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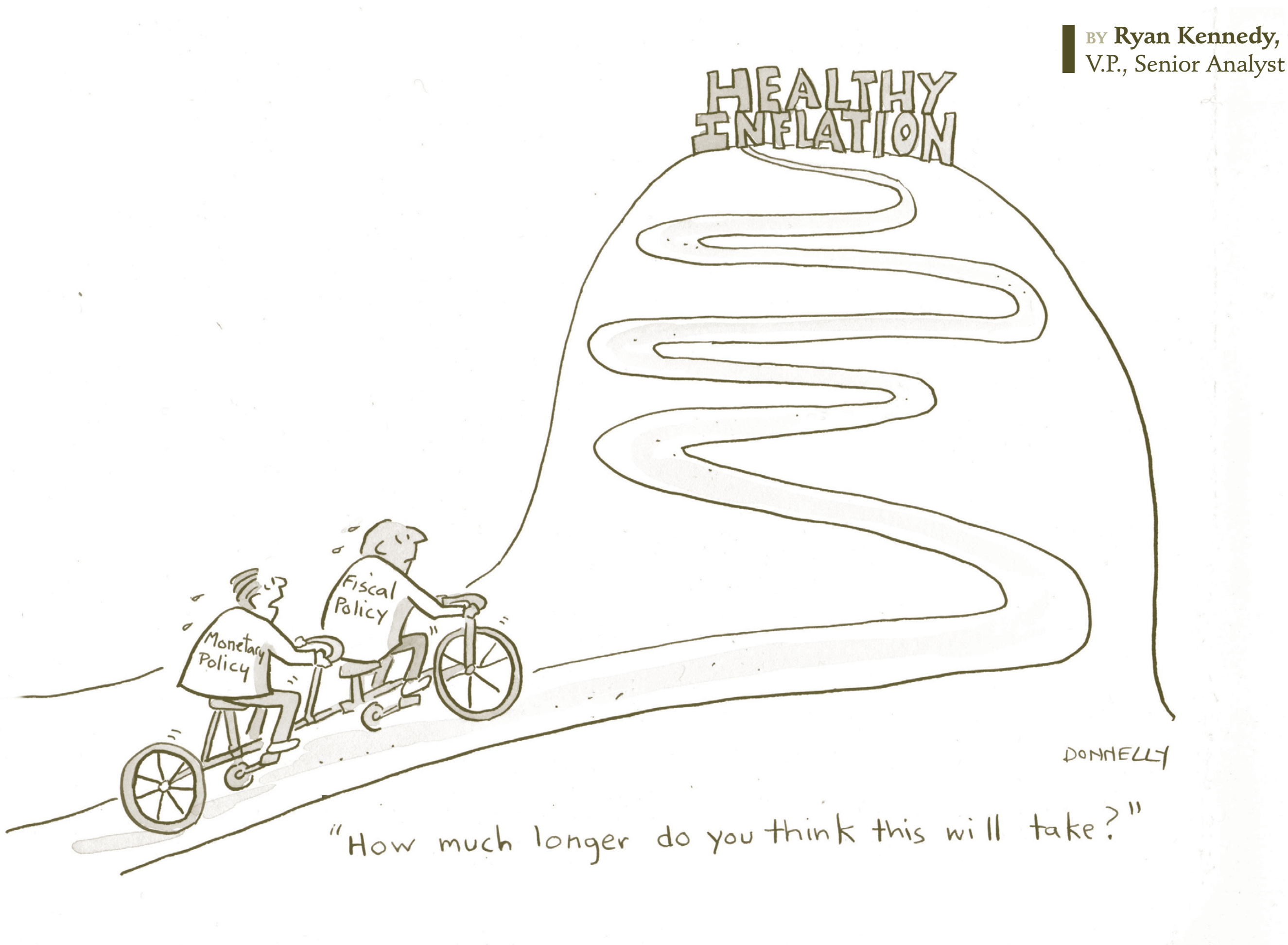

INFLATION

THE PLOT THICKENS

In our Summer 2017 edition, we included an article titled "Don't Turn the Page on Inflation." Back then, economic growth was slow but steady, monetary policy was trying its best to drive inflation up toward Federal Reserve targets, but restrained fiscal policy was acting as a counterbalance. We asserted that the risk of dangerously high inflation was minimal, but that investors ought to begin thinking about which tools to use should inflation perk up. 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. A portfolio invested in ultra-safe U.S. Treasury bills at the end of 1954 would have grown at an annualized rate of 4.35% by the end of 2019. At first glance, that seems satisfactory. »

However, inflation over that time period increased by an annualized rate of 3.48% and would have eaten away nearly 80% of the investment's return.[1] While our philosophy and approach toward inflation have not changed since 2017, it seems as though everything else in the current pandemic-driven landscape has changed. Therefore, we thought it would be helpful to refresh our prior article by highlighting the forces currently at play.

