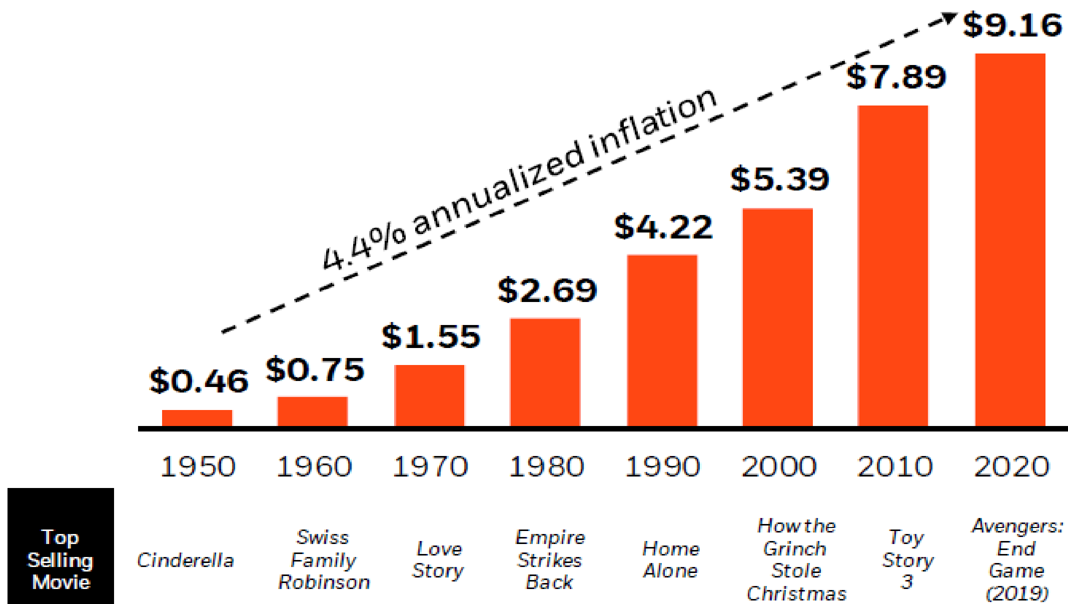
Fighting the Erosion of Inflation

For financial advisors tasked with guiding their clients through financial independence, inflation is public enemy number one. Much like ocean waves relentlessly pounding the beachside cliffs, so is the silent but constant pressure on prices as the cost of living rises over time. Sometimes it will be decades before the impacts of inflation are felt, while other times inflation is headline news as gas prices soar, or the cost of your holiday meal skyrockets. But what is inflation and why is it so important to financial planning?

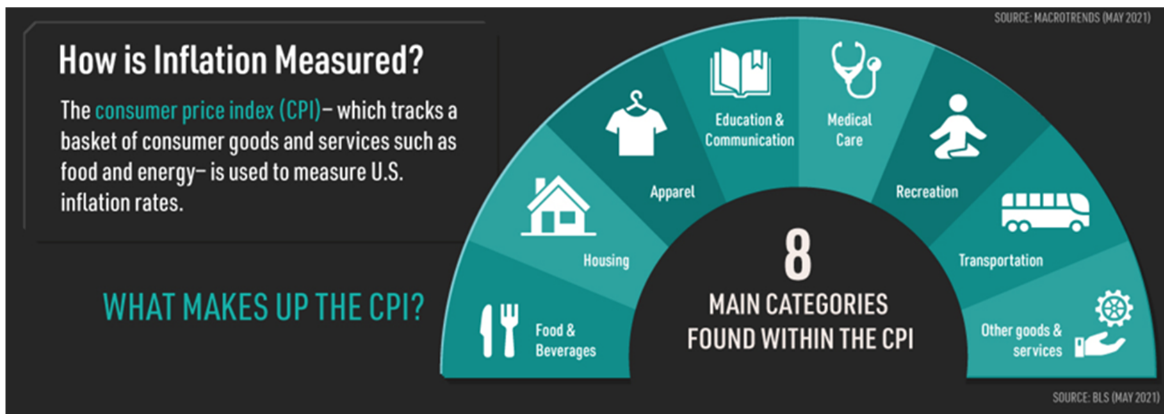
Inflation is defined as the decline of purchasing power of a currency over time. It is erosion… but of your purchasing power instead of the shoreline. This is incredibly important to clients seeking financial independence because retirement may last 40 years without earned wages to pay the bills. That means your nest egg must keep pace with the rate of inflation or you won't be able to afford the things you need and want over the long run. To illustrate this, note the prices to attend the top grossing movies over the years. Watching Luke Skywalker battle Darth Vader in *The Empire Strikes Back* in 1980 would have cost you under $3, while viewing your favorite Marvel characters in *Avengers Endgame* would have been over $9 if you could have found an open movie theater during the pandemic in 2020! This represents a 4.4% rate of inflation which may not mean much until you reframe it in terms of actual cost increase. Realizing the cost of going to a movie ***more than tripled*** during the span of a typical retirement might have more impact. Apply this across all the things one needs or enjoys for four full decades, and it is easy to see why financial advisors consider inflation to be a primary enemy, and why growing a portfolio is necessary to combat it.



