First Ascent Asset Management

UNDERSTANDING INFLATION

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What Is Inflation?

Inflation is a measure of how much prices for goods and services are rising in an economy. Inflation can be caused by a number of factors.

Demand-pull inflation occurs when there is more demand for goods or services than the current supply can meet. This allows companies to raise prices in the face of excess demand.

Cost-push inflation occurs when cost increases make it more expensive for companies to produce the same goods or services. Companies raise prices to maintain their margins.

Inflation can also be impacted by government or central bank policies. If the money supply is increased or the government injects extra liquidity into the economy through stimulus programs, there is more money chasing the same amount of goods, which could cause prices to rise.

Even expectations about inflation can affect the rate of inflation. If workers expect more inflation, they may demand higher wages. Those wage increases may increase the cost of producing goods, which may result in higher prices. The expectations become self-fulfilling.

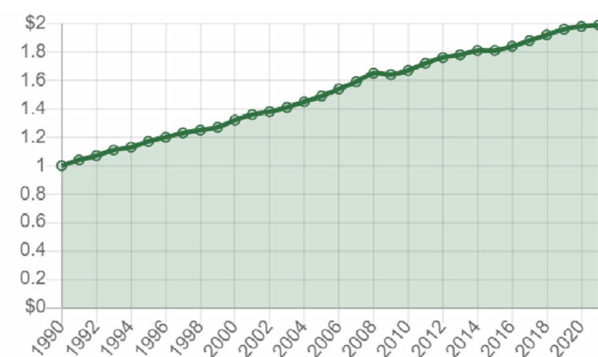
Is Inflation Good or Bad?

If inflation remains at reasonable levels, it can be healthy for an economy. The Federal Reserve has set an official inflation target of 2%. At this level consumers expect prices to rise, so they buy now rather than paying more later. This increases short-term demand, causing sales and employment growth, and increased factory production. The economy benefits.

But even modest inflation erodes purchasing power over the long-term. According to the Bureau of Labor Statistics, a dollar in 1990 was equivalent in purchasing power to about $1.98 at the end of 2020. The average inflation rate was only 2.3% during that period, yet that $1 lost almost half of its purchasing power in 30 years.

$1 in 1990, Adjusted for Inflation

1990- 2020



Source: Bureau of Labor Statistics

If the inflation rate accelerates beyond modest levels, it can have a dramatic negative impact on each dollar's purchasing power. The prices of goods and services rise faster than wages can keep up. These increases can be particularly hard on those with fixed incomes.

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Recent Changes in Inflation

The inflation environment is always changing. For the 10 years ended December 31, 2020, inflation remained low, increasing by an average annual rate of 1.75%. However, for the 12 months ended October 31, 2021, inflation rose by 6.2%. This is far less than in 1974, 1979, and 1980 when rates exceeded 12%, but it still represents a significant increase.

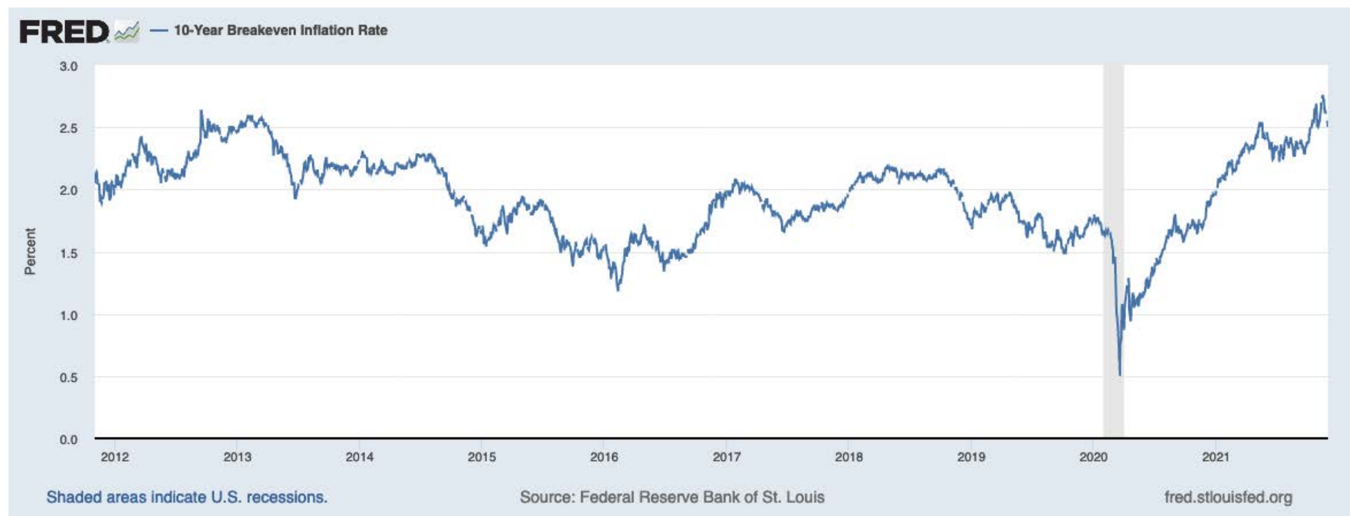
This spike in inflation has been attributed primarily to causes related to the COVID-19 pandemic. As restrictions loosened and the economy opened up again, consumers eagerly resumed shopping, traveling, and dining at their favorite restaurants. Government stimulus payments designed to boost the economy further fueled this pent-up demand.

