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Inflation: Is It Coming and Should We Care?

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In this brief background piece, we explore the recent history of inflation in the US, including the trend toward lower and less volatile inflation, and we discuss the reasons for this. We also briefly discuss why the inflation situation may be changing and what impact inflation may have on asset prices.

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Inflation: recent history

Since the 1970s, the US has had only brief periods of elevated inflation where CPI rose above 4%. These transitory periods have been associated with the first and second Iraq Wars. Moreover, inflation has averaged just 2.1% since 2000,[1] resetting inflation expectations to a much lower plateau than what would have been estimated in previous decades.

[1] As measured by CPI-U, as of April 2021.

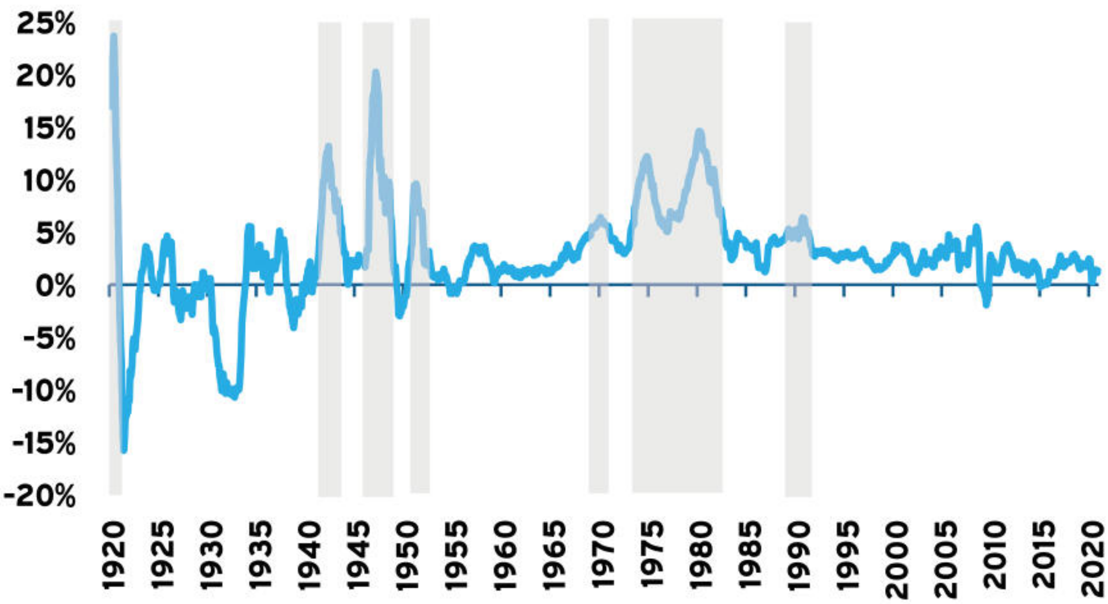

FIGURE 1
Rolling 1-Year Inflation
Source: Federal Reserve Economic Data (FRED) data.

However, such benign inflation has been the exception, rather than the rule, for much of history. As Figure 1 above illustrates, the level of inflation in the US has tended to be quite volatile since World War I. And as Figure 2 on the following page illustrates, it is unusual for inflation to be so constant at such a low level, with many of the observations of 2-3% inflation occurring over the past 30 years.[2] There are many different reasons for both the lower average level of inflation and the lower volatility of inflation, which we explore below.

[2] Specifically, 58% of the months with 2-3% annualized inflation occurred since 1990.

