AN AMERICAN PORTFOLIOS' GUIDE

Inflation: An Investment Playbook

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In 1980 Donna Summer sat atop the Billboard music charts, Charlene Tilton was starring in the top-rated TV series "Dallas" and the U.S. boycotted the Summer Olympic Games to protest the Soviet Union's invasion of Afghanistan.

It was also the year that inflation in the U.S. hit a post-WWII peak of 13.55%.

For millions of Americans, inflation is as remote as some of these names and events from 40 years ago.

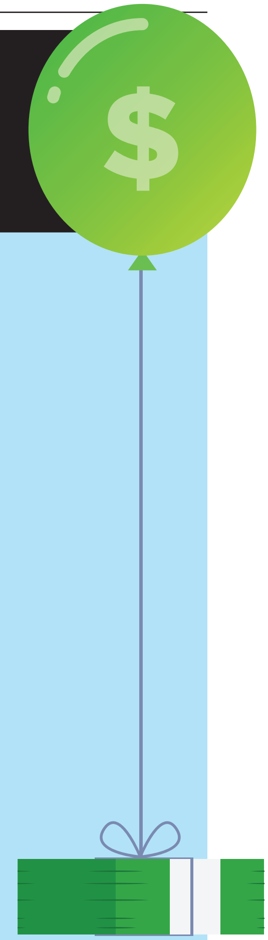
After decades of modest price increases, worries of a new era of inflation have emerged as the economy seeks to adjust to sustained monetary accommodation, massive fiscal stimulus, supply chain bottlenecks and the release of pent-up consumer demand.

While a temporary appearance of inflation is usually of small consequence, persistently elevated inflation is massively consequential to the financial security of both working Americans and retirees. It also rewrites the playbook for investing.

In this white paper, Inflation: An Investment Playbook, we examine the leading inflation theories, the efficacy of common inflation indicators and how investment portfolios will need to be restructured should inflation prove less transitory than anticipated.

A Review of Macroeconomic Theories of Inflation

Inflation may be one of the most deeply analyzed of all economic phenomena—and perhaps the most debated. Here is a quick summary of leading economic theories on the causes of inflation.



1 Monetary Theory of Inflation

Also known as monetarism, this theory holds that the money supply is the dominant, though not only, determinant of the level of prices in the long run. Milton Friedman, the intellectual father of monetarism, argued that inflation is always a monetary event that occurs when the quantity of money rises faster than total economic output.

This theory is a more refined version of the Quantity Theory of Money, whose origins reach back to David Hume and David Ricardo.

2 Demand-Pull Theory

This Keynesian view believes that when the value of aggregate demand exceeds the value of aggregate supply under conditions of full employment, inflation will increase. John Maynard Keynes also argued for the use of policy as a lever to affect demand. For instance, a reduction in government spending can decrease demand and thereby reduce inflation.

3 Cost-Push Theory

Cost-push inflation is driven by wage increases and profit increases. For instance, when wage increases exceed productivity increases, higher wage costs will be passed on in the form of higher prices. Another source of cost-push inflation may be higher prices on imported raw materials.

4 Structural Inflation Theory

This theory focuses on structural issues within an economy that may lead to higher prices. These issues may be wide-ranging, from distribution networks and immigration to the trade gap and variations in a currency's value.

5 Rational Expectations

This theory states that current expectations of the economy influence future economic conditions, whereby individuals base their decisions on human rationality, available information and past experiences. For example, if individuals believe that inflation will be higher in the future, they will act rationally by buying goods now while they are cheaper; this can drive demand higher, which may lead to higher inflation.

More contemporary research has turned its sights toward how non-economic inputs affect inflation, such as elections, political instability and policy credibility.

Reading the Inflation Tea Leaves

The nation's most recent brush with high inflation was during the years of the Great Inflation—a period that began in 1965 and ended in 1982. It was a time of massive changes that witnessed the abandonment of the global monetary system (Bretton Woods), four recessions and two severe energy shortages.

These challenging economic conditions were worsened by breathtakingly bad economic policymaking (e.g., an unprecedented implementation of peacetime wage and price controls).

