SHARPER GRANITE LLC

Letter on the Economy

The Impact of Inflation

As the U.S. experiences higher inflation, investors are wondering what is driving this, how long will it last, and what does this mean for retirement portfolios? Below we explore these questions along with our response to the impact of rising inflation on portfolios.

The Cause

With inflation floating between 1-3% for the millennia, we have become accustomed to even prices and steady budgets. However, in the second half of 2021, a relatively sudden jump in prices shocked consumers. The U.S. consumer price index (CPI) registered an annual inflation rate of 5.5% in November. [1]

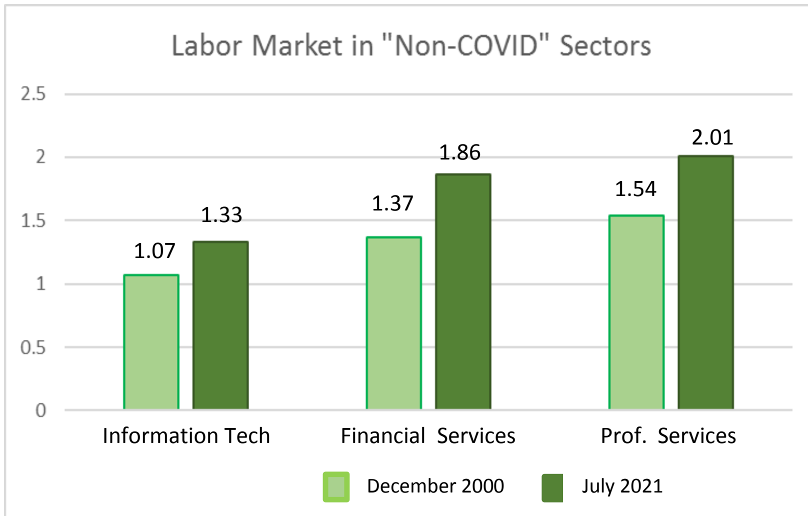
The price increases come from several sources. First, the federal government infused the economy with stimulus. Aid continued as the pandemic lingered, resulting in the highest levels ever in the M1 money supply (checking accounts, payroll, demand deposits). During the financial crisis of 2008, the money supply increased 20% over the course of the year. However, this time money supply increased 40% in just four months (March to July 2020). The most significant difference between 2008 and 2020 is that the 2008 stimulus went to shore up banking institutions, whereas the 2020 stimulus went directly into consumers' accounts.[2] As noted in the sidebar, the government injects money into the economy during deep economic crises to avoid an economic depression.[3]

Why Stimulus?

Through research, Nobel Prize winning economist Milton Friedman showed that the Great Depression of the 1930's could have been avoided if the Fed had injected liquidity into the economy. Economists are now convinced of this theory, and Freidman has been proven correct over the past 20 years during several severe downturns. FOMC Chair Bernanke used Friedman's research to justify massive fiscal stimulus to avoid a depression during the 2008 financial crisis. [13]

Second, price increases are being driven by an imbalance between supply and demand. With high levels of accumulated cash in accounts, demand is high for goods, driving up prices. The share of goods spending within total personal consumption expenditures jumped to 36%, the highest level in 15 years.[4] Prices of core *goods*, those excluding food and energy, have surged beyond core *services* prices, reflecting shifts in spending patterns and supply chain disruptions. Pricing pressure continues as supply chains restart in fits and spurts.

Third, this situation is exacerbated by labor shortages. Multiple sectors are experiencing tight labor markets even though unemployment remains above pre-pandemic levels.[5] The chart on the following page shows the ratio of job openings to unemployed in "hot" non-COVID sectors. Flush bank accounts enable workers to "sit out' of the workforce longer while evaluating options for better opportunities. Salaries increase as employers compete for talent, pressuring businesses to raise prices to cover costs as they ramp to meet demand.



The Duration

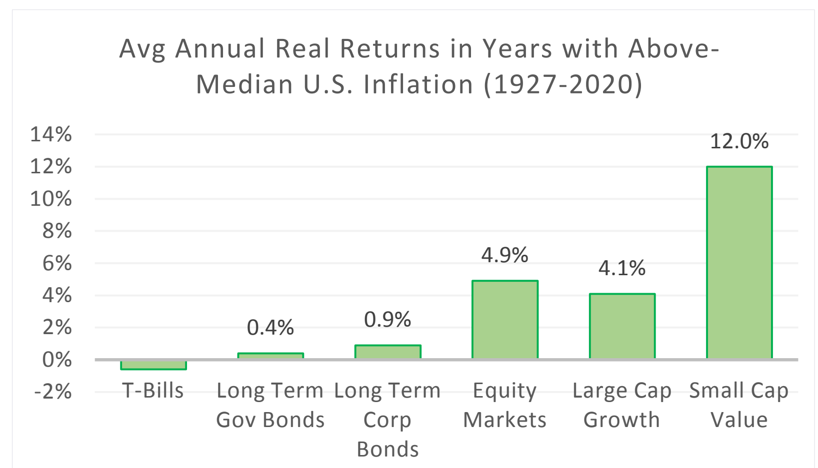
While inflation is somewhat unpredictable, the current factors driving inflation will dissipate over time. Unfortunately, inflation is notoriously "sticky." Inflation tomorrow is likely to be near what it was yesterday. Sharper Granite Research shows inflation has a 7-year memory. That is, inflation values from up to 7 years ago inform the inflation reading of today. Also, inflation can be a self-fulfilling prophecy. If people believe prices will rise, they will rush to buy sooner, thus creating demand which drives up prices.

