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Economic Review & Outlook

THIRD QUARTER | 2021

Inflation: The Hidden Tax

As we all continue—hopeful and grateful—the process of putting the pandemic in the rearview mirror, our focus turns to what comes next, in terms of lifestyle, work habits, and government policy. From a financial perspective, many are concerned about the increasing probability of higher taxes going forward. Others see growing government deficits, as well as recent headlines about rising prices for goods and services and wonder if inflation will become a lasting trend. Will it derail the economic recovery and lower living standards since inflation acts as a hidden tax on everyone's purchasing power?

In this issue, we take a deep dive into inflation. Where does it come from? How does changing government policy impact our purchasing power? What can we do to manage it, in terms of constructing portfolios that help us reach our financial goals?

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Economic Overview

GROWING EXPECTATIONS FOR REOPENING AND THE ECONOMY

Perhaps nothing signaled the winding down of the pandemic in the U.S. more than the Centers for Disease Control and Prevention announcing in mid-May that vaccinated people no longer need to wear a mask in most situations. Rising vaccination rates, positive reopening effects on business and travel, and rapidly accelerating corporate earnings growth from 2020 lows all underline strengthening economic activity as the country and much of the world emerge from COVID-19 restrictions. Forecasts for global and U.S. growth improved, with the World Bank predicting the fastest global recovery from a recession since 1940, and the fastest U.S. growth since 1984. Economists did warn that developing and poor countries continue to battle rising COVID-19 cases and lagging vaccination programs, while many highlighted the increase in inflation since May 2020. In the U.S., headline inflation surged to a 12-year high in May, but the U.S. Federal Reserve (Fed) pledged to keep interest rates low for the near term.

TAXES AND SPENDING LIKELY TO EXPAND FURTHER

After signing the $1.9 trillion American Rescue Plan in April, President Joe Biden turned his focus to infrastructure, announcing proposals calling for approximately $4 trillion in new spending through his American Jobs Plan and American Families Plan. The president's proposals would increase taxes on corporations and the wealthy. He also proposed a budget that would feature the highest levels of sustained federal spending since World War II. How much of Biden's agenda becomes reality remains a mystery, with negotiations surrounding the infrastructure plans showing signs of a long, drawn-out battle in Congress. Still, they will likely pass some sort of infrastructure spending package in 2021, along with increased spending through the budget. That legislation will likely help boost economic growth over the next few years, but also increase deficit spending, which can help drive inflation rates higher for longer.

INFLATION ON THE RISE

In May 2021, U.S. headline inflation reached a 12-year high, and core inflation topped the Fed's 2% target in both April and May. Reopening is unquestionably a driver, given supply chain constraints, rising input prices, and pent-up consumer demand. Many economists expect the rise in inflation to be transient, with the Fed arguing that the run-up will likely not threaten price stability and pledging to keep interest rates low. Still, some investors worry that rising inflation could be a much longer-term issue, especially given the likelihood that government spending will increase.

Asset Class Performance

Equities and risk assets rallied once again in the second quarter amid signs of a continued economic recovery in the U.S. and China, as well as encouraging indicators in Europe and emerging markets. Commodities were among the quarter's strongest performers, as prices rose on a supportive mix of COVID-19 vaccines, massive stimulus spending, and pent-up demand. Gold showed strength at times, amid inflation concerns and a weakening U.S. Dollar; however, speculation around future Fed tightening caused prices to retreat late in the quarter. Global stocks broadly advanced, with U.S. equities outpacing international stocks. Bonds (+1.8%) had more moderate gains.

Year-to-date, double-digit returns have been the norm in risk asset classes, with commodities leading the way as recovering global markets fueled a surge in demand for metals, food, and energy amid lingering supply constraints from the pandemic. Stocks also rode the reopening wave through the first half of the year, led by U.S. equities. International developed markets and emerging markets also posted substantial gains. Despite a sharp rally in April and May, gold remains negative year-to-date, after risk-on sentiment and accelerating growth expectations weighed on prices in the first quarter. Bonds followed a similar track, as rising Treasury yields pressured returns and spreads tightened, especially in the first quarter.