Blackrock – Student of the Market, November 2021

Measuring Inflation

Inflation is best described by the ***increase in price level of a basket of selected goods and services in an economy*** over time[1]. The rate at which these prices increase is assigned a percentage and that is considered the ***inflation rate***. So what is in the "basket" and how is inflation measured? The Bureau of Labor Statistics puts out a measure called the Consumer Price Index (CPI) which is often quoted by the financial media as the measure of inflation. The CPI uses household surveys in urban areas to build the basket of goods and services that consumers pay for. As you can see in the figure below, the CPI tracks eight main categories of consumer spending including food, housing, apparel, education, medical, recreation, transportation, and other goods and services. By measuring the purchases of this basket, the CPI measures the rate of change over time and assigns an inflation rate.



There is a second measure of inflation called the Personal Consumption Expenditures (PCE) index which is issued by the Bureau of Economic Analysis. The PCE differs from the CPI in that it measures what sellers are selling as opposed to what consumers are buying. As a result, they use Gross Domestic Product data and the actual sales from suppliers to build their measurement. In 2012, the Federal Reserve announced that they were moving to the PCE as their primary measure of inflation because they felt it reacted better to changing consumer patterns, it covered more than just urban areas, and it could be revised more extensively. Despite the Fed's adoption of PCE, the CPI remains a very popular measure of inflation. Both CPI and PCE are issued in "headline" and "core" forms each month. The "headline" data includes everything, whereas the "core" measures exclude the categories of food and energy. Because food and energy tend to be quite volatile, economists feel the core readings provide better clarity as to the long-term trend of inflation. However, people need both food and energy to live their lives, so advisors care about the total inflation number over the long run!

Role of the Fed

Speaking of the Fed, the US Central Bank has a stated goal of keeping inflation in the U.S. at 2%. While easier said than done, the Fed influences inflation by setting interest rates (The Federal Funds Rate) and by open market activities (buying and selling U.S. Treasury Securities). When the Fed wants to spur the economy, it lowers interest rates and/or purchases treasury securities in the marketplace driving yields down and the prices of those bonds up. This activity is said to be "accommodative" or "easy" monetary policy which accelerates economic activity and if overdone can lead to inflation. If the Fed is

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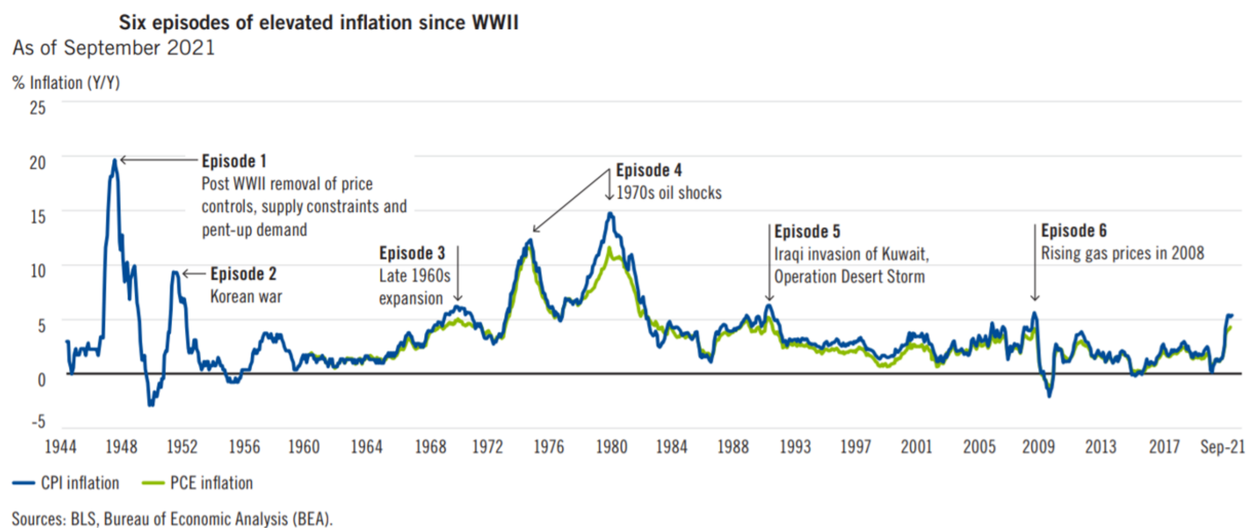
trying to control inflation or slow an overheated economy, they will raise interest rates and stop purchasing Treasury securities. The most famous example of this "tight" monetary policy was under the leadership of Fed Chairman Paul Volker in the early 1980's when he committed to breaking the back of runaway inflation that plagued the economy after the Oil Shocks of the late 1970s. Although highly unpopular at the time, Chairman Volker is credited with bringing inflation under control and helping touch off one of America's largest economic expansions of the 1980s. However, on the way to that occurrence, interest rates rose so dramatically that the average mortgage rate in America topped out at a whopping 16.63% in 1981![2]

