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Inflated Inflation Fears?

Transitory Inflation and "The Rule of 72"

How Does This Apply to You?

Why is Inflation Important to Me?

Inflation reduces our ability to preserve financial independence. Inflation causes prices to rise resulting in our need to spend more money to purchase the same goods and services. Let's look at how this happens…

What is "The Rule of 72?" How Does It Impact Inflation?

When he was asked "What is the most powerful force in the Universe?" Albert Einstein famously replied, "Compound Interest." Benjamin Franklin invented compound interest. The Rule of 72 is a simplified formula that provides an estimate for how long it takes for an investment to double in value based on an annual compounded rate of return. For example, if an asset with a value of $100 earns simple interest of 1%, it will take 100 years to double in value to $200. If the interest is compounded, after year one, you are earning interest on $101 so the doubling occurs in just 72 years. Hence the name of the rule.

If an asset earns an annual compounded rate of return of 6%, it can be expected to double in value in 12 years (12 years = 72%/6%).

The Rule of 72 is an elegant approximation as it enables us to easily learn how to understand the growth of our investments. It works in the same way to help us appreciate the negative impact of inflation on our purchasing power. If inflation is 2%, the purchasing power of an asset will be cut in half in 36 years (72%/2%). This means that in 36 years you will need to spend $2 to buy what costs you $1 today. If inflation rises to 4%, you will have to spend $2 for what now costs you $1 in just 18 years. The rule of 72 demonstrates the importance of investing in assets that can outpace inflation to help you preserve your purchasing power.

How Can Your "Real Return" Protect Your Purchasing Power?

Your "real return" is calculated by taking the return on your portfolio, subtracting the taxes you will pay on the gains, and reducing that number by inflation. If your investment portfolio earns a net-of-tax return that is equal to or greater than the rate of inflation, you will preserve your buying power. For example, assume your portfolio earns 6% and you pay one-third of that amount in federal and state taxes, you are left with a net-of-tax return of 4%. If inflation is 3%, you are left with a 1% real return. Maintaining purchasing power is our goal for clients so they can enjoy remaining financially independent.

How is Inflation Impacting the U.S. Economy?

The U.S. economy is experiencing a boom in activity as COVID vaccinations ramp up (52% of the U.S. total population receiving at least one vaccine dose[1]) and the trend in daily new infections remains at its lowest level since the start of the pandemic. This boom in economic growth has also been accompanied by a sharp rise in inflation or the pace at which goods and services prices increase. The abrupt rise in prices throughout the economy has been driven by a confluence of pent-up demand, supply shortages, and stubbornly low employment trends. While the price of everything seems to be abruptly rising, from lumber to hotel rates, we continue to agree with the U.S. Federal Reserve's ("Fed's") assessment that most inflation pressures will end up being transitory (or temporary).

The most helpful way we have heard this described is to think of accelerating a car so fast that the wheels spin and you "burn rubber" before gaining enough traction to begin moving forward. You then start very fast before adjusting your speed to a normal range. This is happening now with inflation as the economy recovers from the global pandemic.

The factors driving rising inflation are the byproduct of the U.S. economy's transition back to normal after being kept in an extended period of "suspended animation" due to government-mandated lockdowns. Supply chains for many products have been impacted due to low inventories of raw materials and/or intermediates, which experienced significant reductions in production levels during the depth of the pandemic. Labor shortages, especially in sectors hardest hit by COVID (e.g., leisure, hospitality, logistics), have caused wages to rise as enhanced unemployment benefits, childcare constraints, limited public transit options, and lingering quarantining restrictions, particularly in California and New York, have served as headwinds to individuals seeking (re)employment. In addition to product and labor shortages, rising energy prices, stemming from OPEC Plus's decision to gradually lift its production curbs, and the release of pent-up demand as restrictions are lifted are also inflating the prices of goods and services.

Will the Recent Spike in Inflation Persist? What Does It Mean for the Financial Markets?

The key questions regarding rising inflation are: 1) Will it remain broad-based? and 2) Will it persist over a long period of time? If the answer is "yes" to both questions, the Fed will likely need to pursue aggressive monetary policy tightening, including abrupt increases in interest rates to slow down economic growth and to keep inflation from rising too fast. (If a consumer expects the price of a good or service to significantly rise in the future, he or she will be compelled to buy now at a cheaper price, which begets even more demand ultimately leading to an inflation spiral.) Periods of rapid interest rate increases typically do not bode well for the financial markets. Rapidly rising interest rates leads to falling bond prices (bond prices are inversely related to the direction of interest rates) and lower stock valuations by increasing the discount factor applied to future earnings and cash flow streams, which reduces the present value of companies. Periods of rapidly rising interest rates also usually portend bear markets or sustained periods of downward trending stock prices of 20% or greater. For these reasons, investors (and the media) have been keenly focused on monthly readings of broad inflation indicators like the consumer price index ("CPI") and the personal consumption expenditure ("PCE") price index for signs of persistently rising inflation.

