Is It Time for Inflation Risk?

By Gregg Biro

There has never been a shortage of controversial financial topics making headlines, and today is no different. Current newsmakers include cryptocurrencies, GameStop, SPACs, and nonfungible tokens. However, the item that concerns most prudent investors is the recent rise in inflation. It's been over 30 years since the US economy has had to deal with real inflationary pressures, and that was in 1990 when year-over-year inflation reached 6.1%. Since then, US inflation has remained remarkably stable and has averaged 2.4% per year. The obvious question is, how will inflation affect markets and my portfolio?

Inflation typically rears its head during periods of economic growth, so it's not surprising that the expectations for inflation are on the rise given the COVID-19 vaccination rollout, the easing of restrictions on social distancing, and consumers' pent up demand to spend. Inflation is part of the regular business cycle, which means we should put what's going on now in perspective.

Inflation generally occurs when there is more demand than there are goods and services to buy. We previously mentioned pent-up consumer demand, but the other half of the story is supply. Many are pointing their finger at supply chains that have been broken from chicken wings to computer chips to gasoline. A survey of 715 supply chain professionals by Jabil, a Florida-based chip manufacturing company, found the pandemic disrupted 78% of supply chains — more than any other event in the last decade. This led to shortages across multiple industries and products. When you combine supply constraints with pent-up consumer demand, you're likely to get inflation. These factors contributed to the Consumer Price Index (CPI) jumping up to 4.2% for the year-over-year ended in April 2021.

Aberrant or short-term spikes in inflation can be rationalized. But the real concern amplifies when inflation is higher than the long-term average (3.76% average since WWII) for an extended time. Higher than EXPECTED inflation for an EXTENDED period is usually considered negative for stocks because borrowing costs go up, input costs (labor & materials) go up, and profitability goes down. The question then becomes, have temporary inflationary pressures become permanent?

Transitory or Permanent?

There are several things to dissect when you look at the CPI for April. A few key CPI categories had outsized increases from one year ago that will likely not repeat, including airfare, energy, and lodging away from home. Because demand and prices for these services collapsed in the spring of 2020, the 4.2% inflation in April 2021 is less indicative of a runaway concern and more symptomatic of an economy recovering from an extraordinary contraction in the second quarter of 2020.

Let's look at demand and consumer spending. The enhanced unemployment insurance associated with the pandemic, set to expire in early September, is seen by some as a contributor to the increase in inflation. Some economists estimate that between 25%-50% of enhanced unemployment insurance recipients make more money via those programs than if they went back to work. Therefore a growing number of states have announced a halt to these enhanced benefits (22 states as of this writing) before their official

expiration on Labor Day. Because enhanced unemployment benefits are temporary, so too is their impact on rising prices and inflation.

Fiscal stimulus has also been assessed some of the blame as the $1.9 trillion recovery package makes its way into consumers' hands. This also appears to be a transitory issue, given the one-time nature of the direct payments. It's also important to note how (or IF) consumers spend this money. While some funds go toward goods and services, a surprising amount has reduced debt. The Wall Street Journal reported that consumers are paying down credit card debt at the fastest rate in seven years. Data released on May 12 from the New York Fed said credit card balances shrunk by $49 billion compared to the last quarter.

