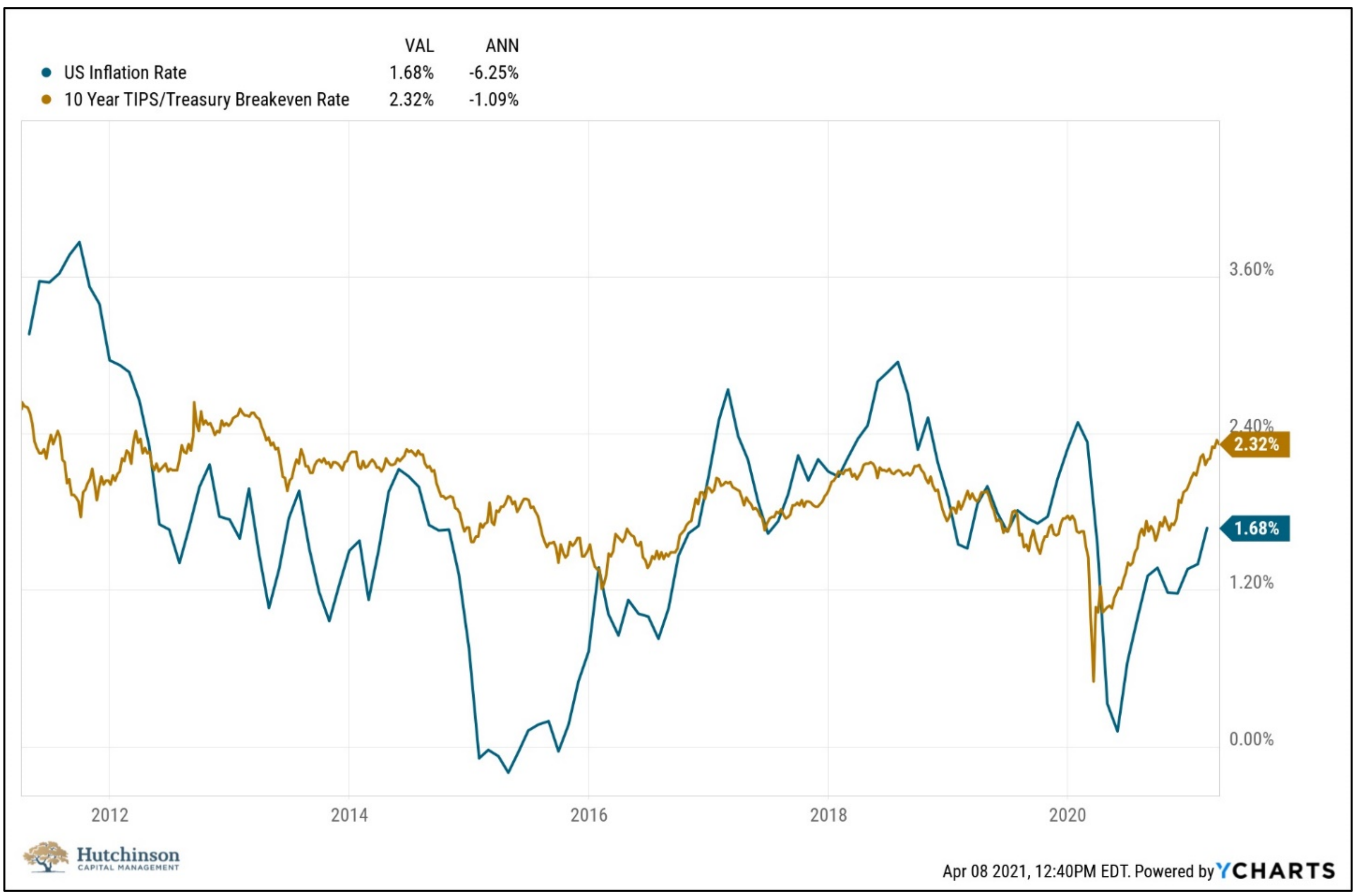
April 2021

<u>What to Make of Rising Inflation Expectations?</u>

Amidst the backdrop of sustained Federal interest-rate suppression and trillions of dollars in fiscal stimulus, it comes as a surprise to few that inflation has become a pervasive topic for investors. For those born in 1960 or earlier, you likely remember, with not so fond memories, the decade of the 1970s, which saw some of the highest rates of inflation on record coupled with weak economic growth. The average inflation rate for the decade was 6.8%, nearly triple the rate of the previous two decades; maintaining the purchasing power of your income was a very real concern. For those born after 1960, it is unlikely you have experienced the wealth destroying effects of inflation firsthand. The rising inflation expectations today are preceded by several decades of economic growth and stable prices; it is easy to see why the word "inflation" has this urban legend-like quality, engrained in the brains of so many. Investors have feared the return of inflation for nearly half a century but to no avail. So why have expectations suddenly changed so dramatically?

Increased inflation expectations are just that—expectations, and it is important to note that while this quarter's *Investment Perspectives* will cover inflation and how we position your portfolios to combat inflation, it has yet to materialize in a meaningful way. Below is a chart over the past 10 years of the actual inflation rate, measured by CPI, versus the breakeven inflation rate, which is a measure of expected inflation derived from the 10-Year Treasury. The latest value for expected inflation implies that market participants expect inflation to be 2.32% over the next 10 years—a significant increase from the lows we saw in expectations last year but still well below the long-term historical average inflation rate of 3%.

