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The Inflation Conundrum

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Not since the 1970s has inflation been such a hot topic. For nearly the entire decade, inflation averaged upwards of 7%. The Federal Reserve ratcheted up interest rates to 20% in early 1980 to rein in inflation. For context, the Federal Funds rate hasn't been higher than 5% since right before the 2008 Global Financial Crisis and inflation had run well below 2% until recently. Inflation numbers began to pick up in April and May of 2021 with year-over-year inflation rates of 4% and 5%, respectively. There's been much handwringing over whether these inflation numbers are transitory and therefore nothing to worry about, or a sign that the United States is headed for a period of out of control inflation.

Before diving into the current inflation environment, a deeper look into what inflation is and how it's measured is needed.

What is inflation?

The technical definition includes words like "purchasing power" and "basket of goods," but for the average American consumer, it's as simple as rising prices. A trip to the grocery store costs more than it did a year ago to buy the same items. While rising costs sound terrible for consumers, policy makers actually *want* a bit of inflation each year (around 2%). Yes, this can result in modestly higher prices for certain goods and services, but it also helps increase wages. For consumers with debt (a mortgage, car loan, student loans) inflation makes payments easier to manage over time, assuming the interest rate is fixed. The same is true for businesses with outstanding fixed-rate debt. Modest inflation is seen as a sign of a healthy economy.

Inflation is measured in many ways, but the most common metric is the Consumer Price Index (CPI) which calculates the change in price of a basket of goods from one year to the next. That basket includes food, rental housing costs, furniture, apparel, gas, utilities, cars, medical costs, and more. CPI is reported monthly by the federal government. Often energy and food prices are excluded from the monthly reported number as those prices can be volatile—gasoline prices jumped 56% in May as compared to the previous year, for example.

Recent inflation numbers have been quite high compared to the last decade. The chart below shows monthly CPI data going back to 1980. Inflation dropped significantly in the early 80s and has remained relatively low. Post-2008 financial crisis, inflation hovered around 2%.

CPI

Source: U.S Bureau of Labor Statistics 01.01.1980 – 05.01.2021. Past performance is not indicative of future results.

Why is inflation so high?

CPI is calculated on a year-over-year basis, which has led to some technical reasons for higher inflation numbers. As the COVID-19 pandemic was raging and the United States largely shut down during March, April, and May, prices for many goods

and services collapsed. Oil, in fact, experienced negative prices during the initial throws of the pandemic. Those depressed prices are used as the base calculation for year-over-year changes in inflation, amplifying the rate of change.

A bigger issue for inflation right now, however, and one that may take time to abate, is an imbalance of supply and demand. As the United States opens back up, demand is kicking into high gear for hotel rooms, airfare, food at restaurants, back to work clothes, cars, and homes. A semiconductor shortage is making some imbalances worse—especially for cars and computer equipment. Supply chains were ratcheted down considerably during the pandemic and those take time to spring back to life, plus pent up demand makes it harder catch up. But they will.

Timber is a great example. From 2009 to 2019, futures prices for lumber were around $400 per thousand board feet, but prices rose precipitously during mid-2020 and into 2021. Lumber futures prices peaked at nearly $1,600 per thousand board feet in early May, only to drop more than 45% in a matter of weeks. Why? Because sawmills were running at full capacity to take advantage of the high prices, helping supply catch up. Demand is also slowing somewhat as builders have reduced the pace of new home construction because lumber prices had gotten so high. Rational market actors will bring the imbalance of supply and demand back in line, though it might take some time.

What should investors do about inflation?

For long term investors, equities are the best protection against inflation, so maintaining equity allocations based on your time horizon to retirement and risk tolerance is appropriate. For investors nearing or in retirement, the focus must be on diversifying fixed income asset classes. Adding inflation-linked investments (whether TIPs or a real return strategy) remains a good choice even though the very-short term "inflation trade" has largely played out. This should not be a short-term allocation, but a permanent fixture in well-diversified bond portfolio.

Adding a smattering of other higher income generating assets classes such as emerging market debt, high-yield bonds, and certain securitized assets can also help. A multisector or global bond manager can access all of these sectors to ensure a well-diversified portfolio that generates a decent amount of income.

Market metrics

During the second quarter, markets continued to rise—the S&P 500 Index closed the quarter up 8.5%, bringing its year to date return to 15%. The Aggregate Bond index gained nearly 2% this quarter, pulling its year to date returns to -1.6%. International stocks did well but continued to lag the US stock market. The MSCI ACWI ex US gained 5.5% for the quarter and 9% for the year. The MSCI Emerging Markets index lagged further behind as it gained just 5% in the quarter and 7.5% for the year to date.

	Total Return (%)					
	2Q2021	**YTD**	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	8.55	15.25	40.79	18.67	17.65	14.84
MSCI ACWI ex USA	5.48	9.16	35.72	9.38	11.08	5.45
MSCI Emerging Markets	5.05	7.45	40.90	11.27	13.03	4.28
BBgBarc Agg Bond	1.83	(1.60)	(0.33)	5.34	3.03	3.39

Source: Morningstar as of 6.30.21. Past performance is not indicative of furture results

Source: Morningstar

U.S. Bureau of Labor Statistics.

https://www.bls.gov/opub/ted/2021/consumer-prices-increase-5-0-percent-for-the-year-ended-may-2021.htm

Important Information:

The Bloomberg Barclay's Aggregate Bond Index is a broad based, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The MSCI ACWI ex US Index is comprised of non-U.S. stocks from developed markets and emerging markets.

The Russell 1000 Index is a broadly diversified index made up of top companies by market capitalization in the United States.

The S&P 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

The Russell 1000 Growth Index is a broadly diversified index predominantly made up of growth stocks of large U.S. companies.

The Russell 1000 Value Index is a broadly diversified index predominantly made up of value stocks of large U.S. companies.

The Russell 2000 Index is a composite of small cap companies located in the United States.

The Russell 2000 Growth Index is a composite of small cap companies located in the United States that also exhibit a growth probability.

The Russell 2000 Value Growth Index is a composite of small cap companies located in the United States that also exhibit a value probability.

The Russell Mid Cap Growth Index measures the performance of the mid- cap growth segment of the US equity universe.

The Russell Mid Cap Value Index measures the performance of the midcap value segment of the US equity universe.

The indices are unmanaged and does not incur management fees, transaction costs or other expenses associated with investable products. It is not possible to directly invest in an index.

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