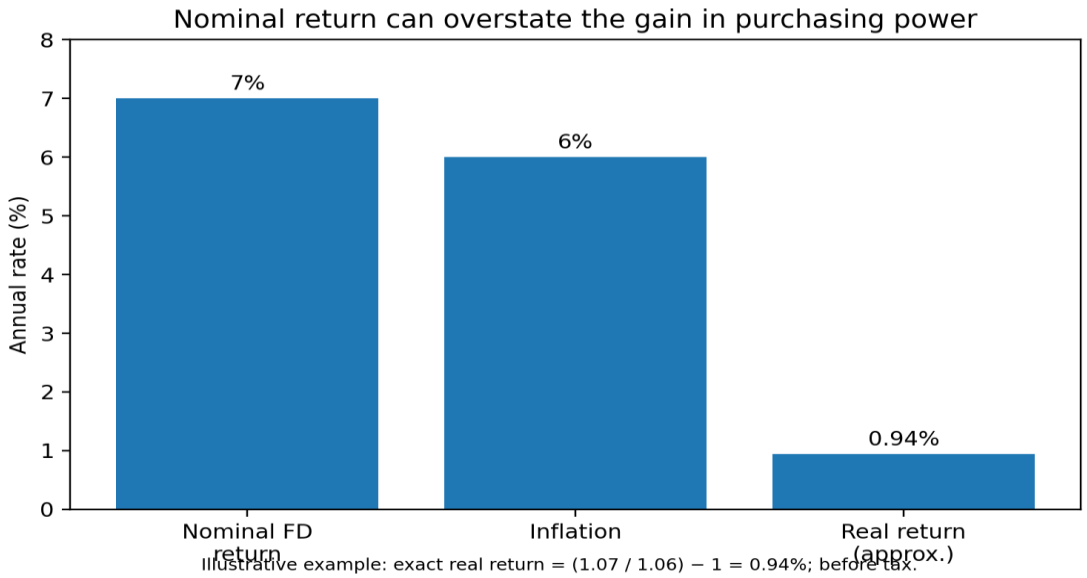


Figure 1: Example of Nominal and Real Returns

Theory

The Fisher hypothesis states that when inflation is expected to increase investors will want a higher nominal interest rate. This will leave expected real interest rates broadly unchanged (Fisher, 1930). Simply:

Nominal Interest Rate ≈ Real Interest Rate + Expected Inflation

However, the exact calculation is (1 + nominal rate) = (1 + real rate) x (1 + expected inflation). This is generally fine for small rates. However, Jaffe & Mandelker (1976) looked at this for risky assets, finding that common stocks do not necessarily follow the same trend.

The three main reasons are:

- **Proxy Hypothesis**

Inflation may have a negative relationship with stock returns because inflation can be seen as a proxy for expectations of worse future real economic activity. Inflation is not necessarily causing equity values to fall but it is indicating that output or profitability will be lower (Fama, 1981).

- **Fiscal and Monetary Policy**

The relationship can be reversed. Falls in stock prices may indicate an upcoming period of economic slowdown. This can cause policy changes to occur such as monetising fiscal deficits (Geske & Roll, 1983) leading to higher inflation.

- **Behavioural**

Often referred to as inflation illusion, investors may struggle to differentiate between real cash flows and nominal discount rates. During periods of inflation, if investors are interpreting nominal values as real, equity valuations can be impacted (Modigliani & Cohn, 1979).

These reasons may not be exclusive and may vary depending on the country, time period, inflation regime, market and investor behaviour.

