Understanding Inflation

First Ascent Asset Management

What Is Inflation?

Inflation is a measure of how much prices for goods and services are rising in an economy.

What Causes Inflation?

Inflation can be caused by factors, including:

- Higher demand for goods and services than can be met by the current supply
- Rapidly increasing costs which cause companies to raise prices
- Government or central bank policies
- Expectations about inflation can affect the rate of inflation

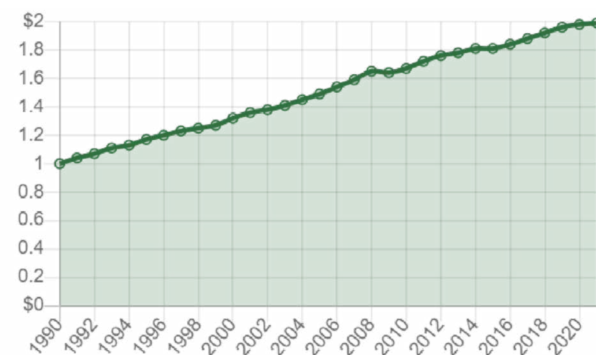
Is Inflation Good or Bad?

If inflation remains at reasonable levels, it can be healthy for an economy by stimulating current spending. But even modest inflation erodes purchasing power over the long-term.

From 1990 through 2020 the average inflation rate was only 2.3%, yet $1 lost almost half of its purchasing power in those 30 years.

$1 in 1990, Adjusted for Inflation

1990- 2020



Source: Bureau of Labor Statistics

Where Are We Now and What Should We Expect?

As of March 31, 2022, the 12-month inflation rate was 8.5%. This spike in inflation has been attributed primarily to causes related to the COVID-19 pandemic and Russia's war against Ukraine.

Experts disagree, but markets are relatively efficient at telling us what to expect. As the graphic below shows, the markets are currently (April 2022) estimating inflation of 2.92% over the next 10 years.

10-Year Breakeven Inflation Rate

2017-2022

Source: Federal Reserve Bank of St. Louis.

What to Do About Inflation

There is no silver bullet that will immunize a portfolio against inflation.

Financial markets incorporate expectations about future inflation into the prices of all assets.

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
- You must reposition your portfolio accordingly based on that belief
- You must be right in your belief

To do this is extremely difficult because the market has, historically, been very effective at anticipating future inflation and pricing those expectations into the prices of all assets.

In the short-term, stock and bond prices may suffer as inflation rises and interest rates increase. But, historically, longer term stocks have provided a good hedge against inflation and bond investors benefit from the increase in interest income received as interest rates rise.

Gold is sometimes touted as an effective hedge against inflation, but its inflation protection characteristics are not very compelling.

TIPS are often suggested as protection against inflation, but they are no more effective than traditional Treasury securities, unless actual inflation is higher than the financial markets have anticipated.

Sitting on the sidelines with cash is a poor strategy, since inflation typically eats up the meager returns that can be generated by cash.

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

- **Invest in a well-diversified portfolio** constructed to reflect the investor's goals and objectives
- **Maintain exposure to stocks and bonds** 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**