The 2021 Inflation Playbook

A look at inflation risk and ideas for insulating your portfolio.

Directional
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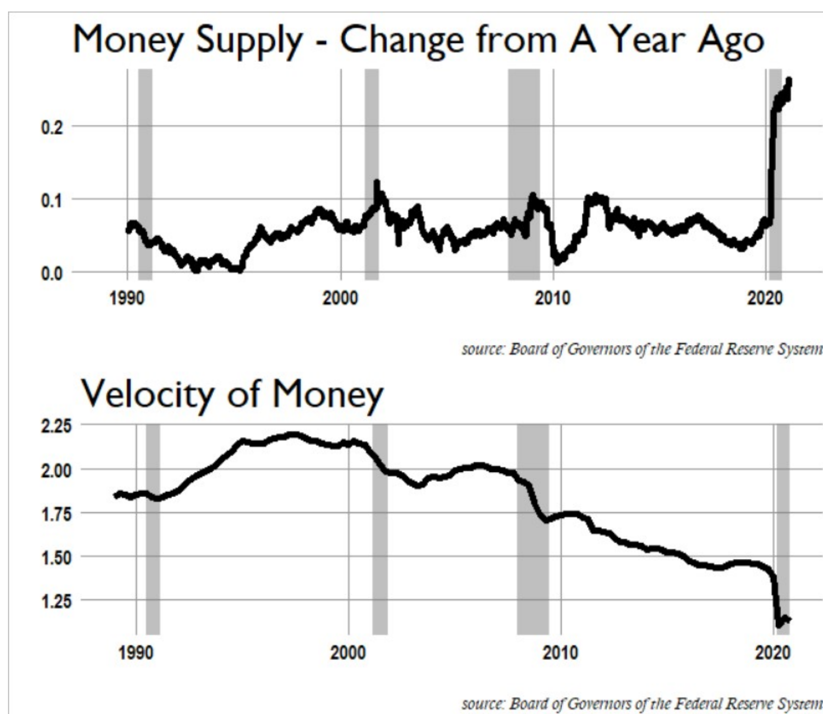
Executive Summary

- The US economy is in a liquidity trap. The dynamics of inflation and economic growth in a liquidity trap are counterintuitive and not so straightforward. Actual inflation is not expected to show up until interest rates rise meaningfully.
- The main worry is not inflation itself, the worry is that inflation will prevent the Federal Reserve (and other central banks) from continuing their policy of low interest rates and printing money.
- Bonds, broadly speaking, do not fare well in an inflationary environments, especially traditional longer-term corporate and sovereign bonds. That said, there are pockets of the bond market where investors may find refuge.
- Stocks tend to benefit from inflation, though some sectors respond more favorably than others. However, inflation does limit the Federal Reserve's policy of low rates and expansion of the money supply. A constraint on Fed policy is generally a negative for stock prices.
- Commodities tend to be fairly insulated from inflationary pressures and from changes in Fed policy, but investors pay for that insulation with increased volatility.



Where is Inflation?

In many ways, our current economic environment is a puzzle. On the one hand, central banks around the world have printed and spent unprecedented amounts of cash into their economies (top chart, above). Yet, contrary to our intuition, inflation has been relatively muted over the past decade or so. So, where is inflation?

In short, the US economy is in a liquidity trap.