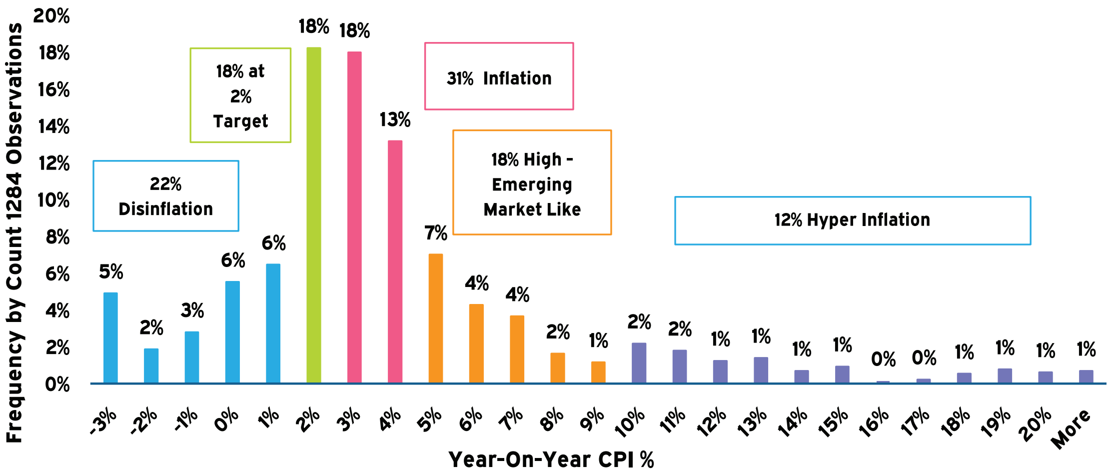

FIGURE 2

1914-2020 Distribution of Annual Inflation Rates in US

Source: FRED data.

Wages

Historically, wages would rise in accordance with economic growth. However, the negotiating power of the average employee appears to have deteriorated in recent decades. There are several reasons for the decline that include: globalization, gains in productivity, minimum wage laws and ERISA, the expansion of salaried work, decrease in private sector unions, the rise of the service sector, deindustrialization, automation in manufacturing, and rising costs of healthcare benefits.

Another reason why wages have less power to drive inflation than in the past is the relative success of the Federal Reserve's price stability credibility. This is, in fact, a self-reinforcing mechanism. Low and stable levels of inflation have resulted in incrementally smaller cost of living adjustments where contractually indicated.

Economists argue that automation and intensive use of technology is lowering the prices of goods and services.[3] As businesses invest in technology and automation, the links between wages and the prices of goods and services become increasingly weaker.[4]

Central bank policy

The 1970s was a decade of stagflation – a period of low economic growth, rising unemployment, and rising prices (i.e., inflation). Only with the appointment of Paul Volker in 1979 did the Federal Reserve move to fight inflation. Volker raised the Fed Funds Rate to 20% by June 1981, targeting the money supply so that the cost of borrowing became very expensive. This approach was very effective at fighting inflation, if temporarily harmful to the economy, and by the end of President Reagan's second term, inflation fell to around 3.5% and economic growth returned. Since that time, the Fed (and many central banks) have used interest rate targeting as their standard policy tool.

[3] Source: https://www.stlouisfed.org/on-the-economy/2018/april/closer-look-reasons-low-inflation.

[4] Source: Daron Acemoglu and Pascual Restrepo; Robots and Jobs: Evidence from US Labor Markets," Journal of Political Economy, 2020 Vol. 128, N. 6. See also: https://economics.mit.edu/files/19696 and https://mitsloan.mit.edu/ideas-made-to-matter/a-new-study-measures-actual-impact-robots-jobs-its-significant. MIT study finds that for every 1,000 robots added; wages fall 0.42% and the "employment to population ratio falls 0.2%." The study finds that adding one robot to commuting area reduces employment by six workers.

The end of inflation?

In recent decades, it has proved difficult for many central banks to create inflation/growth. The modern case study for low inflation is Japan, which has been struggling with too-low levels of inflation and economic growth for decades. In the late 1990s, Japan introduced a Zero Interest Rate Policy for short-term lending, in an attempt to stimulate some inflation/growth, but this has proved unsuccessful.

More recently, the Federal Reserve and other central banks expanded their monetary policy toolkit to include quantitative easing programs in response to the Global Financial Crisis. This was an unproven measure and many market watchers feared that this would cause inflation. However, inflation did not materialize. Although economic theory suggests that inflation is "always and everywhere a monetary phenomenon,"[5] the Federal Reserve's quantitative easing programs that injected money into the monetary system failed to deliver the economic drivers of inflation.

[5] Source: https://www.stlouisfed.org/on-the-economy/2014/september/what-does-money-velocity-tell-us-about-low-inflation-in-the-us.

What about today?

If the inflation beast has been seemingly tamed, why are we worried about it today? The primary reason is that this time, there is unprecedented non-war time fiscal stimulus accompanying the monetary stimulus. And much of the planned spending is set to take effect at a time when the economy will have likely already mostly, if not fully, recovered from the effects of the pandemic. What we do not know is exactly how much additional spending will take place. Likewise, we do not know how the Fed will respond if inflation ticks up. The Fed has already made it abundantly clear that they are willing to tolerate some level of inflation above their 2% target but how much, and for how long, is an open matter.