As you can see in the figure below, there have been six periods of elevated inflation in the US Economy since WWII. Over the last 30 years, inflation has not been the factor that it was in the 30 years prior, and as a result, it has receded into the background for many people. Only the recent spike in inflationary pressure coming out of the COVID Pandemic has brought it to the front page again.



When Inflation Hits

When inflation increases, the impact on consumers is somewhat clear… prices rise, and it costs more to afford their lifestyle. But what about markets and the economy in general? As inflation increases and interest rates rise, it may be helpful to think of the metaphor of sand in the gears of the economy. Friction is increased and everything operates with less ease and efficiency. Borrowing money is more expensive at higher interest rates, so businesses may not be as profitable on the goods and services they provide unless they can pass that cost along to consumers via price hikes. Employees sensing the increases in the cost-of-living require higher wages to afford it. Labor is one of the largest inputs into a business, and if the cost of labor goes up without a corresponding increase in productivity, further profit erosion can occur. This can lead to something economists call a Wage-Price Spiral, whereby workers see the cost of living increasing and demand higher wages, which in turn causes businesses to raise prices to cover the increased wages. With the higher wages, people feel empowered to keep spending and thus demand remains high, furthering the spiral.

From a market perspective, inflation causes a strain on the profitability of companies as mentioned above. Furthermore, the value of future profits is not perceived to be worth as much because a dollar in the future has less value at higher levels of inflation. Since a large factor in stock prices is the discounted value of future profits, the result can be a lower stock price (note that many other factors can impact stock prices too). Investor expectations and emotions can play havoc on stock prices in moments of high inflation as well. Merely the perception of inflation continuing can exacerbate the actual economic impacts.

While inflation isn't great for stocks, it is far worse for fixed income investments. There is an inverse relationship between bond prices and interest rates. Thus, if interest rates rise due to inflation, bond prices decline. A logical example is someone holding a bond paying a 3% coupon rate who finds out that due to rising interest rates, newly issued bonds of the same type now offer a 5% interest rate. That investor will find the price of her 3% bond had gone down if she were to try to sell it on the open market. Inflation also hurts cash investors because increasing interest rates provide an illusion of growth on savings accounts. However, this increased yield is offset by the rising cost of living, thus their dollars are losing purchasing power every day. Ironically, the asset classes often considered "safer" than stocks stand to get hurt the worst in an inflationary environment.

The Resurgence: Transitory or Transformative?

The recent spike in inflation is causing a debate among economists about whether it is short-lived in response to the issues stemming from the COVID pandemic, or if it is systemic and longer lasting. In the same way we would never make a short term call on markets or interest rates, we are not offering a prediction on inflation. However, understanding the factors that could cause it to be transitory or lasting may be helpful.

The Transitory Case:

Blame it on COVID – The global supply chain is a mess, and the massive shift in consumer preferences from pandemic supplies to a re-opened economy was bound to cause inflationary pressure. Furthermore, the measurement year-over-year is going to look inflationary when comparing to a time when the economy was locked down. Airline tickets, hotel rooms, and gasoline can be expected to be dramatically elevated from the previous year when they were on the floor. The supply chain was exposed for being fragile and the comeback has been slower than anticipated, however the dynamic nature of capitalism will fix these imbalances, and the economy will stabilize.

Innovation is the Antidote – Technology has been bringing massive productivity gains to our economy for decades, and the pace is only accelerating. A recent McKinsey study showed that 40% of consumers tried a new method of shopping during the pandemic and that 80% of respondents plan to change their shopping habits permanently[3]. Morgan Stanley economists predict that capital investment will reach 121% of pre-pandemic recession levels in 2022 a pace far above that of previous recoveries (it took 10 years for capital spending to recover after the Great Recession)[4]. This massive spending by companies will fast forward advancement in Artificial Intelligence, automation, and technological disruption predicting massive productivity gains which will dampen inflation.

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The Fed Has Options – Monetary policy has been excessively easy in response to the COVID recession, but the Fed believes it has the tools to fight inflation if necessary. They often overcorrect and do so later than they should, but they can act. Chairman Volker showed them the nuclear option when he battled inflation 40 years ago, and although nobody wants to relive that experience, The Fed believes they have the playbook.