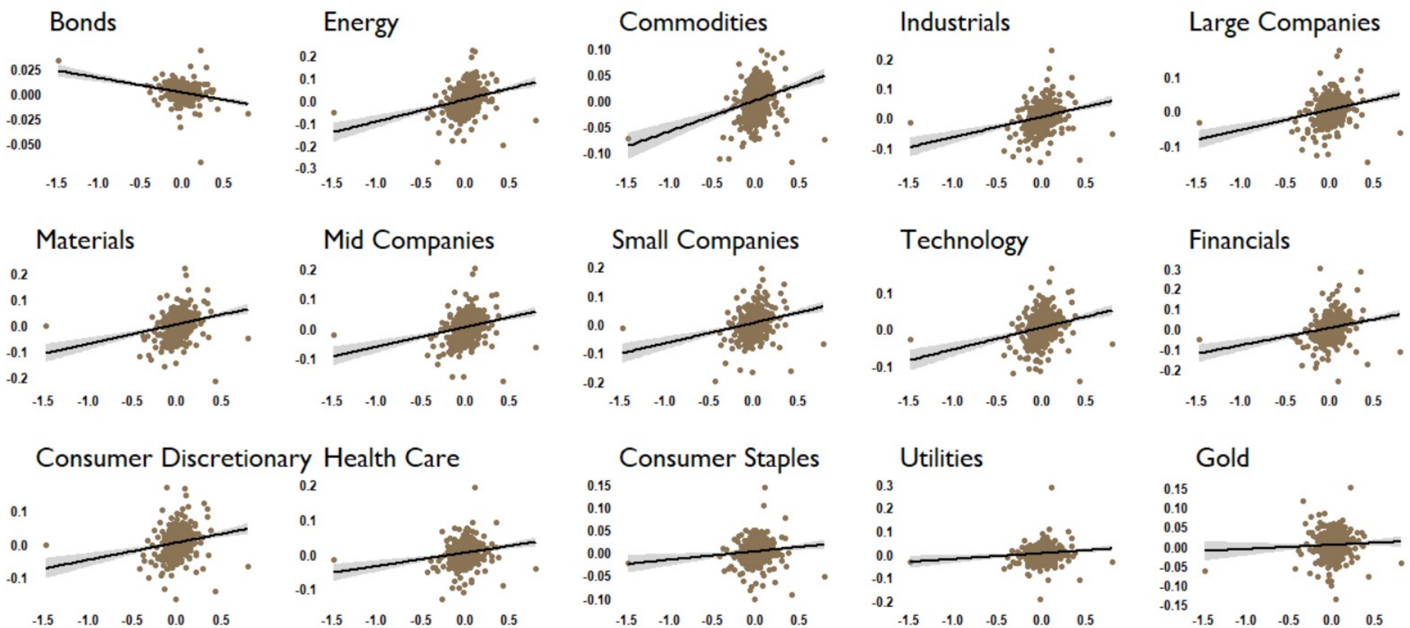
As interest rates approach 0%, there is no difference between owning cash and investing it. When bond yields are below 1%, investors are not eager to invest their money so they hold cash instead. Similarly, companies tend to hold cash rather than invest it in their businesses because cash gives companies flexibility in the future, and investors do not punish them for holding it. This is illustrated above in the bottom chart.

Because all this cash is getting stuck and not moving around the economy, inflation tends to stay low. In a liquidity trap, contrary to our intuition, printing more money tends to lead to stagnant growth and low inflation because companies get ever-less productive, and cash is hoarded at greater levels.

Once interest rates begin to climb meaningfully, however, the opportunity cost of cash comes roaring back. Investors and companies then rush to invest that cash, and it once again begins moving around the economy. That is when inflation begins to take hold.

The metric to watch, then, are meaningfully higher interest rates. Because as rates move higher, the threat of inflation grows.

In the following sections, we will take a look at the various effects inflation might have on portfolio positions, and some adjustments you could make to help insulate your portfolio against the threat of inflation.



Where Does Inflation Bite the Hardest?

When looking at inflation risk, there are two approaches to take. First, we can look at how sensitive are various sectors and asset classes to inflation. This is measured by looking at how much of asset's return is explainable by changes in inflation expectations. Second, we can look at how much influence inflation has over an asset. For example, if inflation expectations move upward by 1%, what return do we expect from the asset? We will look at both in this report.

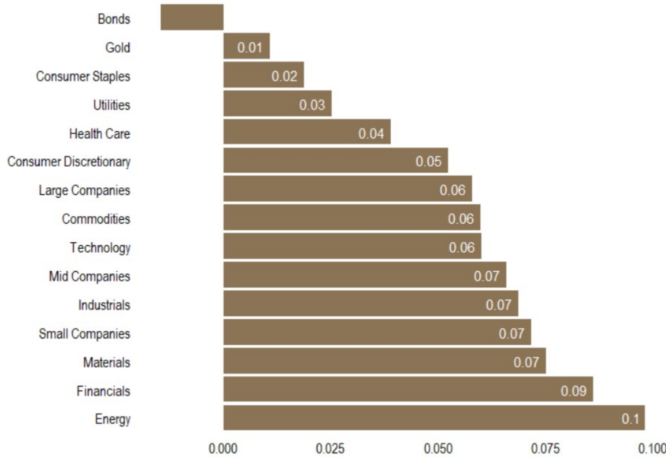
Traditionally, stocks are a good hedge against inflation. Companies are generally assumed to have some pricing power meaning they can pass along increases in their costs to consumers. That has become more difficult in recent years, however, because of globalization. Rather than increase prices, companies tend to seek out lower costs—specifically in labor and manufacturing. That leads to a split in inflationary effects: the prices of consumer goods tends to stay the same while the prices of goods where production cannot be so easily moved tends to rise (such as food and housing).

