How Big a Risk is Inflation Really?

Executive Summary

1. **Faster-than-expected-progress vaccinating Americans and $1.9 trillion in COVID-19 relief on top of the already unprecedented relief spending approved by Congress in 2020 further bolstered investor optimism for the rebound of the US economy which in turn has provided a tailwind for "risk" assets (e.g., stocks) and a headwind for "safety" assets (e.g., Treasury bonds).**

2. **Investor anxiety has quickly (perhaps prematurely) pivoted from anxiety about deflation to anxiety about inflation.** It was only 12 months ago that US unemployment was at its highest level since the Great Depression and GDP was experiencing a severe contraction. Unprecedented amounts of monetary and fiscal stimulus were thrown at the pandemic-induced recession over the past 12 months and all of it was deficit spending that now has the national debt at 110% of GDP.[1] Fears of inflation, or at least Fed tightening to prevent the economy from overheating, drove the 10-year US Treasury yield to 1.74% from 0.93% at the beginning of the quarter and 0.70% at this time last year.

Source: macrotrends.net

3. **Investors have not really worried about inflation since 2011 (at which time the inflation rate only exceeded its long-term average of 3% for a few months before settling into a range around 2% for most of the next ten years). As a result, investors' expectations for inflation tend be based on the experiences of the late 1970s and early '80s when the 10-year Treasury yield ultimately topped 15.8%, but we think today's circumstances are quite different from those.** We think any inflation we might experience this time is likely to be short-lived ("transitory") as it was in 2011 when – after the Federal Reserve and the Obama administration successfully managed the economy back from the recession of 2008/2009 with trillions in bond purchases and hundreds of billions in fiscal stimulus – investors worried that a few quarters of rising consumer prices would inevitably begin a cycle of sustained above-average price increases that would be difficult for the Fed to rein in. Then, as now, the Fed repeatedly reaffirmed its commitment to continued monetary accommodation and would not reverse its position, and the rate of price increases soon dropped below its long-term average and stayed there until today.

4. **One of investors' key concerns about inflation is that it will ultimately lead to rising interest rates when the Fed decides it needs to slow growth in order to pre-empt inflation and that rising rates will hurt stock prices. We believe expectations of higher rates to be reasonable, but history suggests that the stock market has a surprising capacity to absorb interest rate increases and still deliver above-average returns.**

5. **The biggest difference between a portfolio positioned for inflation and an all-weather portfolio for a long-term investor is that the fixed income allocation will maximize cash flow (shorter duration and higher credit risk) in order to re-invest at higher rates.** Although commodities are commonly cited as the best inflation hedge, stocks are also an effective inflation hedge as many companies can protect their margins by passing on their increased costs to customers. Other investments that have historically performed well with inflation (e.g., TIPS, Gold, Oil, and REITs) may not perform as well in the current environment as they have in past periods of sustained inflation, and investors are advised to diversify but avoid over-allocating to any particular inflation-oriented asset given they also carry idiosyncratic risks, independent of inflation.

The Backdrop

2020 provided a relatively unique type of recession. The cause of the contraction was not a sudden tightening in the availability of credit, following an unsustainable overheated economic expansion. Instead, it was a global pandemic caused by a potentially lethal airborne virus that resulted in businesses closing and laying off staff and workers and consumers staying home in an effort to keep themselves and their loved-ones safe. Consumers avoided travel and indoor public spaces in an effort outlast the pandemic until a vaccine could be developed and broadly distributed.

Indeed, science developed new vaccines and therapeutics which in combination with masks and social distancing reduced the risk of hospitalization and death allowing some businesses to re-open and for consumers with "cabin fever" to venture out of their homes. In addition, consumer and worker behavior quickly changed allowing people to be productive and to continue spending from home. Perhaps most importantly, the government provided unprecedented fiscal stimulus giving money directly to unemployed workers and consumers as well as to those workers who saw their incomes drop. This contained the potential economic destruction. Half the jobs that were lost in Q2 2020 were restored in Q3 and the economy now appears (more on this later) to be on track to return to full-employment sometime next year. This does not necessarily mean that we'll have as many workers as we did pre-pandemic because the size of the US workforce (workers with jobs plus workers seeking jobs) was at an all-time high in February 2021.

Against the backdrop of an accommodative monetary policy, investors bid up the price of stocks first of those companies they were confident could survive and continue to grow during the pandemic, and then stocks more broadly as investors began to anticipate the economic recovery that would follow the pandemic/recession. This led to the price of all risk assets being bid up and the price of safe harbor assets falling.