Disruptions to the global supply chain and the labor force caused by the pandemic have made keeping up with the demand for goods and services difficult. When demand outstrips supply for a prolonged period, elevated inflation is a likely result.

What to Expect Going Forward

Experts disagree about whether the current rise in inflation is temporary or will be with us for an extended period. But markets are relatively efficient and can tell us much about what to expect in terms of future inflation. By comparing the difference in yields between a Treasury Inflation Protected Security (TIPS) and a traditional Treasury security, we get a good sense of the market's expectations about the future inflation rate.

The following chart shows this value for 10-year securities. At the end of June 2021, the 10-year Treasury bond yield was 1.47%, while the 10-year TIPS yield was -0.87%. The difference, 2.34%, is the market's estimate of inflation over that 10-year period.



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Although the market's estimate of future inflation is not a precise indicator, it has done a reasonably good job of tracking it. The graphic below shows how the market's estimate tracked the actual rate of inflation from 2003 through 2011. It was close through most of this period, with the notable exception of the period around the 2008 financial crisis.

Data source: Morningstar.

What to Do About Inflation

Financial markets incorporate expectations about future inflation into the prices of all assets. Therefore, to reposition a portfolio in the face of rising inflation expectations and benefit from those changes, you must have a belief that inflation will rise (or fall) more than the market expects it to. Then you must reposition your portfolio accordingly and be right in your belief.

If an investor believes that inflation will exceed the market's expectations or is particularly concerned about the risks and impact of inflation, there are several commonly cited strategies that can be used. As with virtually all investment decisions, there are unique risk and return implications associated with each alternative.

TIPS

TIPS are one of the most often cited hedges against inflation. Like other Treasury bonds, TIPS are issued with a fixed coupon rate. But their principal value is indexed to inflation, as measured by the Consumer Price Index for all Urban Consumers (CPI). That means their principal value rises and falls with changes in the rate of inflation.

Keep in mind that to benefit from investing in TIPS rather than traditional Treasury bonds, real future inflation must be higher than current market expectations. If it is not, an investment in TIPS will provide no benefit and may even cost the investor.

One downside of investing in TIPS, at present, is that investors are "locking-in" a negative real rate of return at current prices. With 10-year TIPS recently yielding -0.87%, an investor that buys and holds until maturity will earn realized CPI minus almost 1%.

Further, CPI may not be an appropriate measure of inflation for all investors. It is a broad statistical measure of the price of goods and services across the country.

Local factors and specific influences may have a more meaningful impact. For example, rents and housing prices in many areas of the country bear very little resemblance to CPI. The principal value of TIPS will track changes in the CPI but may not reflect those local factors.

For a more detailed review of TIPS please see, "Understanding Treasury Inflation-Protected Securities (TIPS)."

Gold

Gold is often positioned and marketed as an inflationary hedge. The reality is that its actual inflation protection characteristics are not particularly compelling.

Research done by Morningstar shows that gold did serve as a hedge against inflation when inflation reached historically high levels in the 1970s. However, during the milder inflationary periods from 1980-1984 and 1988-1991 it showed negative returns and underperformed large cap stocks by a wide margin. You can see the results of their study below.