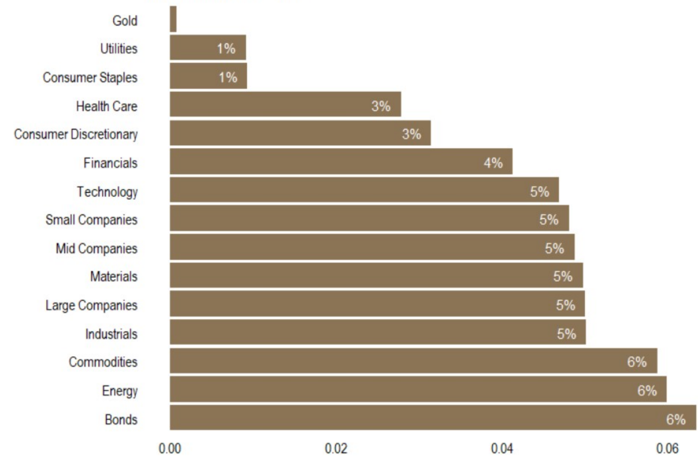
We can see this effect in the chart above, which looks at various economic sectors and asset classes and the effects of inflation. On the *x*-axis is the weekly change in long-term inflation expectations, and the *y*-axis plots the weekly change in price for that asset. The plots are ordered such that inflation explains more of the returns in the top-left (bonds), and the less of the reutnrs in the bottom-right (gold).

Bonds: Be Careful

It isn't too surprising that bonds, generally, have a negative relationship to inflation. That is to say, as inflation expectations rise, bond returns go down. Traditional bond sectors—such as longer-term corporate and sovereign bonds—are likely to be hit the hardest. That said, bond markets are a big place and there are still pockets within it which can insulate an investor from this negative inflation effect.

Floating rate bonds are one place investors can offset inflation worries. Floating rate bonds have coupons that move with prevailing yields, and that ability





to adjust can offset rising inflation worries. As a tradeoff, they typically have long maturities and lower credit quality, so investors are often best served owning them through a fund.

Steepener notes are another area of the bond market that can offer some protection. The yield on steepeners is tied to the difference between two maturities on the US treasury yield curve. For example, a bond like this may offer four times the difference between the 20-year US Treasury yield and the 5-year US Treasury yield. As the difference between those two yields widens (as is often the case in an inflationary environment), we collect more yield. Of course the yield on them can fall, too, so they are not usually appropriate for investors who need reliable income from their portfolio. As an inflation hedge, however, they do offer some protection.

Stocks: It Depends

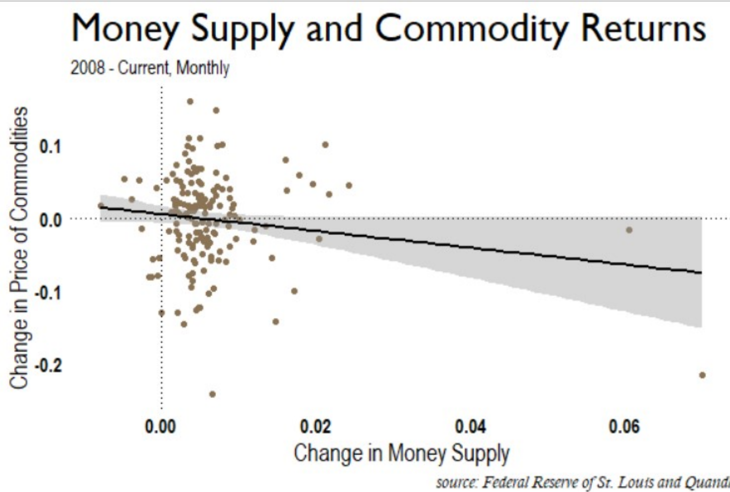
When it comes to stock investments, there are two major forces at play. There is inflation itself, and then there is how inflation effects Federal Reserve policy. We need to look at both to determine how to proceed.

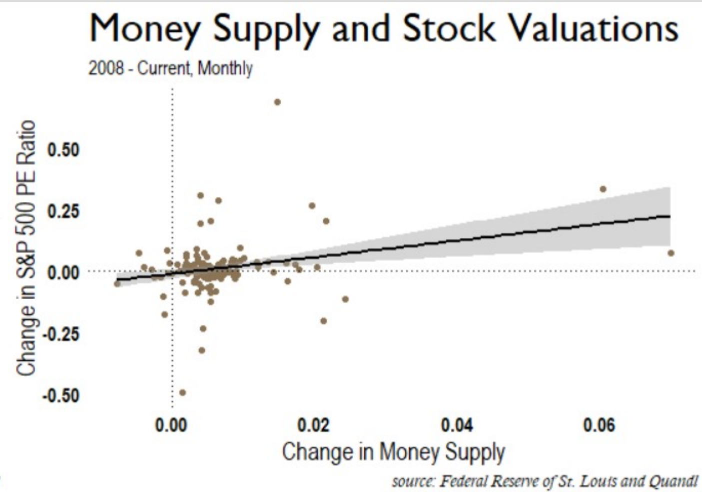
In general, increased inflation expectations are good for stocks of all kinds.

In the face of increasing inflation, energy is a good place to start looking for opportunity. Since Covid, energy companies have still not fully recovered their pre-pandemic prices, making their valuations much more attractive than other sectors. Additionally, the price of energy tends to increase with inflation, benefitting the price of energy companies. We can see this effect in the plots at the top of the page—energy has high sensitivity to inflation and generally benefits from higher inflation expectations.