January	February	March	April	May	June	Q2	YTD
Emerging Market Stocks 3.1%	Commodities 6.5%	U.S. Stocks 4.4%	Commodities 8.3%	Gold 7.7%	U.S. Stocks 2.3%	Commodities 13.3%	Commodities 21.1%
Commodities 2.6%	U.S. Stocks 2.8%	Int'l Developed Stocks 2.4%	U.S. Stocks 5.3%	Int'l Developed Stocks 3.7%	Commodities 1.9%	U.S. Stocks 8.5%	U.S. Stocks 15.3%
Diversified Bonds -0.7%	Int'l Developed Stocks 2.3%	Gold -0.9%	Int'l Developed Stocks 3.1%	Commodities 2.7%	Emerging Market Stocks 1.4%	Int'l Developed Stocks 5.4%	Int'l Developed Stocks 9.2%
U.S. Stocks -1.0%	Emerging Market Stocks 0.8%	Diversified Bonds -1.2%	Gold 3.0%	Emerging Market Stocks 1.2%	Diversified Bonds 0.7%	Emerging Market Stocks 5.1%	Emerging Market Stocks 7.6%
Int'l Developed Stocks -1.1%	Diversified Bonds -1.4%	Emerging Market Stocks -1.5%	Emerging Market Stocks 2.5%	U.S. Stocks 0.7%	Int'l Developed Stocks -1.4%	Gold 3.2%	Diversified Bonds -1.6%
Gold -2.6%	Gold -6.6%	Commodities -2.1%	Diversified Bonds 0.8%	Diversified Bonds 0.3%	Gold -7.0%	Diversified Bonds 1.8%	Gold -7.0%

Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Barclays Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index,Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges, and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

Our Perspective

WHAT CAUSES INFLATION?

Quite simply, inflation represents a decrease in purchasing power driven by a rise in prices of goods and services in an economy. Many economists contend that the root cause of inflation is an increase in the supply of money, whether through printing more currency, giving more money away to people, or loaning more money into the banking system (through central bank purchases of bonds and other securities). This trend has occurred over the last year-plus, as the Biden administration, Congress, and the Fed support the economy through pandemic-related stimulus measures.

Economists generally classify the causes of inflation into three categories:

- When the cost of producing goods and services (such as raw materials or labor) increases, the resulting higher prices are described as cost-push inflation.
- Demand-pull inflation happens when the demand for goods and services outstrips supply, driving prices higher.
- Built-in inflation is often referred to as the wage-price spiral. When prices rise, people expect and/or demand higher wages to maintain their standard of living. Higher wages increase demand for products and services, and each side of the equation drives a continuing cycle of inflation.

WHY DOES IT MATTER?

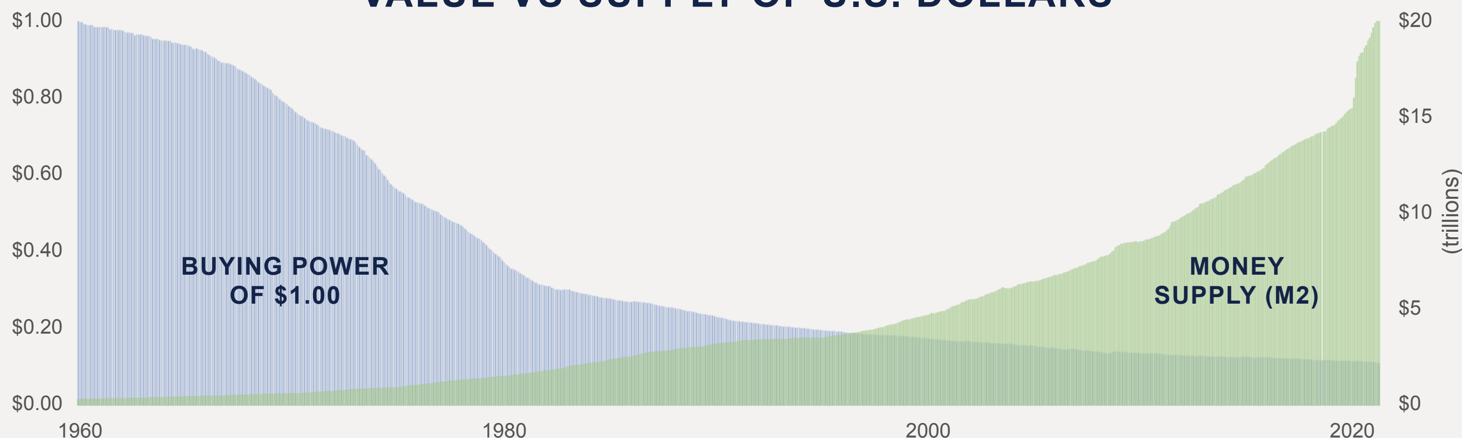
Inflation is a hidden tax in terms of our everyday lives and our investment portfolios. In the very simplest terms, we invest to increase our purchasing power over the long term. Inflation does just the opposite, chipping away at the real value of our money and our nest eggs. Since inflation has been so low for so long, it's easy to forget that impact. However, one needs to look no further back than the 1970s to see when inflation ran above 5% for years and spiked to well above 10%.