Investors Begin to Worry About the Risk of Inflation

In a remarkably fast about-face, investors who had been worried about a contracting economy and potential deflation in April 2020 began to worry that an additional round of stimulus and supplemental unemployment checks provided in Q1 2021, when the economy already appeared to be recovering, would create excessive demand and inflationary pressure. This is somewhat ironic given that, for the past year, an explicit objective of monetary and fiscal policy has been to combat the risk of a collapse in asset prices and consumer demand. The concern is understandable given that deficit spending (vs. tax increases) can be a difficult addiction for politicians to overcome and interest-rate hikes (and the anticipation of rate hikes) can be a blunt tool that has been difficult for a central bank to get just right to balance full-employment with price stability.

Despite the fact that the Fed has not changed its messaging around its intention to keep rates low for the next several years, even if we see a short period of "transitory" inflation (one-time price adjustments) versus sustained and increasing price adjustments, the market appears to be anticipating an increase in inflation as reflected in the difference between the yield of a standard Treasury bond and an inflation-linked bond of the same maturity.

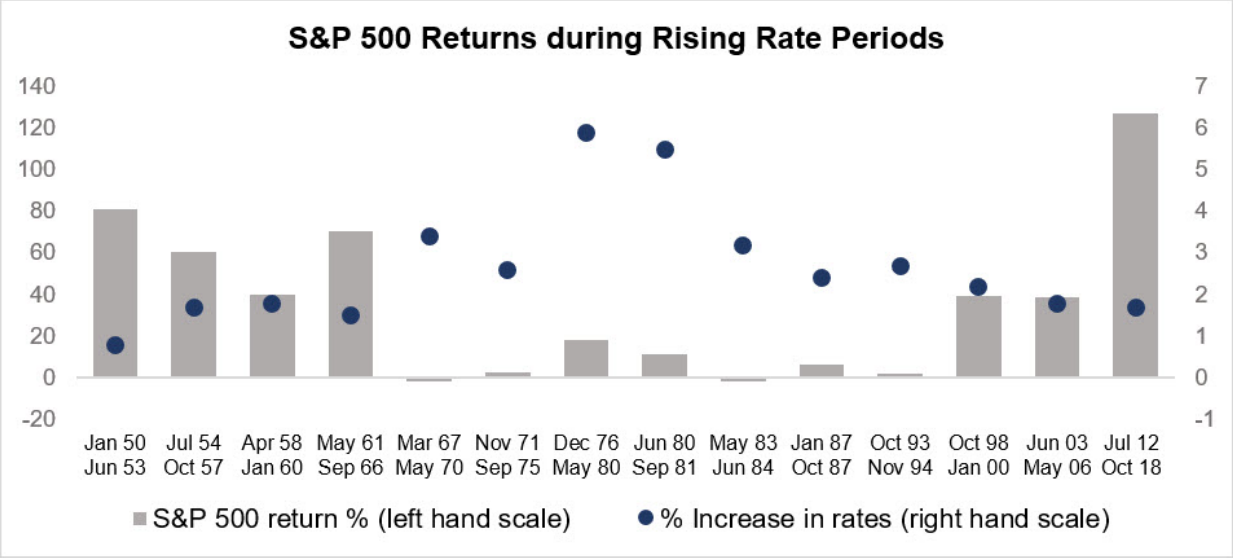
The Implications of Inflation and Rising Interest Rates on the Stock Market

We believe that one of reasons why markets may be more worried about inflation and interest rates than we think warranted, is the rate of change we're seeing in growth, bond yields and employment. The Fed recently revised its forecast for GDP growth in 2021 from 4.2% to 6.5%.[2] 10-year treasury yields have risen from during the first quarter from 0.93% to 1.74%. Unemployment dropped from 6.7% to 6.0% over the first quarter of 2020 and the Fed is forecasting that it will drop to 4.5% by year-end. Given how quickly these numbers are changing, it is understandable to apply a similar rate of change to expected inflation. The problem is there is not a fixed relationship between any of these measures and inflation, and the rate of inflation may accelerate or decelerate based on a variety of other factors. Having acknowledged the risk of trying to forecast rates of inflation, given that the U.S. is coming out of a recession, it would not be surprising if the inflation rate were fast at the start and then slowed as consumers settle into a new normal of post-pandemic spending and once laid-off workers have been reabsorbed.

While we believe worries about the Fed overshooting its inflation target are premature, we believe worries about the Fed tightening monetary policy to preempt inflation is one step further removed and therefore extremely premature. One reason investors care about the future of interest rate policy is because historically low interest rates are often cited as the rationale for the historically high price-earnings multiples currently enjoyed by US stocks. A rise in rates is assumed to equate to a drop in stock prices. Historically, the opposite has been true, with stock prices and interest rates rising together at least up to some threshold rate increase after which their directions diverge. Even when we look exclusively at periods in which the 10-year Treasury yield rose by 1% or more, in 11 out of 13 instances, the stock market enjoyed positive returns consistent with its long-term average.[3]

This dynamic can be explained as an expanding economy means more business activity and less demand for US Treasury debt, causing its yield to rise in order to attract capital, but interest rate increases in excess of 3% appear to signal an effort by the central bank to reduce business activity, thereby reducing the expected

return on stocks. The good news here is that the stock market's ability to absorb interest rate increases would appear to be higher than investors may assume.



