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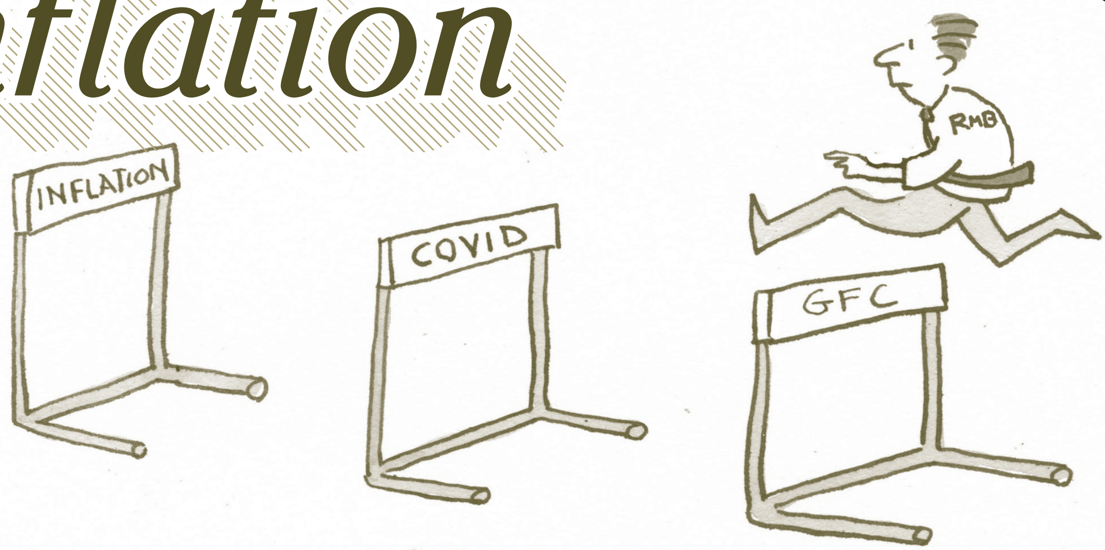
Inflation



While inflation can feel most painful at the grocery store and the gas station, investors may also be feeling it in their investment portfolios. Think of inflation as a hurdle that portfolios must clear in order to maintain the same purchasing power over time. For example, a portfolio that invested in U.S. Treasury bills 50 years ago would have grown at an annualized rate of 4.3% by the end of 2021.[1] That may seem like a good outcome. However, annual inflation over that period was 3.9%, eating away nearly 90% of the portfolio's return.[2] At today's inflation levels, the effects on investment portfolios may be even more pernicious.

The last time inflation ran this hot was in the 1980s.[3] Until recently, some of today's investors viewed inflationary periods more as an arcane textbook reference than as a serious concern. In fact, U.S. inflation averaged a tame 3.1% per year between 1983 and 2008, and just 1.6% per year from 2008 to 2020.[4] Those days feel very far away. In a recent poll, 70% of Americans said inflation is a very big problem, topping a list of issues including health care costs, gun violence, the federal deficit and climate change.[5] According to the most recent National Federation of Independent Business survey, 28% of small businesses consider inflation their single most important problem, compared to only 1-2% in 2019.[6]

Milton Friedman famously described inflation as too much money chasing too few goods. That dynamic can stem from changes in either demand or supply. "Demand-pull" inflation occurs when aggregate demand increases at a faster rate than aggregate supply. "Cost-push" inflation is a result of an increase in input prices due to supply shortages, leading to a decrease in the output supply. As inflation becomes entrenched, workers begin to demand more in wages to keep up with their cost of living. Those higher wages are then pumped back into the economy, fueling another round of price increases. This can lead to a wage-price spiral; a vicious feedback loop that has no easy fixes. Notably, 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 to get a better deal today.