The Case for Lasting Inflation:

Wage Pressure is Rising – initially the increased inflation readings were due to supply chain issues and travel related costs going up. But recent readings are showing wage pressure across the board. Companies with white collar and technically skilled positions are finding it difficult to find suitable workers which is driving up salaries as firms compete for a smaller pool of talent. The pandemic pushed a lot of people out of the workforce that have yet to return as well. Help Wanted signs are prevalent across America and wage pressure is the stickiest of all inflation factors. We could be in this for a while.

The Supply Chain is Compromised – Much has been made of the supply chain issues plaguing the economy as the world opened after the COVID lockdowns. Pictures of loaded ships stacked in harbors, and empty shelves in stores have been commonplace. Even your local Starbucks might be missing your favorite guilty pleasure due to supply shortages! What was once seen as a problem that would resolve in short order is starting to feel like a long-term issue. If the supply chain issues drag on for a couple years, can that still be considered transitory? It may take a while before manufacturing can be re-routed and “onshored” to the US at likely higher cost which would be inflationary.

The Fed is Already Late – Trillions have been pumped into our economy by the Fed and Congress and the American consumer is flush with cash and ready to spend. All those dollars chasing too few goods (due to supply chain issues) is causing inflation and will for some time. Combine this with rising wages and you get the possibility of a full-blown wage/price spiral. Being loath to stifle economic growth, The Fed will be hesitant to reduce their asset purchases and even slower to raise interest rates. In the interim longer term interest rates may rise and inflation may run amok before the Fed reacts more emphatically.

What to do?

Naturally, investors want to know what they can do to protect themselves against inflation. In the same way that we would not recommend making short term shifts in allocation based on market movements, we don’t recommend tossing out your long-term strategy due to the specter of inflation. You may hear all manner of recommendations from pundits or those with a vested interest in you purchasing a particular product. Treasury Inflation Protected Securities (TIPS) are often bid up during inflation, as are commodities and natural resources. Advertisements for gold increase dramatically on media outlets as those who profit from rising gold prices try to capitalize on inflation fears. Success by timing a shift to these categories requires the power of prediction, which we do not possess, and do not recommend. Far better to build a long-term strategy that has held up over time and stick with it. Thankfully, one of the most consistent inflation fighters over the long run has been mainstream equities. The best and most innovative companies in our society have maintained pricing power and profitability regardless of the environment, and their stock price and their dividend have risen

accordingly. Note the statistics for the S&P 500 from the last time inflation touched 6% for a twelve-month period. That year was 1990, and America was just about to enter the first Gulf War. There have been six bear markets since that time, two of which (2000-2002, and 2007-2009) were the deepest since the Great Depression.

- The S&P 500 closed 1990 at 330.22. As this article is written in December of 2021, the level is now 4,700. This represents **an increase of over 14 times!**
- The cash dividend on the S&P 500 was $12.09 in 1990, and consensus estimates for 2021 are for a cash dividend of $61.03 – **a fivefold increase**
- Inflation as measured by the CPI in December of 1990 stood at 133.8, and that same index is at 276.6 in December of 2021 – meaning that inflation has **slightly more than doubled**.[5]

History cannot predict the future, and inflation may well be higher in the forthcoming 30 years than it was for the 30 years prior. Furthermore, this is not to say that stocks will provide some sort of shock absorber to inflation in the short run. They won't… no financial asset can be relied upon consistently in the short run. However, if stocks merely post half the results they achieved since 1990, and inflation is twice that of the same period, stocks will still outpace the erosion of inflation by a measurable margin. Jeremy Siegel, the noted Wharton School professor stated it plainly in his book *Stocks for the Long Run*, "In the long run, stocks are extremely good hedges against inflation, while bonds are not."

We encourage you to talk with your advisor about the topic of inflation and how you are positioned to weather that phenomenon should it persist. Together you can refocus on the long-term strategy and make sure you win the fight against the erosion of inflation.

1. What is Inflation – Investopedia – Jason Fernando, updated November 29, 2021
2. Historical Mortgage Rates from the 1970s to 2021: Averages and Trends – Kevin Graham, RocketMortgage.com, November 4, 2021
3. McKinsey study as quoted by Franklin Templeton - The Deflationary Nature of Growth, Matt Moberg, November 2021
4. 2021 Midyear Economic Outlook, Morgan Stanley Research, June 2021
5. Nick Murray Interactive – December 2021, data taken from Historical S&P 500 Index and dividends: "S&P 500 Earnings History, NYU Stern School." Consensus 2021 earnings forecast: Yardeni Research. Consensus 2021 dividend forecast: Bloomberg. Consumer Price Index: Inflationdata.com.

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