Source: "Inflation matters more for the stock market than interest rates" Ben Carlson, *Fortune*, March 22, 2021

Although the outlook for the US stock market is promising given the gale force tailwind provided by the recent $1.9 trillion of coronavirus relief bill and another $2+ billion proposal for infrastructure and jobs, but stocks are not without their challenges, particularly if the infrastructure and jobs proposal includes tax increases for corporations and wealthy individuals.

Even though the new corporate tax rate would be well below the 35% rate in place in 2017 when it was dramatically lowered, it would still represent an estimated 5% reduction in after-tax corporate earnings.[4] Higher taxes on wealthy households might also cause them to sell some of the stock they purchased with the increased savings they accumulated when locked down. Even if the countervailing pressures of stimulus and a corporate tax increase offset each other leaving broad stock market indices unchanged, we would still expect the significant rotation going on beneath the surface to continue. After the extended run-up in large-cap growth stocks, broad market US indexes had come to resemble actively managed stock funds with a tilt to growth stocks, a big bet on technology stocks and concentrated positions in a handful of names. As interest rates rise, the discounted present-value of earnings in the distant future is reduced relative to nearer term earnings which benefits cyclical and value stocks, and reduces the present value of growth stocks with long earnings tails (i.e., duration).

Market Outlook and Recommended Portfolio Construction

Returns for Q1 2021 seemed generally consistent with what one might expect if investors were anticipating inflation or at least rising rates: positive returns for asset classes that are generally expected to hold their value through inflationary periods and negative returns for fixed coupon, long duration bonds with modestly positive returns for shorter duration high-yield bonds.

Source: FactSet financial data and analytics

Interest rates are expected to rise consistently with the economy's anticipated growth. When interest rates rise, the price of bonds with fixed coupons fall. The longer the maturity of the bond, the bigger the drop in value will be. For this reason, our recommended positioning for fixed income allocations is to consider strategists who are tilting toward shorter maturity bonds and bonds with higher coupons such as below-investment-grade bonds. Another strategy would be to consider strategists that include Treasury Inflation-Protected Securities (TIPS) which are specifically designed to protect the purchasing power of an investors' principal. A third strategy for investors who are looking for a low-volatility tool with less interest-rate risk than bonds to help manage the overall risk of a portfolio would be low volatility multi-asset strategies.

Commodities and real estate are considered – by the typical investor – to be real assets that can provide a store of value during inflation. Indeed, commodities were an effective inflation hedge during the 1970s when oil prices soared due to supply shocks in 1973 and 1979. Gold also performed well during the 1970s when its price surged as anxious investors bought it as a tangible store of wealth after then-President Nixon abandoned the gold standard. It is not necessarily logical that commodities will be reliable stores of value that can hedge inflation or if their appreciation during the 1970s was really attributable to incidental factors that happened to coincide with an inflationary period. If we were to enter a highly inflationary economy, considering a strategist with a small allocation to commodities might enhance return but if anticipated inflation was not realized, the commodities will have added risk with potentially no reward.

It may surprise most investors but historically stocks have been a reliable inflation hedge, especially if a company can pass on its increased costs to customers. For this reason, the equity portion of a portfolio positioned in anticipation of inflation might not look that different from an all-weather portfolio constructed for a long-term investor. A diversified equity portfolio would be the return engine for both, with the biggest difference being in the allocation to bond types and investment strategies used to manage overall portfolio volatility.

Conclusion

Just as it is difficult to feel confident that commodities would be an effective inflation hedge given the idiosyncratic factors affecting the pricing of each individual commodity, diversification continues to be advisable even within the fixed income allocation of portfolio. Consider the possibility that even if US interest rates were to rise, nominal US interest rates remain positive unlike those in Japan and a number of European countries. Increasing US interest rates might even create positive real interest rates which would attract foreign capital to bid up the market price of U.S. Treasury notes and bonds. I cite this scenario only as a warning to beware of betting too heavily on any economic or market scenario, including inflation, since market dynamics are complex and often unpredictable. For this reason, broad diversification across asset classes and strategies remains prudent advice now as always.

[1] FRED, Federal Reserve Bank of St. Louis
[2] federalreserve.gov
[3] "Inflation matters more for the stock market than interest rates" Ben Carlson, Fortune, March 22, 2021
[4] J.P. Morgan, Q2 2020 quarterly call

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