Today, the central debate is whether the inflation that has emerged from the pandemic is transitory or a more permanent long-term phenomenon. Time will be the ultimate arbiter of that debate; but, in the meantime, it represents a potential big-impact risk that bears watching.

Investors have historically used a number of indicators to forecast inflation—including commodity prices, like oil, precious metals and copper; a variety of financial barometers, such as exchange rates, term premia and money supply; and selected measures of the real economy, like capacity utilization and unemployment rates—to gauge inflationary conditions.

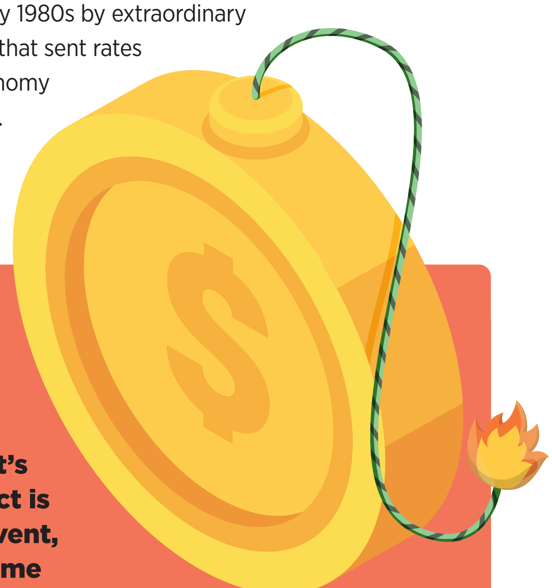
It turns out, according to research by the Federal Reserve Bank of New York, that the predictive powers of 19 indicators most commonly used to forecast inflation were found to be inconsistent and often substantially off-target. Indeed, one challenge with using indicators correlated with inflation is the difficulty in forecasting their price independent of inflation.[1]

Nevertheless, forecasting inflation—no matter how imprecise—is crucial for investors, central bankers and policymakers. And, not surprisingly, there is no shortage of inflation forecasts and forecasters.

The Federal Reserve Open Market Committee publishes its set of inflation forecasts four times a year in conjunction with their quarterly meetings. The Federal Reserve Bank of Philadelphia issues a quarterly survey of professional forecasters. The IMF and OECD also produce their inflation estimates for a range of countries and regions.

For advisors that take stock in the rational expectations theory on inflation, the Federal Reserve Bank of New York publishes a monthly Survey of Consumer Expectations that provides insight into what individuals expect inflation to be over a three-year horizon.

Once embedded in the economy and in the expectations of consumers and businesses, inflation can be very difficult to bring back to a target rate. Our last bout of inflation was conquered in the early 1980s by extraordinary monetary tightening that sent rates skyward and the economy into a deep recession.



How Inflation Impacts Investments

Inflation has been a constant feature of our economic lives. When it's low and steady, as it has been for the last several decades, its impact is negligible. Short-term spikes in inflation—usually arising from an event, such as the shutdown of an oil pipeline or a drought—may cause some short-lived market volatility, but it will generally have little lasting effect.

It is in an environment of sustained higher rates of inflation where the impact of inflation is most felt by consumers, savers and investors.

Inflation's effect on bond investments is fairly straightforward and well recognized. Higher inflation will erode the value of future interest payments and the eventual return of principal, resulting in losses in the value of bonds. The extent of those losses, though, will vary depending on the duration of the bond and the bond's coupon rate.

Inflation affects the value of stocks in more complicated ways. For example, persistent high inflation:

1. **Creates business uncertainty, adversely affecting companies' ability to plan, grow and invest for the future**
2. **Causes margins to shrink, even for those businesses that can pass higher costs to customers since many do not always pass on the full cost to the consumer**
3. **Fosters a belief in future economic weakness, which can reduce future cash flow and profits**
4. **Raises the discount rate used to value stocks**
5. **Reduces the attraction of stocks with meaningful dividend payouts, similar to bonds**

As intimidating as these inflationary impacts may be on equities, there are certain stock sectors that can preserve value or even thrive during inflationary times.

Investing During Inflationary Periods

Building a bond portfolio during periods of high inflation is all about limiting depreciation risk as inflation inexorably reduces the value of a bond and its future interest payments.