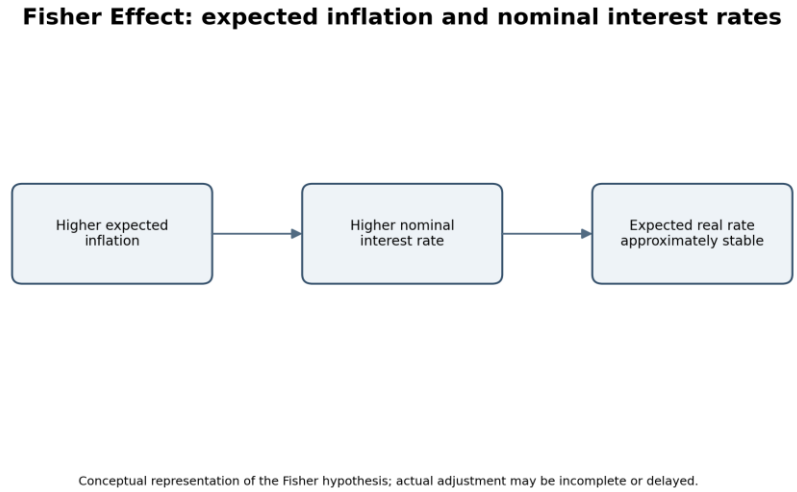


Figure 2: Conceptual Example of Fisher Effect

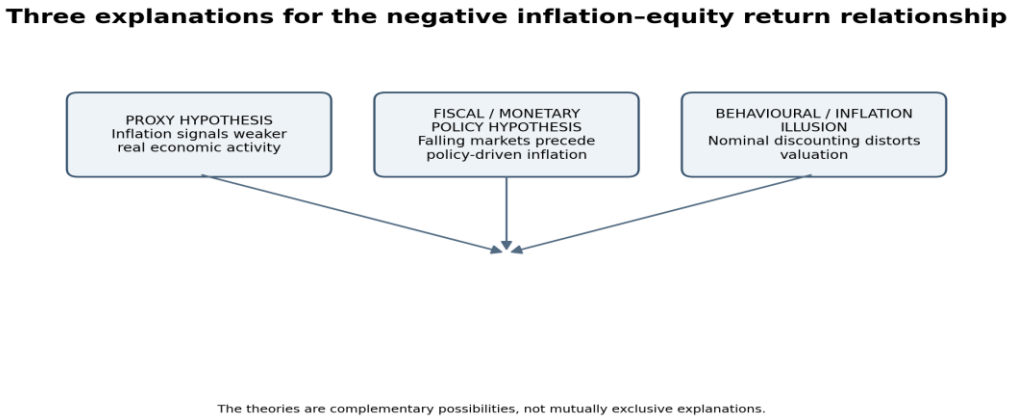


Figure 3: Three Theories Explaining why Inflation and Equity Returns have a Negative Relationship

Literature Review

- **Early Evidence of Inflation Not Being Fully Hedged by Stocks**

Bodie (1976) was some of the early research to look at whether common stocks would act as a hedge against inflation. Using a portfolio approach, it was found that real equity returns had a negative relationship with both expected and unexpected inflation. Bodie also showed that a portfolio of stocks and bills can reduce the variance of real returns if inflation is considered.

Fama & Schwert (1977) looked at different asset classes. They found that US government bills provided a reasonable hedge against expected inflation. However, common stocks had a negative relationship with expected inflation and surprisingly unexpected inflation. Housing and labour income had different relationships.

This alongside Jaffe & Mandelker (1976) and Fama (1981) challenged the assumption that equities would behave as real assets. Fama's proxy explanation is a popular reason but depends on the relationship between money, output and inflation during the sample period.

- **Long Run Evidence**

Much of the early evidence was based on monthly or quarterly data. Boudoukh & Richardson (1993) looked at inflation and stock returns over longer periods of time up to 5 years. They found that stock returns had a positive relationship with inflation. This is more in line with the Fisher intuition.

However, 5 years may still not be long enough for some retirees who are withdrawing regularly. Long run regression analysis can also be problematic due to overlapping data and a small number of independent variables.

- **Cross Country and Sector Evidence**

Gultekin (1983) looked at the relationship across 26 countries and found there was considerable variation. Some countries had negative relationships whilst others had close to zero relationships. This indicates there is no simple rule of thumb. Different economies have different inflation regimes, tax systems, depth of capital markets and listed company structures.

Ang et al (2012) looked at individual equities and found there was considerable variation in how sensitive they were to inflation. This can be explained by looking at the characteristics of the industry. Companies with pricing power can increase their prices to pass on increased costs. However, capital intensive or highly geared companies may be more susceptible. When investing in stocks, this can be important. However, with broad market funds you will have a mix of companies.

- **Mispricing**

Campbell & Vuolteenaho (2004) looked at a behavioural reason for apparent mispricing in equity markets. This includes the relationship between earnings yields and bond yields. This builds on the idea that investors may get confused between real and nominal. Modigliani & Cohn (1979) argued that during periods of inflation, investors may be mispricing corporate earnings due to inflation illusion.

Bekaert & Engstrom (2010) added that the positive relationship between bond yields and earnings yields can be due to inflation illusion and an increase in equity risk premium during high inflation periods. This is an important point as if inflation is increasing economic uncertainty, investors may be rationally demanding higher risk compensation. This can cause equity prices to fall.

- **Commodities**

If equities are not a perfect hedge, commodities may provide some diversification. Gorton & Rouwenhorst (2006) created an index of commodity futures returns going back to 1959. They found that commodity futures had positive correlations with inflation. This relationship increased with longer horizons.