After fighting inflation with all its might during the 1970s, the Federal Reserve has spent the past decade-plus 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. Even before the pandemic crisis hit in mid-March, inflation consistently ran below the central bank's 2% target. Because economic growth and price increases have been stuck in low gear, inflation risk may feel like a thing of the past. Prices had 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 moved to lower-cost markets) and the continued rise of robotics and other technological advances kept downward pressure on prices throughout the economy. Today, monetary stimulus has accelerated, and, perhaps more importantly, fiscal policy has joined the fight.

In the aftermath of COVID-19, the Federal Reserve revived 2007–2008 financial crisis-era tools to keep markets operating smoothly, increasing its balance sheet by nearly $3.0 trillion.[2] Long an absent partner on the stimulus front, the federal government quickly passed historic relief packages, pumping roughly $4.0 trillion into the economy and stretching its annual budget deficit to $3.1 trillion.[3] This stimulus was not unique to the U.S.; the European Central Bank launched a $1.6 billion emergency bond-buying program in response to the coronavirus.[4] Not to be outdone, the Bank of Japan pledged to buy up to nearly $600 billion of bonds, along with over $1.1 trillion of government spending and guarantees.[5] It seems only natural that money creation on this scale should spark fears of inflation, particularly given investors' historically sanguine outlook about it.

Similar inflation warnings were made after the financial crisis but were ultimately proved wrong. So why would this time be different? After the financial crisis, much of the stimulus was held on bank balance sheets. Today, more of the stimulus has ended up in household bank accounts. During the height of COVID-19-induced lockdowns in April, Americans' total incomes rose by 11%, even as more than 20 million workers lost their jobs.[6] According to classic economic thinking, more money in consumers' pockets means that more money is likely to be spent; making inflation more likely this time around.

However, this mountain of cash needs to be considered against the headwinds in place. As countries continue to battle the pandemic, the scope of economic damage is immense. Global GDP is expected to shrink by 4.9% in 2020, while 2021 GDP is expected to be 6.5% lower than the pre-COVID-19 forecasts of January 2020.[7] Even as economies reopen, spending is likely to remain slow given continued feelings of uncertainty. As a result, wage growth seems unlikely to become a significant factor in such an insecure employment backdrop. Households are slashing consumption, having increased their savings rate to the highest level since 1975.[8] Government support cannot continue indefinitely, and many countries (including the U.S.) have begun to roll back their support in order to get people back to work.

Lastly, we must bear in mind that inflation is not just a financial manifestation but also a psychological phenomenon. After decades of benign inflationary conditions, consumers may no longer feel pressure to pull their purchasing forward in order to get a better deal today. That has been central bankers' goal all along: a healthy level of inflation that encourages people to buy now and avoid paying more in the future. Buying products and services increases the sale of those products and services, which helps keep people employed and should keep wages on the rise. But stagnant or declining prices may create a self-fulfilling prophecy. As of late November, the market was pricing in a benign inflation environment. But investors ought to remember the danger of low-probability, high-impact events—while the » probability of dangerous inflation seems low, the potential for a painful outcome for investors remains high.

How should investors prepare themselves for higher inflation in the future? In answering this question, we used history as our guide. As shown in Exhibit 1, we looked at past periods of low, mild, high, and very high inflation, and we compared the performance of five major asset classes. We found that equities performed positively when inflation was rising and low or mild, but they were one of the worst-performing assets when inflation was high or very high. Equities underperformed U.S. Treasuries in periods of both high and very high inflation, while commodities and U.S. TIPS were the best performers.

Each component provides a hedge against the different drivers of inflation. At RMB, we work hard to combine those components through prudent asset allocation, helping to insulate our clients from the negative consequences of inflation. 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 utilize strategies to explicitly target inflation sensitivity. 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), energy infrastructure, and commodity futures. These days, that's a story worth reading again. ■

1 *FactSet.*
2 *Federal Reserve Bank of St. Louis.*
3 *Wall Street Journal, "U.S. Budget Gap Tripled in Fiscal 2020," 10/8/20.*
4 *Financial Times, "ECB to Review Flagship Bond Buying Tool in Fighting COVID Crisis," 9/20/20.*
5 *The Economist, "Japan Probes the Limits of Economic Policy," 6/4/20.*
6 *The Bureau of Economic Analysis.*
7 *International Monetary Fund, "World Economic Outlook Report," 10/7/20.*
8 *Federal Reserve Bank of St. Louis.*

EXHIBIT 1 RECOMMENDATIONS FOR DIFFERENT LEVELS OF INFLATION

	Low Inflation	Mild Inflation	High Inflation	Very High Inflation
Threshold	Less than 2.3%	Between 2.3% and 3.3%	Between 3.3% and 4.9%	More than 4.9%
Best Asset-Level Hedge	Equities	Equities	Commodities and U.S. TIPS	Commodities and U.S. TIPS
Best-Performing Equity Sector	Technology	Energy	Energy / Materials	Defensive Sectors
Best-Performing Commodity	Energy	Energy	Industrial Metals	Gold

Sources: RMB Capital and BCA Research