Mixed Record as an Inflation Hedge

Annualized Returns

	1973–79	1980–84	1988–91
LBMA Gold Price PM USD	31.77	-10.06	-7.58
S&P GSCI Gold TR	n/a	-11.45	-7.12
S&P GSCI Precious Metal TR	28.59	-15.50	-7.60
US Fund Equity Precious Metals	25.79	7.79	-5.32
US BLS CPI All Urban NSA 1982–84	9.26	6.54	4.55

Source: Morningstar. Data as of June 30, 2020

In addition, our research shows that over the long-term, gold's performance tends to lag that of both stocks and bonds. Between January 1987 and December 2020, gold returned 4.57%, while US bonds returned 5.91% and US stocks returned 10.64%.

During this period, the volatility of these asset classes, as measured by standard deviation, was 15.12% for gold, 3.80% for US bonds, and 15.42% for US stocks. Gold returned less than US bonds, but was about as volatile as US stocks, which had far higher returns.

Research shows that gold has excelled in down markets and periods of high volatility. However, use of gold as a reliable inflation hedge is questionable, and overweighting it in a portfolio at the expense of stocks, for example, can detract from long-term performance.

For a more detailed review of GOLD, please see, "The Glitter of Gold."

Stocks

In the short-term, stocks can certainly take a hit from rising inflation, particularly if it causes the Federal Reserve to raise interest rates. However, over time the stock market adjusts as companies pass on higher prices to consumers.

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This makes the stock market perhaps the best vehicle for outpacing inflation and growing wealth. Since 1926 the long-term inflation rate has been 2.88%, while the inflation-adjusted average annual return for the S&P 500 index has been 6.82%.

Even during periods of higher inflation, the stock market often performs well. In the last 80 years there have been five periods of higher inflation: 1941-1951, 1966-1980, 1987-1992, 2002-2008, and 2020-2021. As you see below, in four out of those five inflationary periods, the S&P 500 has essentially equaled or outperformed its long-term average return of 6.82%.

Inflation Regimes

How T3K, a custom index of 3,000 largest stocks, has performed during inflation regimes. Measured from 5-year CPI trough-to-peak

Monthly data since 1926. Source: FMRCo, NBER, Haver

Some research suggests that value stocks may do better than growth stocks during periods of higher inflation. Many value stocks have strong cash flows, which investors often value when prices are rising. Growth stocks tend to have higher sensitivity to increases in interest rates, and the Federal Reserve often raises interest rates in response to rising inflation.

So, investors may wish to consider a tilt toward value stocks during periods of high inflation. However, there is no guaranty that past patterns will repeat during future inflationary periods.

Bonds

Rising inflation is often accompanied by rising bond yields as the market incorporates higher inflation expectations into its pricing. Rising yields means current bond holders will suffer a decline in the principal value of their bonds. But those losses are often temporary.

As their bonds mature, and as they receive interest payments from their bond holdings, they can reinvest those amounts at the new higher market rates. Depending upon the circumstances, they can make back any losses they experienced in a relatively short period.

Even if bond holders suffer temporary losses in the short-term, their bonds still play an important role in their portfolios. Those bonds can help preserve capital due to their lower volatility, and can reduce overall portfolio volatility due to their low correlations to stocks.

Cash

Moving to cash during a period of rising inflation is almost guaranteed to cost an investor dearly. Cash is unlikely to keep up with rising inflation and is likely to be pulled from an allocation in the portfolio that would better maintain its value. Stay fully invested.

Global Diversification

Inflation rates vary around the world. Spreading portfolio assets across different countries and regions can buffer the portfolio from an unexpected spike in inflation in any single country.

The Bottom Line

There is no silver bullet that will immunize a portfolio from the impact of rising inflation. Financial markets are relatively efficient and react quickly to new information, including information about rising inflation. Inflation expectations are reflected in all asset prices.

To benefit from changes in inflation, an investor must have a view that is different and more accurate than the view incorporated into current market prices. Then the investor must make portfolio adjustments that are later rewarded by the market. This is hard to do consistently.

There will always be analysts and pundits who offer prescriptions designed to address or minimize the impact of inflation. Some have a vested interests in their prescriptions, while others are genuine in their beliefs. None have fool-proof solutions.

An investor's best bet for dealing with inflation is to:

- Invest in a well-diversified portfolio constructed to reflect the long-term return objectives and risk profile of the investor
- Maintain exposure to stocks consistent with the investor's objectives and risk profile
- Keep portfolio costs and expenses low
- Trust in the relative efficiency of the financial markets
- Screen out the noise and have patience