Inflation is a threat to our goals, because our income, savings, and investment returns need to keep pace with inflation before real purchasing power can grow. Put $1 million in a safe, or a no-interest savings account, and 25 years of 4% inflation will cut the real value in half because prices of goods and services will more than double. Even at 2%, inflation will eat up more than a third of your purchasing power in a quarter century. Likewise, if your $1 million portfolio gains 8% annually, it would grow to approximately $5.2 million over 25 years. However, with inflation at 2%, the portfolio would only be worth about $3.2 million. If inflation averaged 4%, your actual purchasing power would drop to less than $2 million. The chart below illustrates the long-term decline of the U.S. Dollar's purchasing power, which has corresponded with an ever-increasing money supply.

Official numbers aside, we've all seen the rise in prices over the last year-plus—from the car dealership, to the grocery store, to the gas pump. The big question is whether we are seeing a transitory increase tied to the post-pandemic economic recovery or the beginning of a lasting trend that could reduce people's standards of living and potentially derail the recovery.

THERE ARE REASONS FOR CONCERN

When the Fed injects money into the economy, interest rates tend to fall, and inflation tends to rise. Since the global financial crisis in 2007-2008, the Fed has kept monetary policy looser than ever before (with near-zero interest rates) and maintained supportive measures for more than a decade. Throughout that time, some economists have warned about a forthcoming surge in inflation. It hasn't occurred yet, even as central banks tried to increase the inflation rate. The U.S. Federal Reserve, which established a 2% inflation target in 2012, signaled a willingness in 2020 to let the economy, and inflation, run higher at times amid the post-pandemic recovery.



Source: Federal Reserve Economic Data (FRED)

COVID-19 has prompted an unprecedented combination of monetary and fiscal stimulus. The market reacted to the inflation threat in early 2021, driving up U.S. Treasury yields to multiyear highs, but things settled down fairly quickly. Still, despite the apparent waning of the pandemic and what appears as a sharp rebound in economic growth, our government leaders continue to increase the deficit spending.

The president's budget proposal, released in May 2021, would increase federal spending by about 35% from pre-pandemic levels, with many of the increases dedicated to programs such as education, infrastructure, and high-speed internet for all. At least in the short term, the president would fund these projects by borrowing money (at today's low interest rates) and growing the deficit by more than $1 trillion a year for the next decade.

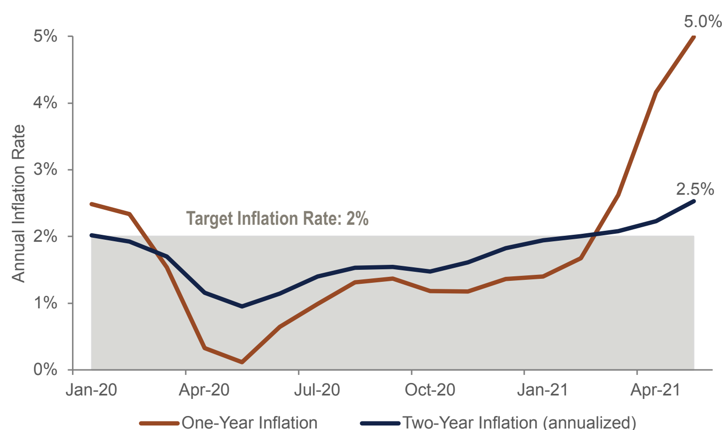
Inflation is a long-term problem, so politicians tend to ignore or place it on the back burner—especially when many of them, and a large swath of the population, have never experienced high inflation over a sustained period. Politicians are incentivized to address short-term issues, which makes it increasingly difficult to slow down spending. Today, it seems like the debate around spending is less about whether or not to run large deficits, and more about how large and which groups to target.

This government spending—combined with the estimated $2 trillion-plus that was distributed to Americans during the pandemic and the desire for people to spend some of that money as everything reopens—is a recipe for potential economic overheating and inflation. Sustained inflation is tough to combat, usually requiring tighter policy and higher interest rates, which can lead to recession.

