In the Markets Now

The inflation question

We believe in the old saying: a picture is worth a thousand words. Here, we aim to recap recent market action and provide some perspective to investors.

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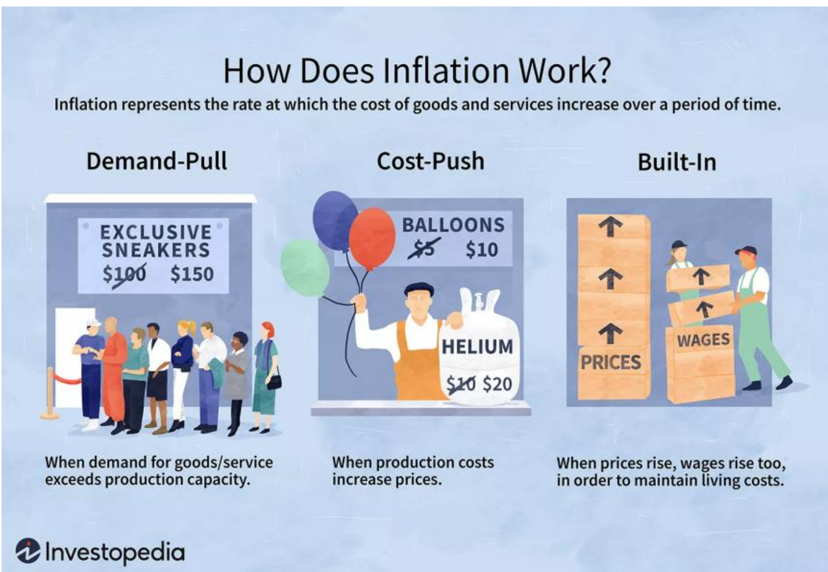
ON INFLATION, THE PANDEMIC, AND PORTFOLIO BUILDING

Inflation is a thorny concept. Though its definition is simple, inflation is influenced by a multitude of factors, is difficult to forecast, and affects everything from policy to investing to economics. And recently, concerns have re-entered the conversation in a big way over fears that 2020's stimulus policies could make higher inflation inevitable. Before we try to answer that question, however, let's start at the beginning.

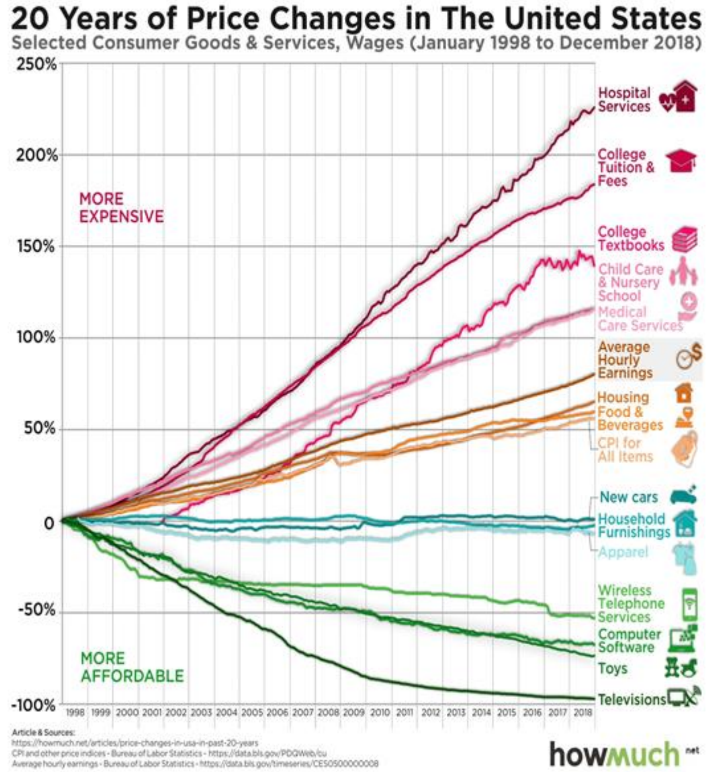
By definition, **inflation is simply the decline of purchasing power over time: one dollar buys less than it used to.** It's commonly measured by the price movement for a basket of goods and services that represents the expenses in an average person's life—rent, gasoline, food, haircuts, and so on. If the price of the basket is rising, that's inflation (and if it's falling, deflation). Both high inflation and deflation are bad for different reasons, so the Federal Reserve targets an average ~2% inflation rate over time. This is their "goldilocks" level—not too hot (the economy is overheating!), not too cold (demand is crashing!).