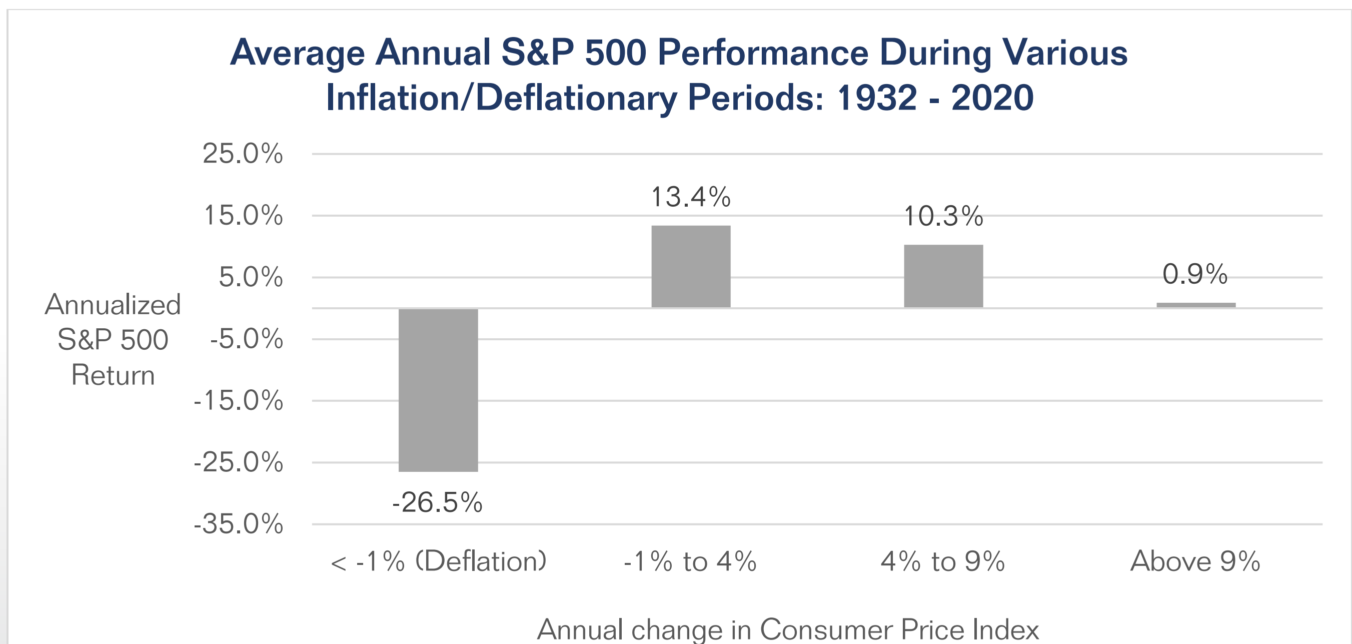
As for supply constraints leading to inflation, Federal Reserve Chairman Jerome Powell said on April 28 that pressures from supply-chain issues would likely be temporary and wouldn't prompt the central bank to change policies aimed to keep borrowing costs down. This makes economic sense as companies recover from involuntary factory shut-downs during the COVID-19 pandemic and navigate the slow return of skilled labor to the workforce.

All of this makes a compelling case that bolsters the academic stance that the current inflationary pressures are transitory.

How Does Inflation Affect Your Portfolio?

Stocks: Some inflation is generally good, as it indicates that demand for goods and services is strong, allowing businesses to raise prices and hire more employees. Real returns for the S&P 500 have been historically healthy when CPI is between -1% to 4% (see below).

While equity returns were lower when inflation is above 4%, note that they were still positive, even in the limited data set, when inflation was over 9% year over year.



Short-Duration Bonds: Although rising rates result in bond price declines, the impact is relatively muted for short-term bonds because their prices are less sensitive to interest rate fluctuations. Short-term bonds

in your portfolio are resilient during periods when interest rates are rising because they typically mature in one to three years and allow investors to get their money out and reinvest it at higher rates relatively quickly.

Treasury Inflation-Protected Securities (TIPS): TIPS are bonds issued by the US Treasury and can be a source of inflation protection because their principal value and repayment at maturity directly tie to the Consumer Price Index (CPI). TIPS will outperform nominal bonds if, and only if, inflation is higher than expected, as nominal bonds already have inflation expectations priced into their coupon. TIPS can reduce the risk of unexpected inflation, but investors pay for that reduction with lower overall returns. Owning TIPS is a bet that you know more than the bond market and institutional bond traders about the expectations for future inflation. For this reason, we do not include TIPS in your portfolio.

Gold: Spend a little time on social media, and you'll hear that protecting yourself against inflation involves the purchase of gold. That hasn't been the case this year, with inflation increasing and gold prices falling. Gold tends to rise in anticipation of inflation versus rising with inflation. Tactically investing in gold to hedge against inflation is a form of market timing, something we all know conclusively doesn't work. For more information, please read our article on gold from 2014 (Worth Its Weight in Gold).

The End Goal Remains the Same

Ultimately, there is a good chance we will see a continuation of elevated inflation in the coming months. But it seems unlikely that inflation will spiral out of control or have a long-lasting impact. In other words, it should be temporary inflation as things settle into the new normal.

The primary goal of investing is to grow your assets at a rate greater than inflation without taking undue risk. That hasn't changed. While several factors contribute to rising inflation, the risk of hyperinflation is low. In our view, stocks are the best long-term position to hedge inflation, even if one might expect below-average returns in years with above-average inflation rates.

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