We expect the trend in the CPI and PCE indices to run "hot," or stay above the Fed's 2.0% stated target, over the coming of months as the U.S. economy continues to reopen. However, we agree with the Fed's assessment that these inflationary pressures will be largely temporary as supply chains recover and inventory levels rise. We also expect wage pressures, which have been clustered at the lower end of the income spectrum, to also decelerate over the near-term as more individuals reenter the workforce due to the expiration of enhanced unemployment benefits and the lifting of remaining COVID restrictions. This will increase the pool of available candidates and reduce the need to raise wages to attract new employees.

It is important to note that the Fed has a dual mandate: maximum sustainable employment and price stability. Since there are 9.3 million individuals still unemployed[2], the Fed stated that it is comfortable with inflation trending above its 2.0% inflation target over the near-term to promote economic growth so people can get back to work as fast as possible. While we expect broad-based inflation pressures to ease after a couple quarters of economic adjustment (i.e., the "burning rubber" phase of the economy's transition back to normal), we do anticipate there will be pockets of inflationary pressures persisting for longer periods of time. These sectors include certain residential real estate markets (e.g., Bay Area housing prices) and semiconductors due to structural supply issues and robust demand trends that predated the pandemic. Ultimately, the strategists we speak with expect inflation to settle in at a range between last economic cycle's average of 1.8% and the long-term historical average of 3.6%[3].

How Are We Responding to Higher Potential Inflation?

We have generally positioned client investment portfolios based on the expectation that broad based inflation pressures will subside over the coming months but ultimately settle in at a slightly higher rate than what we have experienced over the past 11 to 12 years. For most clients, we previously increased their equity exposures back to their strategic long-term targets as the rebound in economic growth will benefit corporate earnings growth thus provide the potential for continued stock share price appreciation. We are generally emphasizing balanced exposure to stocks. We favor value-oriented, cyclically sensitive industries closely tied to the current economic recovery (e.g., financial sector stocks) and growth-oriented sectors, such as healthcare and technology, whose earnings are driven by robust long-term, secular growth tailwinds such as innovation and aging demographics and less by the ebb and flow of the economic cycle. We are also emphasizing foreign stocks, both developed international and emerging markets, given their cheaper valuations compared to U.S. stocks, along with their potentially longer runway to compound returns (due to being earlier in their economic recoveries), and their exposure to more economically sensitive sectors of the economy.

We have also taken a balanced approach for most of our clients' fixed income (bond) investments preferring to hold similar weightings to globally diversified, predominately investment grade government, corporate, and securitized bonds. For many clients we are maintaining a modest amount of duration (a measure of interest rate sensitivity) to reduce the impact from an abrupt rise in interest rates, should this occur, while still providing ballast during periods of heightened stock market volatility (longer-duration, investment grade bonds tend to have a negative relationship to stocks). We are cognizant of the potential for broad-based inflation persisting longer than anticipated, which is why we advocate incorporating real assets into most client portfolios. The funds we use to invest in real assets own physical assets including those that can produce relatively low interest rate-sensitive, stable income streams, such as real estate and infrastructure assets, and inflation-sensitive real assets (e.g., hard commodities, natural resources, and inflation-linked bonds).

We appreciate the likely approval by Congress of an infrastructure bill that will lead to an even more economic growth. However, we anticipate the final version of the bill ultimately approved will only have a modest impact on annual GDP growth. This is because it will likely be in the range of $1.0 trillion to $1.5 trillion (versus the $4.1 trillion bill initially announced by the Biden administration), get enacted over a 7-to-10-year period, and be offset by personal and corporate tax increases. Many of our client portfolios emphasize assets that are direct beneficiaries of increased infrastructure spending including industrial and technology sector investments and natural resources and commodity holdings within our clients' real asset funds.

Will Stocks Continue to Deliver Good Returns?

With U.S. stock valuations now at 1.6 standard deviations above historical levels[4] and bond yields trading near historical lows, experts predict future returns for U.S. stocks and bonds will likely be lower than the returns experienced over the past 12 years. This also means clients may need to assume more risk to generate sufficient returns to support future cash needs and/or their financial goals. Our disciplined investment process will help you to confidently navigate the available investment opportunities while minimizing risk.

We Are Here to Help You Attain Your Financial and Personal Goals!

The general information in this commentary is not intended to reflect our specific recommendations for any client portfolio. Please contact us with any questions to discuss your personal goals and your investment portfolio.

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We welcome the opportunity to discuss your goals and the most appropriate strategy to pursue them. We are also honored to speak to any of your friends, associates, or relatives should they have an interest in our financial planning or investment management services.

Please stay healthy and safe!

Footnotes:
[1] Covid.cdc.gov COVID Data Tracker
[2] Fred.stlouisfed.org FRED Economic Data Unemployment Level as of May 2021

[3] Core CPI; last cycle period: 06/30/09 to 02/28/20; historical average period: 01/01/58 to 05/01/21
[4] JPMorgan Asset Management Guide to the Markets presentation dated 06/14/21; median standard deviation for the following S&P 500 Index price multiples: forward price-to-earnings, Shiller's price-to-earnings, dividend yield, price-to-book, price to cash flow, and earnings yield spread (S&P 500 earnings yield minus Baa yield)

This information was compiled by Ginsburg Financial Advisors.

Unless otherwise noted, financial data are as of June 15, 2021.

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