However, there are some considerations to make. Futures returns are impacted by roll yield and collateral return. The sample period also includes the strong performance of commodities in the 1970s. This means results may vary depending on the sample period. An investor investing after 1982 may not have had such a favourable outcome.

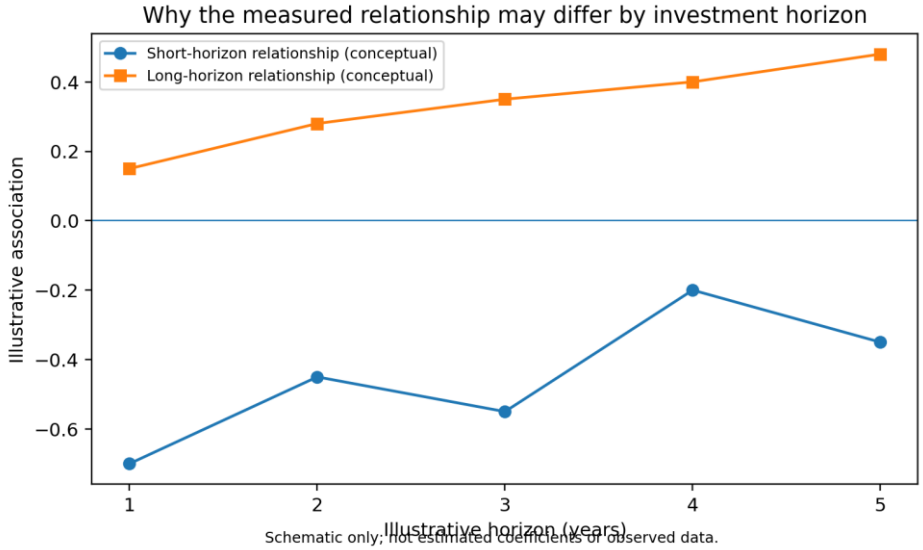


Figure 4: Schematic of how the Relationship may vary Depending on Investment Horizon