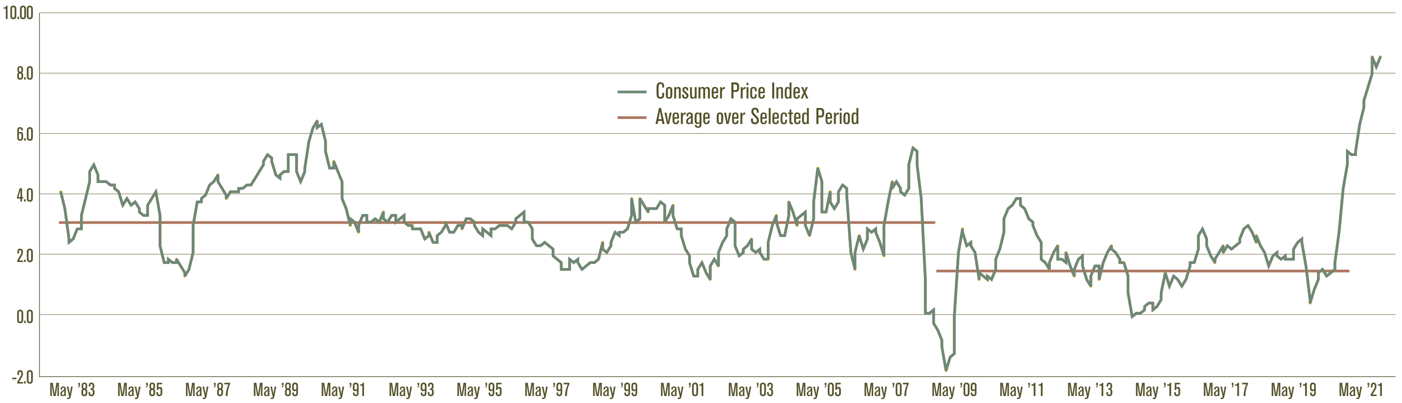
How RMB Hedges Against Inflation

Keep the duration of our fixed income portfolios short

Own high-quality companies with pricing power

Manage a diversified real assets strategy, RMB Real Return »

EXHIBIT 1 CONSUMER PRICE INDEX—PERCENT CHANGE FROM YEAR AGO



Source: Federal Reserve Bank of St. Louis as of June 2022

That increased activity leads to higher prices, creating a self-fulfilling prophecy. Recent history provides helpful examples of each of these scenarios, both of which have combined to form the basis of the inflation we are experiencing today. Weak demand in the years following the global financial crisis led to inflation being so low and economic growth being so weak as to require central bank support, including interest rate cuts and experimental monetary policy, such as quantitative easing and policy rates below zero. As manufacturing and other jobs moved to lower-cost markets, deflationary pressures from a more global labor supply market and the continued rise of robotics and other technologies kept downward pressure on prices throughout the economy. After the onset of the pandemic, those monetary tools were combined with powerful fiscal policy, including stimulus checks sent directly to consumers. Soaring demand for consumer goods met a disrupted global supply chain. More recently, inflation has been further exacerbated by supply constraints stemming from the war in Ukraine, including energy and agricultural commodities.

At RMB, we work hard to craft prudent asset allocations that have the potential to outpace inflation over time. Since forecasting the sources of 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 reinvest at the higher interest rates that may accompany higher inflation. As inflationary regimes shift, investors can tilt the odds of positive returns in their favor by taking a granular approach to sector selection. Second, we maintain a preference for owning the equity of high-quality companies with strong cash flows and pricing power. Third, we manage a diversified real asset strategy, RMB Real Return, specifically designed to hedge against inflation and deliver solid total returns over a full market cycle. This is done through a toolbox of investments that includes, but is not limited to, REITs (which have the ability to raise rents on tenants), energy infrastructure companies (many of which have contracts with escalators tied to inflation), CPI swaps (which trade in direct response to changes in inflation expectations) and a diversified portfolio of commodity futures (which have historically performed well in periods of high inflation). Investments are made in liquid vehicles such as mutual funds and ETFs, with the asset allocation and manager selection being controlled by RMB. Each component, managed in concert with the remainder of clients' portfolios, can provide a hedge against the different drivers of inflation. ■

1 *Bloomberg as of December 2021*
2 *Bloomberg as of December 2021*
3 *Federal Reserve Bank of St. Louis as of June 2022 CPI defined as Consumer Price Index for All Urban Consumers: All Items in U.S. City Average, Percent Change from Year Ago, Monthly, Seasonally Adjusted*
4 *Federal Reserve Bank of St. Louis as of June 2022*
5 *Pew Research Center as of May 2022*
6 *National Federation of Independent Business as of May 2022*