The combination of high money supply, labor shortages, supply chain disruptions, and strong pent-up demand suggest inflation may stay for a while and that the Fed will need to become more aggressive in fighting inflation. Recently, the Fed has signaled a willingness to tackle inflation, changing their dovish stance. As indicated at the December 15th FOMC meeting, the Fed will terminate its bond purchase program sooner than planned and begin raising short-term rates to tighten money supply and slow inflation.

The Impact

The news cycle makes inflation seem frightening. Some inflation, though, is beneficial for equities. Stocks are valued in part based on the hard assets they hold, such as land and machinery. And inflation means rising prices, so companies are maintaining or improving profitability. The Fed has stated that a 2-3% inflation rate is best for the economy and has kept their inflation target at 2%. However, we ended the year well above this Fed target inflation rate, and some wonder what this may mean for equities.

Historically, we see that from 1927 - 2020, in years with above-median U.S. inflation, most equity assets outpaced inflation. As shown, equity markets returned +4.9% above the inflation rate. With a *real* return (return in excess of inflation) of nearly 5%, not only is purchasing power protected, but these asset classes are also growing. Small-value stocks were especially powerful among the equity categories, outpacing inflation by 12% during high-inflation years.[6]



While stocks generally perform well in periods of high inflation, other asset classes struggle. Historically, bonds are challenged initially during these periods as interest rates tend to rise along with inflation. As seen in the chart on the previous page, short-duration bonds or T-bills trailed inflation by 0.6%. Like cash, this asset class lost purchasing power. Longer-term government bonds and corporate bonds beat inflation by 0.4% and 0.9%, respectively. Even in periods with higher-than-average inflation, these fixed income classes outpaced inflation, protecting purchasing power.

The Response

High inflation does impact the market, but it does not predict market behavior. It is just one factor. Investors need to outpace inflation, hedge unexpected changes, and preserve purchasing power over the long term. Your investment advisor plays a key role in navigating economic conditions such as high inflation to help meet your goals.

Our role is to preserve purchasing power and income throughout market cycles and challenging economic times. Consequently, advisors at Sharper Granite design portfolios to respond to these challenges and adjust portfolios in response to changing economic conditions. Specifically, below are some of the adjustments we make to protect portfolios in times of high inflation and rising interest rates.

ACTIONS FOR EQUITY	REASONS
Tilt towards equities and away from bonds	Bonds are challenged by unexpectedly rising interest rates, while stocks are a “real” asset and theoretically should rise with inflation
Tilt towards cyclical sectors	Cyclical sectors perform well in periods of high economic growth and inflation
Tilt towards value equities	Value equities tend to outperform growth during periods of high inflation
Tilt toward dividend producers	Receiving cash dividends now is better than in the future when dollars will have less purchasing power
Increase real estate-based holdings	Real estate assets correlate positively with inflation and rising interest rates
Increase commodities	This sector often surges during inflationary times due to demand for input goods

While bonds play important hedging roles within portfolios, adjustments to specific bond holdings may be needed. For example, we emphasize more inflation-adjusted bonds, and adjust the duration (time to maturity) of bond holdings.

By proactively responding to the expectation of higher inflation in the future, your advisor can mitigate the impacts of a high-inflation environment. If you have further questions or short-term needs that have not been raised, please contact your advisor for more information.

Notes and Acknowledgements:

1. JP Morgan, “Guide to the Markets,” December 31, 2021
2. Jeremy Siegel, Wisdom Tree Webinar, “Another Episode of That 70s Inflation”, June 17, 2021
3. Milton Friedman and Anna Jacobson Schwartz, “A Monetary History of the United States from 1867-1960”, Princeton University Press, 1967
4. BlackRock Global Weekly Commentary, November 15, 2021
5. Vanguard, “High Inflation but not Stagnation,” US Bureau of Labor Statistics, November 24, 2021
6. DFA Webinar, “2021 Hot Topics: Inflation, Crypto, and Market Highs,” September 10, 2021

All forms of securities investing involve risk of loss for which clients should be prepared. There are no guarantees or insurances of principal preservation and market fluctuations of any level may occur and impact portfolio value. Past performance is not a good predictor of future performance.