November 10, 2021

Managing inflation risks

Key takeaways

- Inflation accelerated at the fastest pace in 30 years and high price growth may persist into 2022.
- Future inflation risks are broad and two-sided.
- Historically, equities and real estate have performed well in inflation environments, but we are assessing alternatives.

Inflation captured headlines today, with the Bureau of Labor Statistics' Consumer Price Index (CPI) accelerating 6.2 percent in October relative to a year ago. Inflation increased at the fastest pace since November 1990, when oil prices more than doubled in the wake of the Iraqi invasion of Kuwait, both major oil exporters.

While oil prices have also doubled this year, the factors driving inflation's current rise are broader than rising energy prices amid a major Gulf war. Global oil demand is improving as economic activity recovers from the coronavirus pandemic, and major oil exporters are expanding output as demand returns. Major central banks continue to maintain low interest rate policies and are just beginning to reduce asset purchase programs, factors that support economic growth for the next year. Additionally, prices beyond just oil are experiencing meaningful price gains, with housing and rental prices rising on strong demand and wage gains accelerating at the fastest pace since the 1980s. The key questions for us are whether prices will continue their spiral higher and how best to position portfolios given these risks.

Historically, price spirals have required some systematic increase in wages to compensate for higher goods prices. Over the past 30 years, income growth has been more consistent and modest, so price spikes, such as the 1990 oil price shock, have resulted in consumers reducing spending to accommodate the price shock. In contrast, during the 1970s a much higher proportion of the workforce was subject to employment contracts with automatic wage increases based on inflation. As a result, despite rising prices for oil and many other goods, consumers were able to maintain their level of spending, further accelerating price and wage inflation until the 1982 recession.

Today, very little of the labor force benefits from automatic cost of living adjustments (COLA), with wage gains more sporadic and episodic. Instead, the current issue is one of limited supply of key items, including labor, oil, semiconductors and even shipping. Demand remains strong, with consumers' incomes growing along with the ability to tap into high savings levels, while business inventories remain constrained. Additionally, higher housing prices are leading rent increases in coming quarters.

While current inflation pressures appear likely to persist over the next couple of quarters, low borrowing rates and strong demand should lead to resolution of many supply issues for goods. Also, the attraction of higher wages, the end of emergency pandemic assistance programs such as extended unemployment benefits, and continued COVID vaccine and therapeutic progress should lead to an increase in the number of workers seeking jobs, alleviating the currently tight labor market. This reflects our base case for moderating inflation pressures over the next year or so. However, we acknowledge there are significant two-sided risks to our base case. Should supplies for labor or goods remain constrained, price pressures may persist much longer and higher. Alternatively, if preferences to not work or take more flexible, lower-paying jobs have increased among consumers, the contraction of family incomes would likely lead to slowing demand, significantly easing price pressures.

Investors' major concern is how best to position their portfolios given the risks of inflation. Historically, equities and real estate have performed well in inflationary environments, while traditional fixed income investments have fared the worst as inflation erodes the purchasing power of those fixed interest payments. Currently, we lean toward large U.S. stocks and lower-quality bonds with higher yields and maintaining exposure in real estate at the expense of high-quality fixed income investments. This reflects strong corporate fundamentals and the prospects for continued solid domestic economic growth and the fair compensation investors receive for risks in lower-quality bonds, such as bank loans, high yield corporate and municipal bonds and non-government backed residential mortgage bonds, relative to the low yields for higher-quality bonds. However, we are assessing whether this will be sufficient for investors as we seek fair compensation for the risks we bear. We are evaluating the risks and costs relative to the opportunities in broader real asset strategies such as inflation-linked bonds, commodities and commodity-related equities or even global infrastructure equities.

Inflation pressures are concerning as price growth reaches the fastest pace in 30 years. While our base case is for these pressures to slowly moderate, we must consider risks for further acceleration or a faster normalization of these price pressures as the economy continues to recover from the coronavirus pandemic. Historically, equities and real estate have been effective in managing inflation risks in portfolios relative to bonds. We continue to evaluate inflation risks and prospects and additional portfolio tools to effectively manage these risks. For now, we lean toward an emphasis on large U.S. stocks in portfolios, but we will update you should that change.

Please connect with your financial professional for how best to manage your specific needs, concerns and risks in your portfolio.

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Past performance is no guarantee of future results. All performance data, while obtained from sources deemed to be reliable, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for direct investment. The S&P 500 Index consists of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general. The Consumer Price Index is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is one of the most frequently used statistics for identifying periods of inflation or deflation.

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