As a consequence, the strategy is simple—keep a bond portfolio to shorter duration, higher-quality bonds. According to recent research by the Man Group, a U.K. money manager, investment grade and high yield corporate bonds have historically underperformed 10-year Treasuries despite having shorter durations.[2]

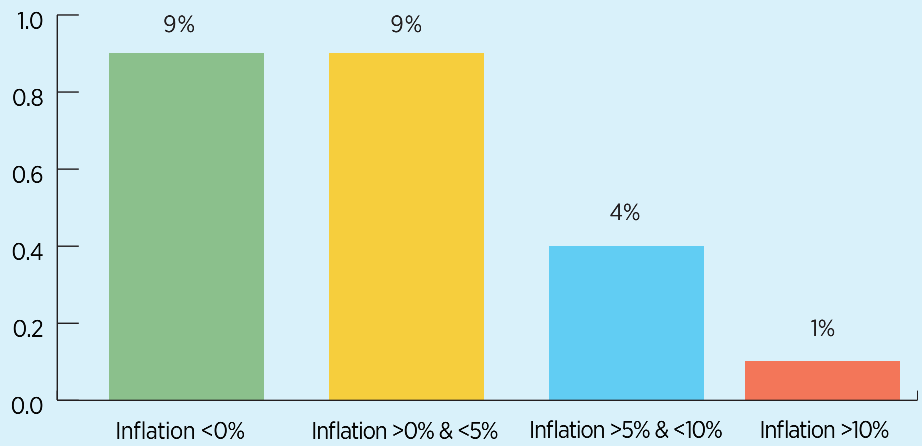
While TIPS may appear to be one answer for protecting against inflation, the prevailing market may not make them a smart alternative. In this pandemic era of easy-money monetary policy, the real yield on TIPS have traded at negative real rates, exposing these bonds to further downside risk should interest rates rise. The primary reason behind TIPS' negative real yield has to do with Fed purchases of TIPS to anchor them to its 2% inflation target. Fed policy changes with regards to TIPS purchases may change the calculus of TIPS investing, but investors need to be aware of prevailing market conditions before reflexively buying these securities.

Equities do not escape the ravages of higher inflation, and their performance during inflationary periods may depend upon the level of inflation, as illustrated in Chart 1.

CHART 1

Real Monthly U.S. Equity Returns by Inflation Regime, 1947 to 2021

SOURCE:
CFA Institute https://blogs.cfainstitute.org/investor/2021/07/19/myth-busting-equities-are-an-inflation-hedge/

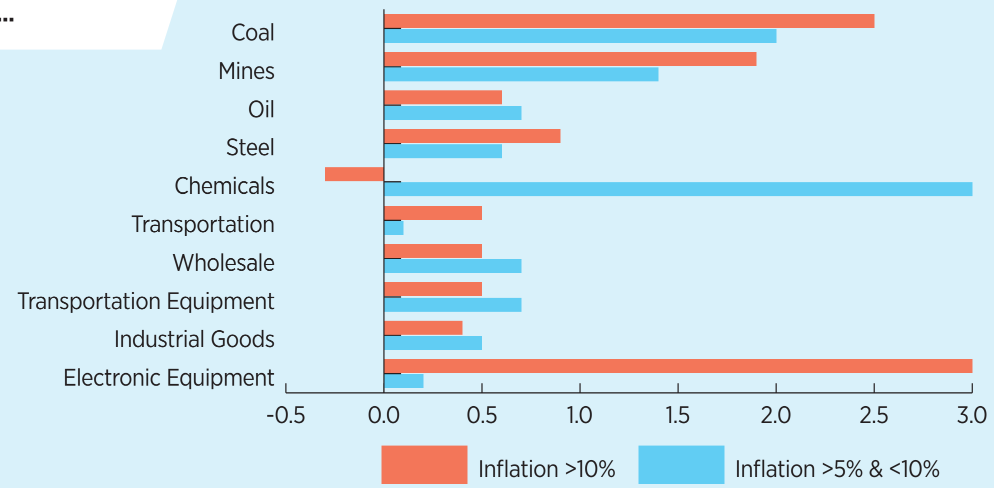


However, not all stock sectors will perform equally. For example, some sectors will thrive...

