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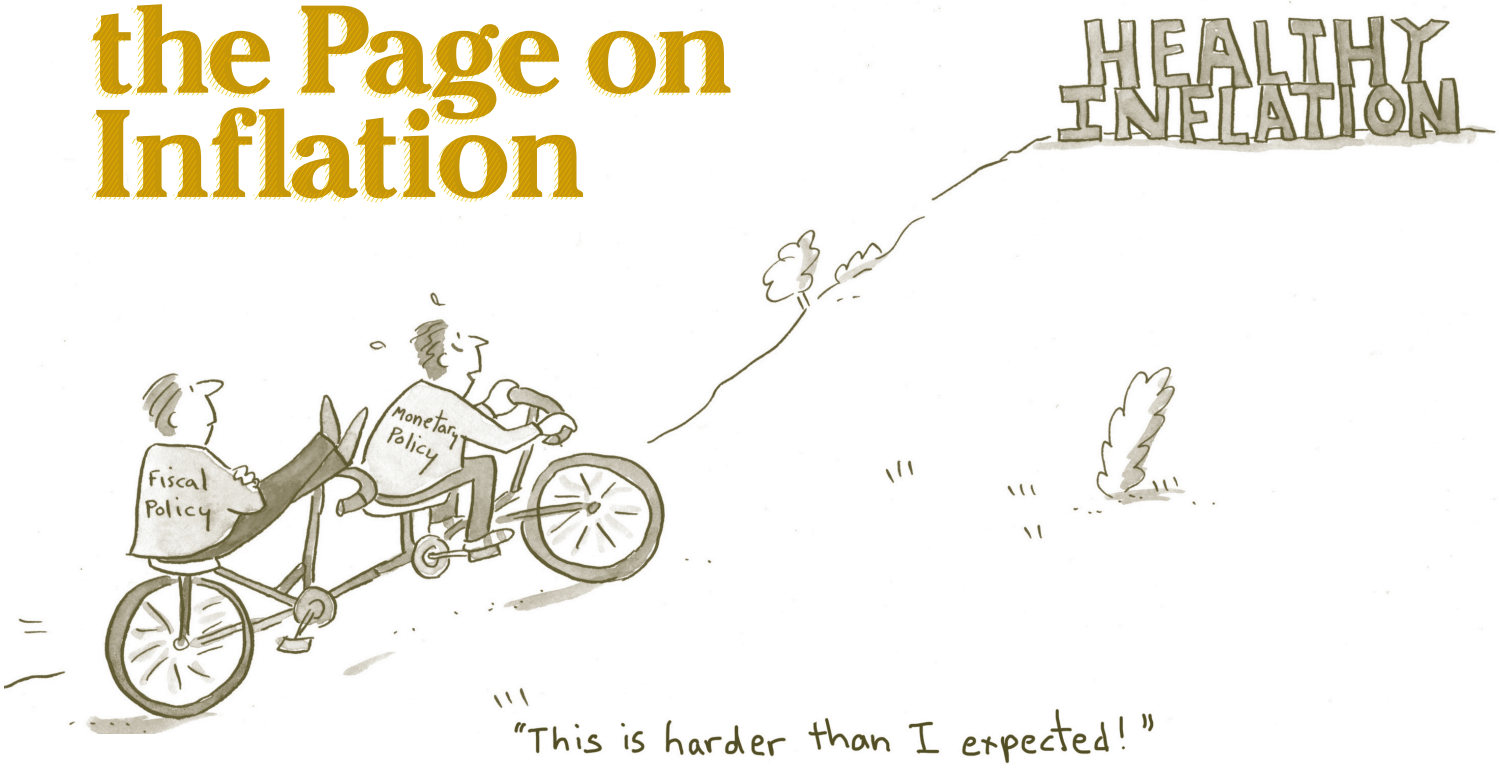
Don't Turn the Page on Inflation



> "Americans are getting stronger. Twenty years ago, it took two people to carry ten dollars' worth of groceries. Today, a five-year-old can do it."
>
> – *Henny Youngman*

We all remember our grandparents telling us stories of how cheap things used to be – back when a dollar was a lot of money, when kids walked to school uphill both ways, and when people used their phones to actually talk to each other. Those stories about how far a dollar used to go are reminders of a simpler time, but they also speak to a real risk. As prices grind higher over time, the value of our wealth (our retirement accounts and our kids' college savings) amounts to less and less. Because economic growth and price increases have been stuck in low gear the past few years, inflation risk may feel like a thing of the past. Inflation can be a dull topic but it's one that we cannot afford to ignore, as the risks to our financial goals can be pernicious. Maybe it's time to remind ourselves of our grandparents' stories.