At the other extreme are utility companies where inflation tends to have very little effects on return outlook. This can be helpful for investors looking for yield, or looking for a bond replacement, as utilities tend to have higher-than-average dividends. It isn't all upside, though, as utilities tend to be very sensitive to higher borrowing costs, and an increase in yields may be a net negative for the sector.

Financials could be another home for inflation-concerned investors. Most banks make money by borrowing at short-term rates and lending at long-term rates. The difference between those two yields, in recent years, has been





severely compressed which has limited the profits banks can make from their traditional business. As inflation concerns increase, banks stand to benefit as the difference between the long-term and short-term rates increases. Of course, banks also benefit considerably from Fed policy, so that is an effect investors will have to consider in their portfolios overall.

For stocks in general, however, inflation could constrain the Federal Reserve from continuing to expand the money supply. As the plot above illustrates, increases in the money supply tend to yield increases in stock valuations, and the opposite is also true. In fact, for every 1% reduction in the supply of money we can expect about a 3.5% drop in P/E ratios. Considering that the supply of money has expanded at 25% over the past year, investors are right to be concerned about a reversal of Federal Reserve policy.

Careful analysis is required to balance the forces at work in a stock portfolio, from fundamental economic data to actual inflation to changes in the supply of money.

Commodities: Not so Straightforward

Traditional wisdom tells us that commodities should increase in value when inflation heats up. That is generally true, however the effect varies by commodity type.

Gold, contrary to popular belief, has little correlation with inflation expectations. Despite often being sold as *the* inflation hedge, inflation explains less than 1% of gold's return over the past fifteen years. In addition, gold has benefitted from the increase in money supply, a trend which is likely to reverse when the Fed stops printing money. That doesn't mean gold has no role to play in a portfolio, it just means that investors should not automatically assume gold is the asset to buy to offset inflation worries.

Commodities, more broadly, do tend to increase with inflation. Energy prices (oil and natural gas), food prices, and industrial metals (like copper), all tend to increase in price with inflation. In many cases, increases in these prices is the definition of inflation. To help offset inflation concerns, an increase in commodity holdings is a sensible first step, though investors need to be cognizant of the increased volatility that can come with holding commodities of all kinds.

In addition, commodities tend to be less influenced by changes in the supply

of money, as can be seen in the plot on the previous page. While there appears to be an inverse relationship, the relationship is not particularly strong—it is certainly weaker than the relationship between stock valuations and the money supply.

The Fed

If it is not clear by now, it should be stated more clearly: the Federal Reserve is largely responsible for driving current market dynamics. We must, therefore, analyze what it is the Fed is saying about the current environment to get a fuller picture of what may be next.

Fed chairman Jerome Powell delivered his most recent congressional testimony on February 23-24, 2021. He reiterated many of the points he has delivered in the past. Namely, that the Fed plans to continue its current policy of low rates and printing money for the foreseeable future.

On the current economic environment, Powell pointed out that the real economy is still a long way from healthy:

> "*The economy is a long way from our employment and inflation goals, and it is likely to take some time for substantial further progress to be achieved.*"

And that the job market is still in poor shape:

> "*The high level of joblessness has been especially severe for lower-wage workers and for African Americans, Hispanics, and other minority groups...The economic dislocation has upended many lives and created uncertainty about the future.*"

On inflation specifically, Powell was clear about the expectations of the Fed:

> "*I really do not believe we'll be in a situation where inflation rises to troubling levels.*"

Recall, also, that the Federal Reserve has changed its inflation targeting scheme. In the past, the Fed would take action if inflation crossed the 2% annualized mark. Recently, however, they announced that they would seek to target 2% *average* inflation over the course of a business cycle. This change allows policymakers to let inflation run much hotter than they otherwise would have.

Additionally, the Fed tends to factor out food and energy prices because they are volatile. As mentioned in a previous section, food and energy tend to be the first place inflation shows up. By focusing more heavily on the prices of consumer goods, the Federal Reserve can more-or-less look past the most inflation-sensitive sectors.

In the end, the Fed appears positioned to continue its current policy. So long as the Fed continues on this course, the bias in prices is upward, at least in our view.

Your Goals are Key

Inflation has different consequences for different people, therefore we must handle that risk differently for different people. For example, for folks who are nearing or are at retirement, inflation can be a serious risk. In the end, it is your goals which will determine how you manage inflation risk.

Proper money management sits at the intersection of your objectives and the broad trends in markets. While we need to understand what is happening in markets, we *also* must understand what is happening in your world. Investment perspectives cannot be proper recommendations until we understand your ability to take risk, time horizon, and objectives!

As always, these are conversations we are eager to have with you. ■