CHART 2

Inflation Winners—Real Monthly U.S. Equity Returns: 10 Worst Sectors Amid High Inflation, 1947 to 2021

SOURCE:
CFA Institute https://blogs.cfainstitute.org/investor/2021/07/19/myth-busting-equities-are-an-inflation-hedge/

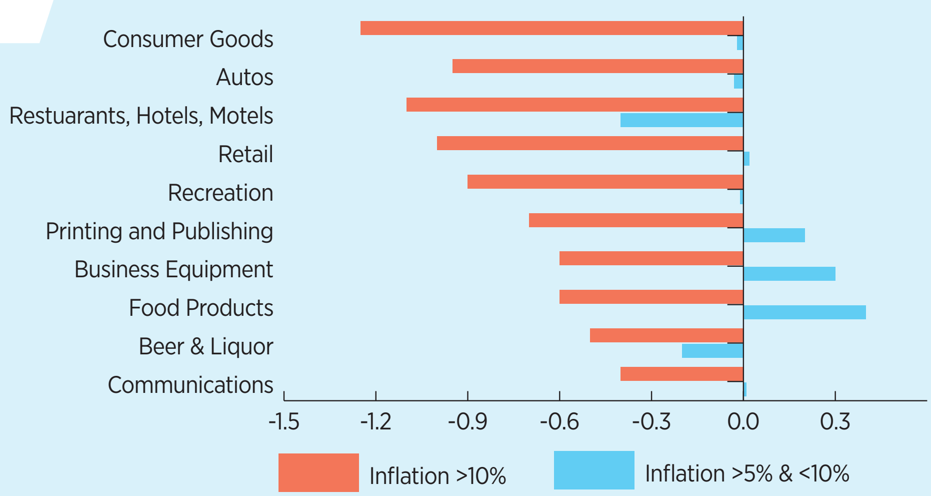


... while other sectors struggle ...

CHART 3

Inflation Losers—Real Monthly U.S. Equity Returns: 10 Worst Sectors Amid High Inflation, 1947 to 2021

SOURCE:
CFA Institute https://blogs.cfainstitute.org/



Investing during inflationary periods is inherently uncertain, but some general guidelines may be helpful in repositioning portfolios amid higher inflation.

1. **Valuations of hypergrowth companies whose values are based on earnings seven to 10 years out may shrink as a consequence of a higher discount rate.**
2. **Growth companies with sustainable business models, reliable profits and relatively attractive valuations will be better positioned to hold or increase their value.**
3. **Value stocks may benefit from secular outperformance.**
4. **Defensive stocks and low-beta stocks have underperformed during past inflationary cycles.**
5. **Companies with pricing power that allows them to pass higher input costs to customers should fare well.**
6. **Smaller companies tend to perform less well.**
7. **Bond holdings should be shorter duration, higher quality issues.**
8. **Asset classes—such as commodities, real estate, foreign exchange, commodity-linked equity investments and other real assets—have historically performed well.**

Commodities are generally believed to benefit most from higher inflation (and they do), but investors need to remember that not all commodities are created equal.

For example, agricultural products performed the least well during inflationary regimes, producing an average annualized positive real return of 7%. This return is well below energy, which led the commodities studied with a 41% return. Industrials (+19%), gold (+13%) and silver (+12%) generated significant average annualized real returns among the eight commodities analyzed.[3]

Residential real estate had a negative real rate of return, while real annual returns for art (+7%), wine (+5%) and stamps (+9%) were positive.[4]

While it's impossible to know for certain how inflationary pressures will play out, the boiling frog fable may be instructive. A frog thrown into boiling water will sense the danger and immediately jump out. However, placed in warm water that is slowly brought to a boil, it is unaware of the rising danger and, as a consequence, eventually becomes frog soup.

Inflation can be the same way, creeping up imperceptibly until it's elevated and entrenched. Avoiding the fate of the frog, investors need to remain on guard for signs of inflation and be ready to respond appropriately before a boiling point is reached.

Sources:

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