What We Talk About When We Talk About Inflation

"By 2005 or so, it will become clear that the Internet's impact on the economy has been no greater than the fax machine's." – Paul Krugman, 1998

In 1998, when Krugman made his prediction, Amazon had been public for just one year. Today it has a market cap of $1.7 trillion. A list of other trillion-dollar public companies—which are nearly all internet based—only scratches the surface of the massive economic value created by the internet. In the prediction business, it only takes the passage of time to make even Nobel Prize winners look ridiculous. A good description of asset management is to take the prediction business and add skin in the game.

The axle on which the active asset management industry turns, the fuel on which it runs, is one fundamental question: Will this trend continue? This question was asked about railroads and air travel, later about the internet, and now about cryptocurrencies. Only with hindsight is the answer finally known. And now The Question — is this transitory or general? — is being asked about inflation.

Rising inflation is always both transitory and general. That is, any attempt to measure the rate of inflation will capture both temporary and lasting increases. It's a shade of grey that no one can agree on. Certain price increases look to recede, as lumber already has. But hourly wages and commodities prices are still increasing and flowing through the economy. At its core, the inflation debate is mostly a disagreement over timeframe.

After a review of Q2's market activity, we review what inflation might do to asset prices and what investors should consider.

2021 Q2 Economic Summary and Market Performance

Q2 2021 continued Q1's trends: GDP climbed, yields stayed low, stocks surged, and credit issuance remained robust.

Economic Performance: Still Recovering

Consumers are vaxxed, relaxed, and taking off masks. And they are eager to spend. In June, the Fed bumped its FY 2021 GDP growth estimate to 6.6%, up slightly from March.

The US job market continues to recover. The unemployment rate dropped to 5.8% in May, a sharp decline from the 15% rate at the peak of the pandemic. Worker demand has caused hourly pay to tick up. Still, firms are struggling to fill openings, as potential workers stay on the sidelines. The WSJ recently noted: "Nearly 20% of all jobs posted on job search site ZipRecruiter in June offer a signing bonus, up from 2% of jobs advertised on the job search site in March." A signing bonus may be seen as a temporary increase in wages, a way to normalize future wages without future cuts in hourly pay.

Monetary Policy Overview: Rate Increases on the Horizon

In Q2, the inflation rate hit its highest level in 13 years. At the same time, the Fed raised its annual inflation forecast to 3.4% from 2.4%, suggesting the second half of the year will bring even higher prices. This means higher interest rates are coming. Two rate hikes are expected by the end of 2023, says the Fed.

The Federal Reserve began messaging plans to taper its bond purchase program. In Q2, the Fed's balance sheet crossed the $8 trillion threshold, up from $7.7 trillion in Q1. By contrast, immediately following the 2008 crisis, the Fed's balance sheet was a comparatively paltry $2 trillion.

US and Global Equity Market Summary: Retail Traders Rushed in as Equity Markets Kept Climbing

US equity markets crushed Q2. The S&P 500, DJIA, and NASDAQ each hit new all-time highs during the quarter. Equity valuations remain frothy, buoyed by new retail investors. Whether due to strong convictions or weak imaginations, new retail investors seem to have extraordinarily high levels of risk tolerance. Recent data from MagnifyMoney, a personal finance website, shows that 80% of Gen Z investors have taken on debt to invest (vs. only 9% of Boomers). And 60% of investors who have borrowed took out a personal loan or borrowed from friends and family.

Global equity markets generally surged in Q2. Leading the YTD pack was Canada (+21%) and Russia (+20%).

Credit Markets: Bonds Boosted as Defaults Decline and Rates Rise

Investment Grade[1] bonds (IG) recovered some ground from Q1's decline, gaining 3.3% for the quarter and putting IG at -1.5% YTD. High Yield[2] has returned 3.4% YTD. The Leveraged Loan[3] market returned 3.3% through Q2. BBB yields have increased slightly YTD but are still 50% below their long-term average.

Loan defaults will likely remain low for the remainder of 2021, according to Fitch Ratings. Fitch lowered its 2021 loan default forecast rate to 1.5%, a ten-year low, from 2.5%. Loan defaults are tracking materially lower than last year.

With Covid mostly in the rearview, asset managers are watching inflation and tracking the strength of the economic recovery. If inflation increases are widespread, then interest rates will rise. For that reason, inflation is getting an outsized amount of attention.

Inflation's Dueling Narrative

On one side of the inflation debate is the Fed. It insists that recent inflation increases are transitory. That rising prices are the expected (and temporary) result of restarting an economy, of high government spending, and of pent-up demand. These should normalize in time. The Fed points to idiosyncratic price increases, like the recent 30% jump in used car prices that increased CPI by 1.1% percent. And, the Fed argues, once the supply bottlenecks are addressed, inflation will normalize to 2% or so.