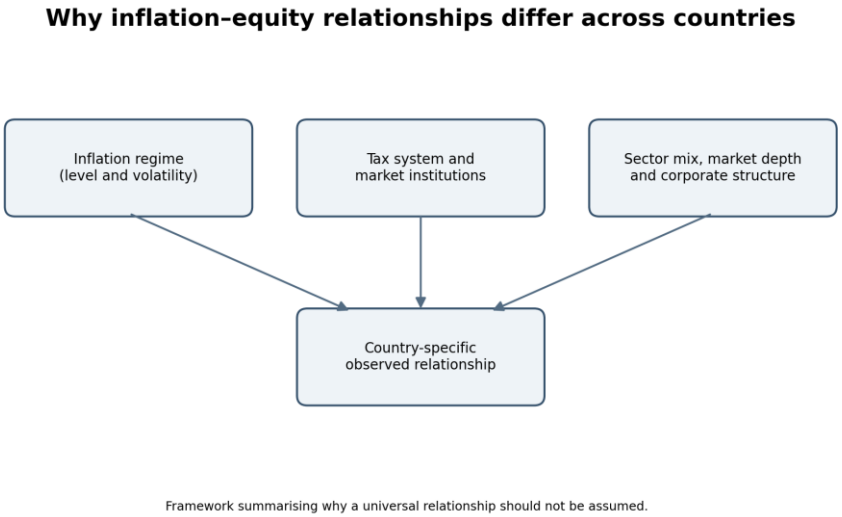


Figure 5: Factors that may cause Differences between Countries

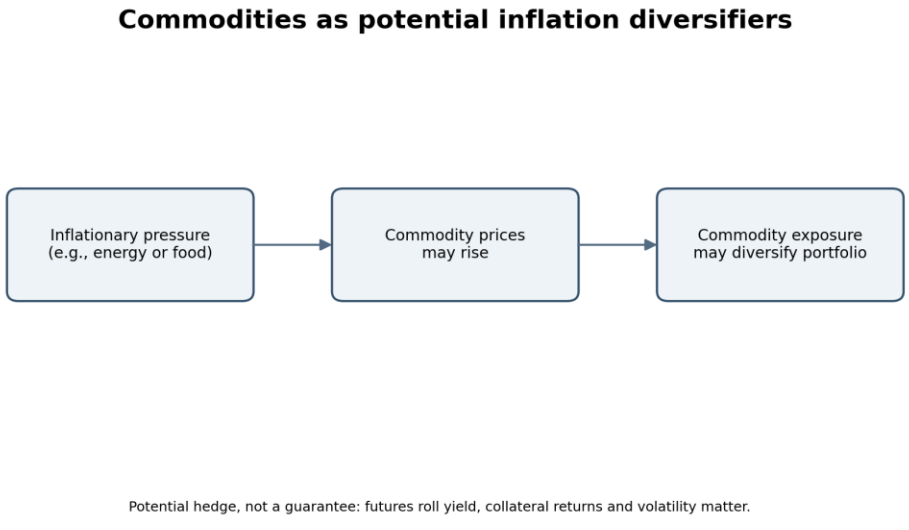


Figure 6: Commodities Providing Diversification

- **Evidence from India and Regional Studies**

There is not much direct evidence on the impact of inflation on portfolio returns in India. However, there is useful context from adjacent research. Choudhary & Madhwani (2013) looked at the impact of recession on the tourism and hospitality industry. This is a sector with a lot of discretionary spend. Whilst this does not look at inflation, it does look at the mechanism. During periods of pressure on household budgets, cyclical sectors may see reduced demand. This fits with the general intuition of Fama's (1981) proxy argument.

Sharma et al (2022) looked at the impact of the pandemic on financial indicators for selected BSE listed companies. Supply chain issues caused price pressures. Firm level indicators can help to identify which companies were better able to cope with increased costs. However, this does not allow us to separate inflation from other pandemic impacts.

Mehta (2024) looked at how financial issues impact entrepreneurial innovation and growth in Rajasthan. Abid (2026) discussed how access to finance can impact growth in small and medium enterprises under the Aatmanirbhar Bharat agenda. If inflation is causing increased borrowing costs,

smaller companies with limited access to credit may be very exposed. This may impact the performance of listed small cap companies with similar characteristics. However, this is inferred from adjacent research.

Shrimali & Abid (2017) looked at accounting practices within wholesale and retail enterprises in the Udaipur district. If accounting practices are informal it can be difficult to measure inflation adjusted performance. Investors and lenders may struggle to determine whether profits are increasing due to nominal or real increases. Mehta (2017) looked at the composition of tax revenue. The balance between direct and indirect tax can impact how inflation affects government revenue and the economy through fiscal policy.

Chaplot (2017) looked at marketing within the financial services industry. This is important as retail investors may invest through distributors and banks. Marketing can impact how much investors like nominal return products like fixed deposits. Dhakar & Mehta (2025) discussed issues with mergers and acquisitions. Corporate restructuring may be one way companies respond to ongoing increases in input costs. These studies provide useful context but do not directly look at the impact of inflation on investment returns.

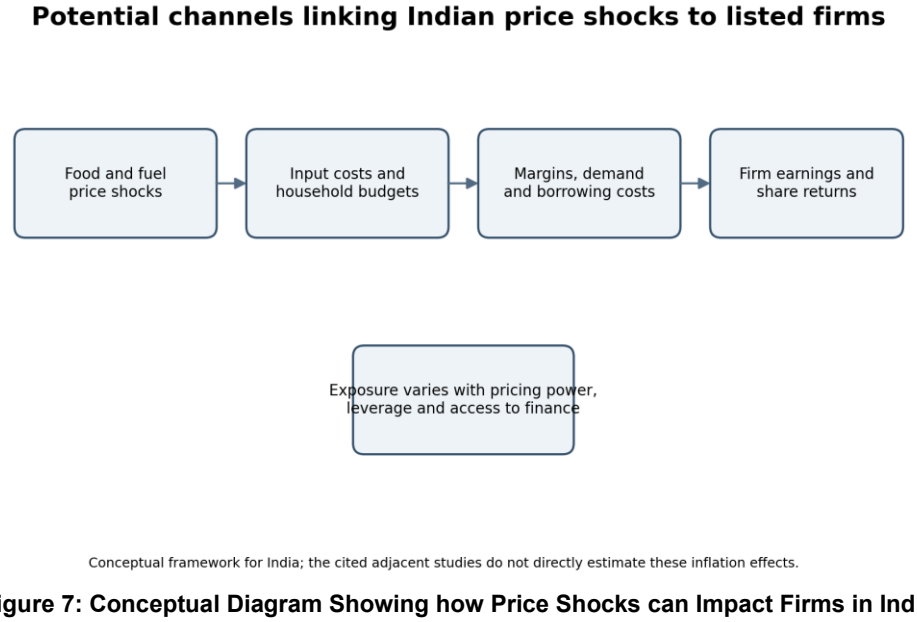


Figure 7: Conceptual Diagram Showing how Price Shocks can Impact Firms in India

Synthesis and Discussion

Overall, there is evidence to suggest that equity returns often have an inverse relationship with inflation in the short-term. This is especially true during periods of stagflation (Bodie, 1976; Fama & Schwert, 1977). However, this relationship can become more positive over longer periods of time (Boudoukh & Richardson, 1993). This does not guarantee protection for investors needing to withdraw regularly.