Inflation's impact on asset performance

Inflation has an impact on asset prices, though the extent, and even the direction, depends on many factors, including the source of the inflation, its level, the coincident level of economic growth, the length of the inflationary period, and whether it was anticipated. The choice of assets that an investor might use to hedge inflation depends on these same factors.

Most publicly traded securities have a negative correlation to expected and/or unexpected inflation, so that when inflation rises, both equities and bonds can suffer losses. Unexpected and persistent inflation may be more difficult to incorporate into a portfolio's construction. Traditional public market securities tend to have a negative correlation to unexpected inflation.

However, there are investible assets that are positively correlated with rising inflation and unexpected inflation, and these can be incorporated into a portfolio's asset allocation to offset inflation's drag on nominal and real performance. For example, we find that natural resource equities, commodities and gold have exhibited a positive sensitivity to unexpected inflation historically (see Figure 3), which may make them potential candidates for inflation protection. A meaningful allocation to assets expected to generate good performance in inflationary periods is required to benefit at the total portfolio level.

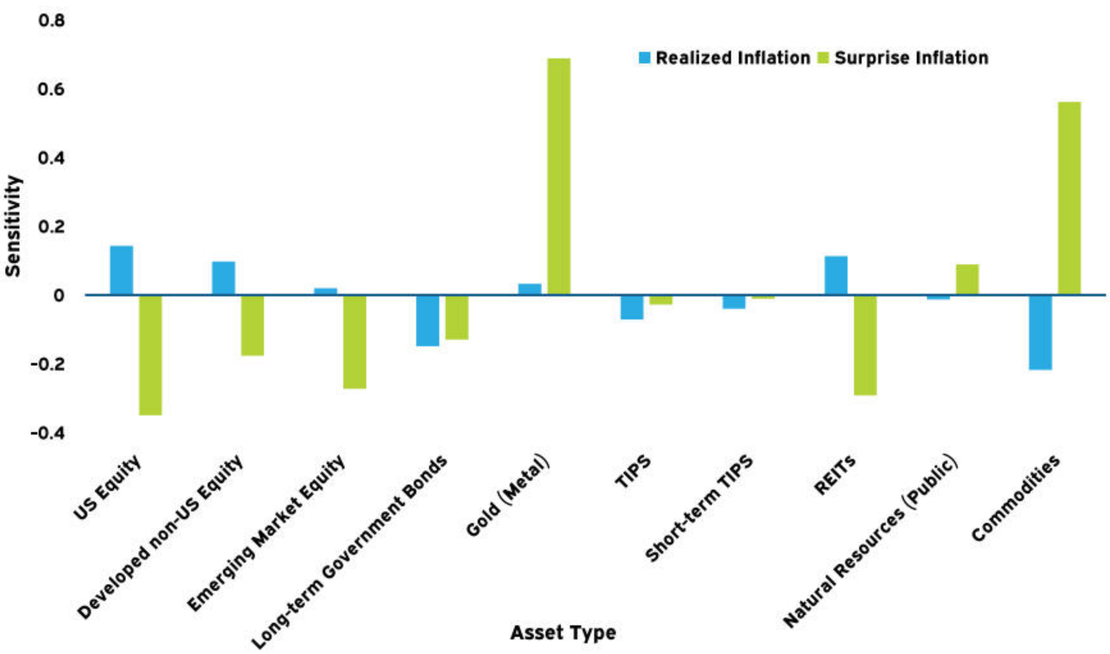

FIGURE 3

Asset Sensitivity to Inflation (Post 1973: High Inflation Periods)

Source: Meketa Capital Markets Expectations and FRED, St. Louis Federal Reserve.

Conclusion

The rationale for asset allocators' commitment to equity/growth assets (e.g., public and private equity, non-core real estate and infrastructure) and defensive assets (e.g., core and government bonds, core real estate and infrastructure) is relatively straight forward. These asset classes have a robust and well researched history. Their role in the portfolio is well understood.

Construction of a component of a portfolio to offset the impacts of high or unanticipated inflation is not straightforward. As discussed, the causes of inflation and the different policy responses from central banks to legislative bodies is uncertain, at best. There is no simple answer.

We recommend that investors initiate a discussion on how inflation may impact assets and liabilities, since benefits are tied to compensation and compensation is, at least in part, tied to inflation. That discussion should include a review of strategies and investment vehicles that will provide an increased level of diversification in the event of high or unanticipated inflation.

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