In the other corner are those who think inflation is here to stay. This group sees commodity price increases and wage hikes as the start of permanently higher prices. After all, if you add together enough idiosyncratic price increases, the result is generally higher prices. Citing Milton Friedman that "Inflation is always and everywhere a monetary phenomenon," those seeing permanently higher prices note that Global Central Banks have deployed staggering amounts of capital. Eventually, they believe, this liquidity will result in inflation (though, so far, this excess liquidity has resulted mostly in higher asset prices).

The Winds of Anti-Globalization

A trend that has helped maintain lower prices for decades is now slowing. The forces of economic globalization—the free movement of people, goods, and services—had absorbed price increases through increasing efficiency. For decades, supply chains expanded across the globe, as corporations squeezed every advantage out of environmental, tax, and wage arbitrage.This economic tailwind has now shifted to a headwind. First because supply chain disruptions during the pandemic will incentivize companies to keep manufacturing close, trading a low cost of goods for a high certainty of delivery. Second is increasing populist skepticism towards globalization. This may bring more restrictions on the flow of capital, people, and goods. And with it, remove a key shock absorber of inflation.

The Stock Market Likes Low Inflation

Equity investors benefit from low inflation. Charles Schwab recently examined 70 years of data and showed that when CPI is under 1%, the S&P's gain is about 17% annualized. High inflation is generally bad for equities. When CPI is above 9% the S&P generally rises less than 1%. You can, however, have too much of a good thing. A negative inflation rate is worse for stocks than 0-2% increases.

Asset managers are watching to see if inflation leans towards transitory or general. Higher inflation rates may dampen further equity upside. With higher inflation and higher interest rates, safer investments such as credit or cash will begin to look comparatively more attractive.

Fixed Income Investors Brace for Inflation and Switch to Floating Rate

Inflation is painful for fixed income investors. Especially when interest rates are low. Bond prices are annihilated when low interest rates rise. This is most acute in longer duration holdings, where investors had been seeking yield. For example, long-term Treasury Bond funds are down about 8.5% YTD. By contrast, the short-term Treasury funds are just about even. Reaching for yield is risky in a low-rate environment.

Corporate bond investors are also suffering from low yields. BBB yields are at 2.3%, far below their long-term average of 5.3%. Even investors in so-called High Yield are struggling. The effective yield of the ICE BofA US High Yield Index is now 4.0%, the lowest on record.

Leveraged loans are in high demand by investors seeking yield and hedging against rising rates. Outside of private credit, where yields have remained relatively high and defaults remained low, investors are running just to stay in place. Higher interest rates that only just match inflation will only just maintain purchasing power.

Real Estate Investors Can Benefit From Inflation

The real estate market is white hot. In May, the National Association of Realtors reported that the median price for existing homes exceeded $350,000 for the first time ever.

Real estate has historically been an excellent inflation hedge. Stanford University economist Monika Piazzesi says that even during stock market declines, home prices keep pace with the economy. Meaning that real estate owners gained wealth more quickly than stock owners. The inflation mitigating properties of real estate applies to offices, retail stores, and apartment rentals as well. Commercial rents are generally tied to inflation, acting as a natural hedge against rising prices.

Although asset managers have been investing in single family rentals (SFRs) for over a decade, the asset class is now hitting its stride. SFRs are ideal assets for asset managers, who can support the market in ways that individual homeowners cannot. Because asset managers can raise assets and deploy capital at their leisure, they can avoid overpriced markets and focus on more attractive ones. Selective deployment supports real estate prices and can lower home price volatility. This asset class is receiving increasing interest from investors looking for inflation mitigation.

A Problem to Solve vs. A Condition to Manage

One swallow does not make a spring, any more than one quarter of high CPI means inflation is back. Whether transitory or general, inflation is not under the control of any individual investors. In other words, it's a condition to manage rather than a problem to solve. Investors today have more options than ever to manage rising inflation and higher interest rates.

Institutional investors are shifting to assets that are designed to perform in inflationary environments. This explains higher allocations to alternative investments, floating rate instruments, real estate, and other yielding assets and away from high yield and investment grade fixed income. Other investors can learn from this. That way when the question "Is this increase in inflation transitory or general?" is asked, you'll know that your portfolio will be designed to perform regardless of the answer.

[1] As represented by the Barclays Capital US Investment Grade Bond Index.
[2] As represented by the Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged USD
[3] As represented by S&P/LSTA Leveraged Loan Total Return Index