Transitions

HOW WILL INFLATION IMPACT INVESTING?

We are all seeing increases in gas prices, food prices, lumber prices, and housing prices. The price index for GDP surged to 3.9% in the first quarter of 2021, compared to 1.7% in the previous quarter. The core personal consumption and expenditures index, which excludes food and energy, had the biggest rise in twenty years. There is a global supply chain breakdown which is causing shortages in many products needed to complete customer orders. Our economy is also experiencing a labor shortage just as businesses emerge from the Pandemic. All these pricing pressures are causing higher prices of goods and services for consumers and business. This is a textbook definition of inflation.

The Federal Reserve has taken the position that this inflation is transitory and is something they are not worried about. What if they are wrong? Especially with further pricing pressures from a White House proposal to spend an unprecedented $6 trillion to further stimulate the economy. The Federal Reserve always was in front of inflation by tightening monetary policy (which includes raising interest rates). When the Pandemic hit, the Federal Reserve properly loosened monetary policy. Short-term rates declined to almost nothing.

If the Federal Reserve lets inflation run, we should soon see higher interest rates. However, if their policy lags too far behind inflation, they will have to re-tighten monetary policy to attempt to control inflationary pressures from spiraling higher. This action will further increase interest rates, and this is not factored into today's markets. This is not a bad outcome, especially since the Federal Reserve has kept rates artificially low for a growing economy.

What does this mean for stocks? For many, inflation will be a shock. Many investors and most portfolio managers have no experience in an inflationary type of environment, for they only have been investing during a period of lowering interest rates and inflation. My experience in the late 1970's was that staying in cash was more prudent than being exposed to declining stock and bond markets. Back then the mantra was "Cash is King." Certain sectors can perform well in inflationary

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periods, but corporate earnings will be under pressure. I would expect a refocus on fundamentals of companies instead of the speculative fever of buying a stock simply because others are.

What does this mean for bonds? In the rising rates of the late 1970's to early 1980's, I used to earn 5% tax exempt returns by reinvesting bond portfolios in short term, top quality municipal bonds maturing within two years. As interest rates and inflation stopped moving higher, we changed our strategy. In the mid-1980's, I locked in 7 ½% tax exempt returns for many of our portfolios by buying non-callable, top quality municipal bonds maturing in fifteen to twenty years. My experience of investing in a period of rising yields brings a completely different perspective when contemplating locking in today's 1% to 2% fixed income returns. Although we could invest at today's rates to fill out a portfolio allocation to bonds, these historically low returns are not sufficient to earn an inflation adjusted return on investment.

If inflation is not transitory, we should see money market yields increase. Corporate bonds and municipal bonds will also experience an increase in yields. These higher fixed income returns will provide an investment without exposure to equity markets. To remain competitive with higher bond returns, I would expect many equities to increase their dividend payments. Therefore, a properly managed portfolio should benefit nicely with a return of inflation.

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