The relationship will also depend on the characteristics of the companies. Different sectors, pricing power and gearing can cause considerable differences in sensitivity to inflation (Ang et al, 2012). Commodities may provide diversification but are volatile and can be impacted by the sample period and futures market.

All three reasons can be used to predict a negative relationship. This means we cannot determine which reason is causing the negative correlation. If the main reason is increased risk premia (Bekaert & Engstrom, 2010), investors may need to expect higher returns to invest in equities. If mispricing is an important factor (Campbell & Vuolteenaho, 2004; Modigliani & Cohn, 1979), patient investors may benefit from the correction. However, the evidence does not allow us to determine which reason is the correct one.

India may be more complicated as food and fuel prices can be a big source of inflation. This means supply shocks can have a large impact. Regional studies suggest that smaller companies, informal accounting and financing constraints could increase the impact of price pressures (Abid, 2026; Mehta, 2024; Shrimali & Abid, 2017). However, this is just a hypothesis as these studies do not directly look at the relationship between inflation and investment returns.

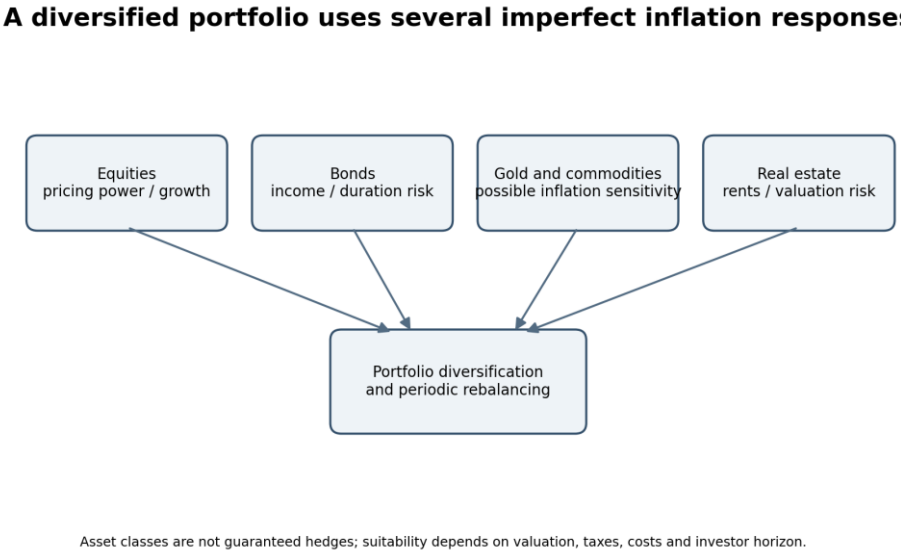


Figure 8: Diversification with Different Assets with Imperfect Inflation Responses

Limitations and Future Research

This review has some limitations. Much of the foundational evidence comes from the US and other developed markets. Some of the influential sample periods include the unusual inflation of the 1970s which may not reflect current inflation regimes. The studies from India do not directly look at inflation protection but instead look at adjacent issues. This means the relationship between the studies and inflation are interpretations.

This review has only looked at a selection of published studies. Working papers, central bank research and reports from practitioners have not been searched. Full references, page numbers, volume numbers and publication details should be checked against the original documents.

- **Future Research**

Future research could look to calculate inflation betas for different sectors in India using post-liberalisation data. This could look to differentiate between supply driven and demand driven inflation as this may impact corporate costs, sales and discount rates differently. Further research could look at whether inflation linked bonds, gold and real estate provide protection for Indian household portfolios after considering tax, transaction costs, liquidity and holding periods.

A useful empirical design would look at how different sectors perform compared to headline and specific inflation. This would control for interest rates, exchange rates and business cycle factors. It could also look at how company characteristics such as gearing, pricing power and size impact the relationship. Separating the models into food and fuel led inflation shocks could help to identify the channels.

Conclusion

Overall, the assumption that equities will automatically provide protection from inflation is not supported by the evidence. Equities seem to provide at best a conditional partial protection. This protection can improve over longer periods of time and may be better for companies with pricing power. However, this will depend on whether inflation occurs with economic growth or stagnation. Commodities can provide some diversification but are volatile and subject to implementation and sample period risk.

Investors in emerging markets such as India will face additional complications due to financing constraints, informal accounting and price shocks from food and fuel. More direct research is

needed in India. In practice, investors should not rely on one asset class to provide guaranteed protection. A diversified portfolio of imperfect hedges should be considered with after tax real returns and time horizon in mind.

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