Inflation is often thought of in abstract terms, but economists have developed multiple ways of calculating its effects. The most common measures are the consumer price index and the personal consumption expenditures price index, both of which approach the topic from slightly different angles. These indices also come in different flavors – headline, which measures the average change in prices of a broad basket of goods and services over time, and core, which strips out the more volatile ingredients like food and energy to focus on longer-term trends. The goal of both indices is to gauge the change in prices over time. That change can be thought of as a hurdle our portfolios have to clear in order to maintain the same purchasing power over time. After all, future »

spending is one of the main reasons for owning a portfolio of risky assets in the first place. A portfolio invested in ultra-safe U.S. Treasury bills at the end of 1954 would have grown at an annualized rate of 4.4% by the end of 2016. At first glance, that seems satisfactory. However, inflation over that time period increased by an annualized rate of 3.5% and would have eaten away nearly 80% of the investment's return.[1]

As previously mentioned, inflation risk has fallen down the list of investor concerns in recent years. Prices have risen quite slowly as we have recovered from the global financial crisis. Deflationary pressures from a more global labor supply market (as manufacturing and other jobs have moved to lower-cost markets) and the continued rise of robotics and other technological advances have kept downward pressure on prices throughout the economy. After fighting inflation with all its might during the 1970s, the Federal Reserve has spent the past decade doing everything it can to create inflation. Interest rate cuts and experimental monetary policy, such as quantitative easing, had limited effect. Despite a parabolic increase in the Federal Reserve's balance sheet, inflationary pressures remained low. Investors piled into fixed income securities, leading to historic distortions in the bond markets. At their peak in mid-2016, the total market value of negative-yielding bonds reached $12.2 trillion.[2] Governments and even corporations were being paid to borrow money – a phenomenon that would have been unthinkable just a few years earlier.

In the summer of 2016, that started to change. Investors' expectations for future inflation began to steadily increase. In many areas of the world, economic activity finally began to perk up, and "animal spirits" began to awaken. The rise of protectionist and populist governments both in the U.S. and in Europe adds further fuel to the belief that inflationary pressures may return. If fiscal policy begins to contribute to central banks' monetary policy efforts, that belief may turn into a reality.

Inflationary pressures are driven by three main forces: currency strength, economic activity, and consumer expectations. A long period of U.S. dollar strength may be coming to an end. The Trump administration has diverged from long-standing convention in many ways, including vocalizing its belief that a strong dollar is bad for the country. Many of President Trump's core supporters want a return to American prominence in manufacturing and exports, both of which would be aided by a weaker dollar. We have also seen a reduction in the amount of slack in the economy, as more people enter the workforce, and the unemployment rate has declined meaningfully. This has led to expectations of upward pressure on wages (something that has been missing for a number of years) and would have a meaningful effect on inflation. Lastly, we have to bear in mind that inflation is not just a financial manifestation but also a psychological phenomenon. If consumers expect prices to increase tomorrow, they tend to pull their purchasing forward in order to get a better deal today. That increased activity leads to higher prices, creating a self-fulfilling prophecy.

At RMB, we work hard to craft prudent asset allocations that can help insulate our clients from the negative consequences of inflation and outpace it over time. Since forecasting inflation is notoriously difficult, if not impossible, we do this by maintaining a consistent approach. Our asset allocation remains tilted toward providing modest inflation protection through three different means. First, we have kept the duration of our fixed income portfolios short, giving us the opportunity to invest at the higher interest rates that may accompany higher inflation. Second, we maintain a preference for owning the equity of high-quality companies with strong cash flows and the ability to pass along price increases to their underlying customers. Third, we have a long-standing allocation to a diversified Real Return strategy specifically designed to hedge against inflation. This is done through a toolbox of investments that includes, but is not limited to, CPI swaps (which trade in direct response to changes in inflation expectations), real estate investment trusts (REITs), master limited partnerships (MLPs), and commodity futures. Each component provides a hedge against the different drivers of inflation. These days, that's a story worth telling. ■

1 *FactSet.*
2 *Bloomberg.*