WHY WE MAY NOT NEED TO WORRY

Fed officials say recent consumer price increases are transitory, tied to the COVID-19 crisis. Part of what we've seen in recent inflation data is attributable to the reopening of the global economy and was expected. In 2020, we saw many activities and industries shut down completely during the height of the pandemic, leading to a temporary but very steep drop in prices during the first half of the year. The subsequent recovery from those depressed 2020 values has led to a very high year-over-year inflation figure of 5%. However, as you can see in the graph, if you look back to pre-pandemic price levels, the increases we've seen over the past two years are elevated but not out of the ordinary.

Additionally, COVID-19 has had a lingering impact on global supply chains, which led to some of the inflation we've already seen. For example, sawmill closures drove a rapid rise in the cost of lumber, and the semiconductor shortage has impacted the prices of cars and other goods. Rising demand and prices for airfare, lodging, and food—all key ingredients in the recent inflation spike—shouldn't surprise us after the pandemic severely undercut those areas of the economy. Prices that were particularly depressed during the pandemic were bound to bounce back and will continue to rebound, to a point. Likewise, supply chains and shipping shortages will likely recover and start to rebalance supply/demand issues, but it may take time.



Source: FactSet

While the conventional wisdom is that big deficits to fund government spending can lead to overheating and inflation, some economists argue that right now is a good time to spend at higher levels, taking advantage of the ability to borrow at low rates and make long-term investments in things like infrastructure and education, which could help bolster economic growth over the long haul.

As for monetary and fiscal stimulus over time, one reason why governments and central banks are less concerned about inflation is their belief that inflation is easier to combat than deflation. Preventing deflation is a big reason why central banks have been so aggressively accommodating in the wake of both the financial crisis and COVID-19. Structural forces such as the rapid advance of technology, labor market globalization, high indebtedness, and the demographics of an aging population have helped limit inflation in recent decades, and some economists believe they will bring prices back down after this period of adjustment.

OUR VIEW

We build inflation into our expectations, as everyone should. We hope that it stays somewhat consistent and reasonable over time, but we also expect it to run hot from time to time, particularly when economic growth is strong. Nonetheless, we still believe that fiscal responsibility is important, and that the long-term consequences of steady, massive deficits are the hidden taxes of inflation and currency devaluation.

Our Investment Strategy

We think in terms of purchasing power, and we build inflation expectations and concerns into our portfolio construction and risk management processes. When we set portfolio goals and returns expectations, we always think in real, after-inflation terms, because outpacing inflation is a bedrock of successful investing.

Our time-based investment approach allows us to look past today's headlines. We always have an eye on inflation, of course, but we also know to expect uncertainty. At this moment, no one knows how much prices will rise, or for how long, nor do we know how policymakers will respond over time. In the same vein, while we are concerned about government spending levels and rising deficits, we also recognize the power of expansive monetary policy and stimulus measures, especially in the wake of the pandemic's economic shock.

Investors may want to lean into areas of the market with a higher probability to outpace inflation—generally stocks over bonds. Over the long term, equities are usually a good investment relative to inflation, because companies can raise prices to match rising costs, and higher prices can drive stronger earnings. At the same time, unexpected or surging inflation tends to weigh on stock prices in the near term, so it's especially important to pay close attention to valuations and ensure we're not overpaying for equities or buying a short-term narrative. That's not to say we should pull back hard on bonds or eliminate tech and growth stocks, because diversification and a long-term approach have historically been the best way to protect and grow portfolios. Any asset class can go through periods of difficult performance.

We think investors should consider other ways to diversify even more, such as owning a broad basket of currencies through international stock investments. Higher inflation tends to put downward pressure on a currency, so owning multiple currencies can help spread out our risk. A reasonable allocation to real assets, such as gold, commodities, or real estate, can also help protect against inflation surprises—again, as long as we buy in at a reasonable price.

Conclusion

Rising inflation, ballooning deficits, and government policy—all areas of focus for investors as things move back to "normal" in the wake of the pandemic—are cause for concern and must be monitored. That said, there is no reason to panic, to allow the headlines to scare you away from the market, or to worry that any or all of these issues mean you won't be able to reach your financial goals. Rather, know the threat of inflation exists and understand it. Know that it is a normal, expected part of investing and build it into your decision-making process. We build it into everything we do. Manage your expectations, remain patient, and diversify your portfolio to account for all potential outcomes. Remember: We have found that taking a long-term approach and sticking with your process helps build wealth over time.

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