But what causes inflation**? Broadly, either too many dollars are chasing too few goods or producers are passing price hikes on to customers as their inputs get more expensive** (see left). Expectations are also a key component—if people expect prices to rise in the future, they might spend more today, thereby increasing inflationary pressure. Good times produce confidence, and confidence can fuel an inflationary cycle. Finally, many economists suggest inflation is at least partly explained by how much cash is in the economy. In theory, higher money supply leads to inflation (more dollars chasing too few goods again). This is also why inflation fears are currently resurgent, as the massive pandemic stimulus greatly increased the amount of cash in circulation (to get technical, M2 money supply is up a massive ~25% from last year).

To examine the current environment, let's first go to the past. For many, concerns about inflation are drawn from the experiences of the 1970s. In that era, rampant inflation and high unemployment were commonplace as the US experienced widespread economic malaise and stagnant stock markets. To many, inflation fear cannot be separated from the issues of this "lost" decade. However, many items that fueled the high inflation in the '70s are unlikely to be repeated. The end of the gold standard, two massive oil shocks, and uniquely strong labor unions were among the key factors.

Today, not only are these inflationary forces not in play, but there are several key deflationary factors at work. Perhaps most importantly, technological innovation has led to sweeping productivity increases and price cuts (e.g. not only are TVs today much nicer, they're also cheaper). As we can see to the right, many household expenditures have actually dropped in price over the last twenty years. Elsewhere, globalization (via lower labor costs and trade specialization) and demographic shifts (aging populations tend to lead to slower growth/inflation) are both deflationary themes likely to persist.



So the question is: will 2020's fiscal and monetary policy tsunami outweigh a deflationary recession and the longer-term forces discussed above?

We think the answer is probably no, at least not in the near-term. We do believe the combination of putting cold hard cash directly in people's hands AND limiting their ability spend it due to pandemic lockdowns has led to pent-up demand of epic proportions—an aggregate consumer ready to spend and spend big. This unprecedented demand will challenge supply, particularly in services sectors (e.g. airlines, concert tickets, Airbnbs) and likely force prices higher in the near-term. Let's put it this way: seeing Springsteen in 2021 is going to hurt your wallet.

But is that true inflation? That is to ask: Is a one-time price boost in some industries "inflation?" Fed Chair Jerome Powell doesn't seem to think so, saying in late 2020 that individual price increases related specifically to economic reopening were not inflation. Inflation is a long-term rise in price levels across the board, a process by which prices go up year after year after year. Can this occur with deflationary forces around every corner and an economy still recovering from a global pandemic? Even with additional stimulus in the pipeline, we think it's unlikely. While there will almost certainly be odd price movements and strange bottlenecks in the near-term as we work through the back-end of an unprecedented pandemic, key parts of the stimulus packages (e.g. the direct checks) are one-off in nature while others (e.g. unemployment benefits) will shrink automatically as the economy recovers. While fiscal policy may be a bigger part of the picture going forward, we'll tackle that when we get there.

Still, many may find it prudent to add inflation hedges to their portfolios. So where to begin? Stocks have provided returns above inflation over most time frames (small-caps have outpaced inflation every decade since the 1930s). Within the broad stock universe, my colleague Kris Rosemann suggests "maintaining exposure to high quality companies that are able to compound returns on invested capital over time, even if we do get an 'inflation scare' in the near-term." Strong operators can better manage both input price inflation and wage pressure. Sectors like Strategas favorites Financials, Energy, and Industrials have also been solid hedges over the years. Elsewhere, Gold has protected against inflation decently well throughout history, though we rarely advocate more than a small position in the yellow metal. And finally, as inflation poses the biggest risk to fixed income investors, an allocation to TIPS (Treasury Inflation-Protected Securities) might make sense.

In the end, inflation risk should always be a consideration when building portfolios and financial plans—it can affect your expenses, your purchasing power, and your investment returns, among other things. While the tweaks above may help protect a portfolio from this risk, any changes should always be made within the context of a larger plan. And while we may see some inflation "scares" as our economy gets back to normal, we ultimately think the risk of persistently high (or hyper-) inflation is overstated for the coming year. Be sure to reach out to your Baird Advisor with any questions on this topic.

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