18 Questions on Inflation Asked by Our Clients

PATHSTONE
THE MODERN FAMILY OFFICE™

By John Workman, ***Managing Director***

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1. Is inflation transitory, or is it going to be more sustained?

The inflation we have experienced in the past year appears to be largely a consequence of rapidly returning demand and a supply chain that hasn't been able to ramp up supply nearly as quickly. Some portion of inflation is likely to be relieved as covid-induced kinks in the supply chain get worked out. We expect that greater vaccination rates and new therapeutics should allow for a greater re-opening. One piece that we are concerned about may not be as easily resolved is the upward pressure on wages and the growing collective demands of workers.

2. What has driven inflation to rise so spectacularly over the past year?
Energy and Core Goods have been the biggest contributors to the rise in inflation this past year. Underinvestment in fossil fuel has caused supply to come up short relative to the pace of rebound in demand. Demand is still below pre-pandemic levels. Remember it wasn't long ago that oil storage facilities were overflowing, and oil was basically being given away. It's not a shortage of availability of the commodity, but rather a lack of availability at the points of consumption that have driven prices higher. This we believe will abate as operations ramp back up.

3. Why does the Fed believe that inflation is "transitory"?
- Inflation should grow somewhere near the level of economic growth over time, with technology and slowing demographics being heavily deflationary forces. Supply chain issues/unemployment due to covid have been a major factor.
- They are carrying on longer than the Fed anticipated. Markets were believing the Fed for a while, now they are starting to question things as markets are pricing in higher inflation expectations.

4. What could cause inflationary pressures to be more sustained?
- We think it is on the wage front. Companies are in a solid place from a profit and balance sheet perspective.
- Workers haven't participated in the wealth nearly as much and they are starting to act, demanding a bigger piece of the pie. If inflation goes up it will be difficult for companies not to increase wages if they wish to remain competitive.

5. Is the Infrastructure Bill recently passed in the U.S. and the Build Back Better bill likely to add to inflationary pressures?
Yes.

6. Adding to the demand side of the equation will likely further add to inflationary pressures. Do we think it is going to tip the scales?
Not really. Spending will be spread over a decade, but it does highlight that there is still a lot of stimulus to make its way into the marketplace.

7. How is the current inflationary trajectory likely to impact Central Bank decision making?
- Global central banks have been more active in talking about raising interest rates.
- Expectations are being pushed closer and closer to the present in terms of when rates may need to rise.
- The ECB has stated they won't do anything in 2022, but the Bank of England may act before year-end 2021 and the Fed is anticipated to make an interest rate hike or two in 2022.

8. Is my portfolio positioned to succeed in a higher for longer inflation scenario?

We consider multiple scenarios and the probabilities we assign to each.
The two most prevalent scenarios are "Passing the Baton" whereby we see a rotation during the ongoing economic recovery towards the companies that were most impacted by covid-related restrictions. Secondarily, we are mindful of the fact that inflation is currently running hot and may very well overshoot the Fed's anticipation of easing significantly in the near term. We are cautious of high P/E multiple businesses and investments most sensitive to rising interest rates.

9. Is inflation a bad thing for the economy?
Inflation is a likely outcome of growth (an increase in demand) which may be a result of higher wages or the wealth effect (high stock market) and perhaps even a different view of the world post-covid recession. Inflation becomes a problem when it starts to dampen consumer sentiment and shuts down demand. There is a nice balance that the Fed is aiming for, but for now, things are overshooting to the upside. If price increases don't subside, expect consumption to be impacted at some point.

10. What can we learn from the past?
I think one of the most important lessons from the past is that equities are a good hedge for inflation over time and that trying to time commodities or real estate investments relative to inflation is not easy. Current inflation and inflation expectations are two different things. Inflation expectations are difficult to forecast and that is more important than current inflation rates.

11. What does it mean and what are the chances we enter a stagflationary environment?
It would be rare to have a period where both economic growth is collapsing, and inflation is soaring. Rather it is more likely that sustained inflation leads to rising interest rates and slowing consumption (slowing economic growth). With so much fiscal and monetary policy support still circulating through the economy, wealth at all-time highs, and wages growing, it is doubtful that the economy slows meaningfully in the near future.

12. If consumers and many businesses are the losers in an inflationary environment, who are the winners?
Certain segments of the markets should be winners either because they have pricing power and/or they are the owners of the raw materials/commodities that are gaining in price. We believe these are some of the more value-oriented sectors such as Materials, Energy, Real Estate, and Financials (because of higher anticipated interest rates).

13. The other "winners" are those workers that are enjoying higher wages which is partly what is responsible for driving inflation higher.
Higher wages should increase the size of the economic pie. While profit margins may get squeezed at corporations, overall sales should compensate somewhat as the pie expands.

14. How does the time horizon impact investor decisions?
Correlations in the short term aren't that high even between commodity prices and inflation. Equities even less so. But with a perspective over longer time horizons, one finds that equities have historically provided a greater real return for similar levels of risk.

15. What do I have in my portfolio already that should help protect against inflation?
We believe higher inflation is likely going to lead to higher interest rates and therefore greater scrutiny around the heightened P/E multiples being paid for the more expensive stocks (mostly Large Cap Growth). As a result, we have biased portfolios away from large-cap towards small caps. We have also maintained value tilts in portfolios. Additionally, because the indices have gotten so skewed due to market cap weighting, we have

been leaning more towards active equity management including equity risk alternatives specifically. Active managers may dynamically tilt the portfolios towards companies better positioned to pass through inflation to their end markets. On the Stability side of the portfolio, there are not a lot of places to find Real Returns, therefore we have accepted illiquidity risk to capture some in Private Income strategies. We are underweight core fixed income because of the interest rate and duration risk. We would rather be more in short-duration or credit risk alternatives to mitigate a likely rising interest rate environment.

16. If I am more concerned about inflation and its impact on my portfolio, what more can I do?

From a near-term perspective, the assets that should be most directly linked to inflation include Real Assets (Real Estate, Commodities, Natural Resource Equities) if you anticipate higher prices because demand is outstripping supply.
There may be other factors, like rising wages, that may cause you to take a different view.

17. Which asset classes tend to be most closely linked with inflation?
If inflation is driven by a weakening currency, then commodities and especially precious metals would be most likely to benefit. If inflation is driven by higher demand relative to supply, then it may be more specific categories of assets. If inflation is driven by growing demographics or a wealth effect (ex. Higher wages) then still you might find different forms of inflation (financial asset, real estate, etc).

18. Which asset classes are most at risk of higher inflation that I should avoid or reduce?
We think the two areas to be careful with today are high Price-to-Earnings stocks and Core Fixed Income (Treasuries/Municipal Bonds) with duration. The traditional 60/40 portfolio is in the crosshairs. Remember that most portfolios already include exposure to REITs and Natural Resource Equities though their equity allocations and active managers may shift exposure to these areas as opportunities present themselves.