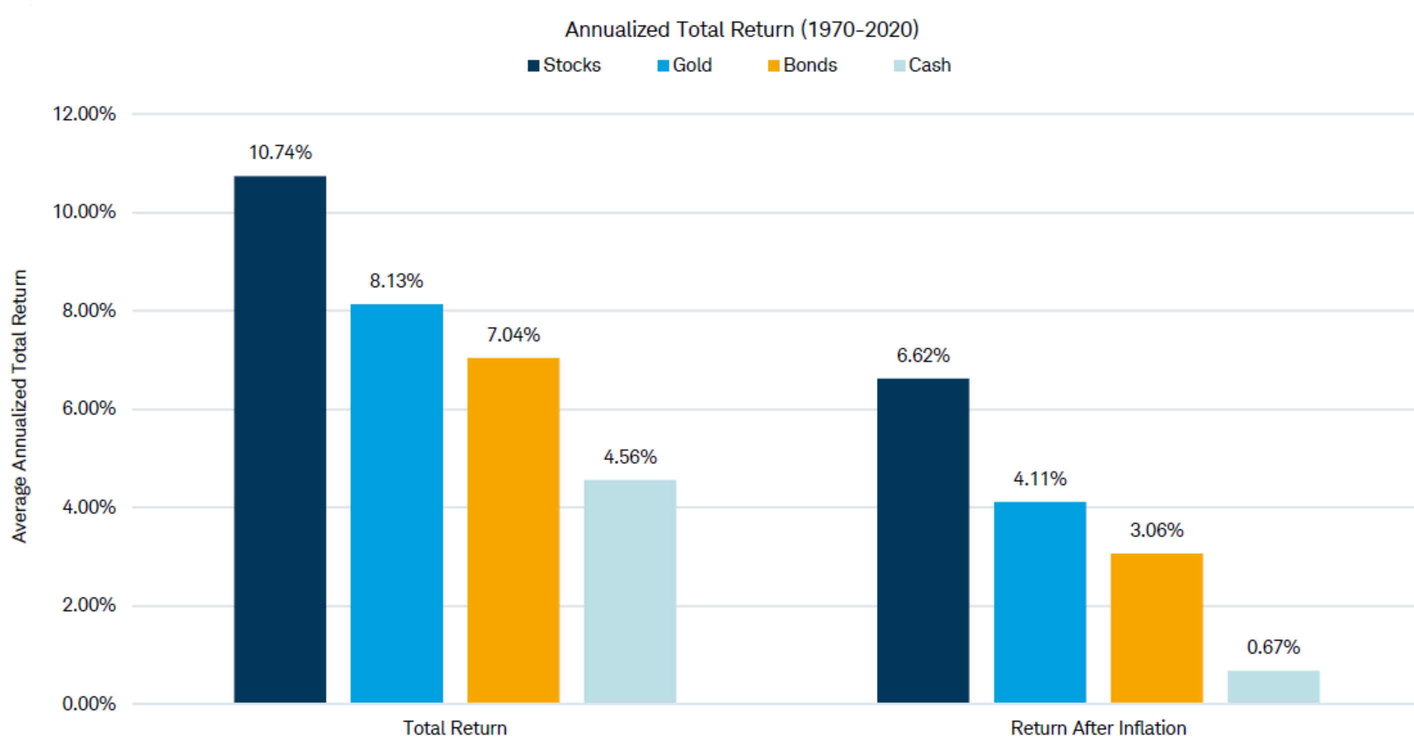


These expectations are built on the back of a long period of low and relatively stable prices. An aging demographic, slowing population growth and technological innovation has held inflation at bay for several decades. This low floor has set the stage for higher inflationary expectations going forward. Additionally, as we alluded to earlier, highly accommodative fiscal and monetary policy are important factors in the recent increase in inflation expectations. However, the substantial growth of the money supply due to federal stimulus does not directly cause an increase in prices, as ultimately it is the fundamental forces of supply and demand that lead to inflation, or a lack thereof. The pandemic has constrained supply in the short run for many goods and services, which in turn created growing pent-up demand for these products. It will take some time for supply chains to adjust, but as the rollout of vaccines continues to progress and strong consumer demand returns to the economy, a pick-up in near-term inflation is expected to be transitory in nature.

Where do we go from here?

One of our primary goals is the preservation of your capital, which means sustaining the purchasing power of your dollars over a long-term time horizon. This responsibility is more challenging during periods of elevated inflation. We are mindful of the fact that the underlying ability to sustain your lifestyle comes down to being able to generate an inflation adjusted cash flow stream.

As investors, we try to anticipate the factors that impact portfolio performance over the long-term. Inflation is just one of those factors. Theoretically, stocks should provide somewhat of a hedge against inflation because a company's revenues and profits should grow at a similar rate, after an adjustment period. However, inflation's varying impact on stocks confuses the decision to exit longstanding positions or establish new positions in companies that may be better suited for an inflationary environment. If inflation accelerates in the short-term, which many economists are predicting, we will begin to see a lot of financial media reports highlighting the attractiveness of assets like gold, commodities and even cryptocurrencies. While these may experience positive short-term performance, their long-term relationship with inflation is often a mixed bag. We are inclined to invest in companies with predictable revenues because companies with predictable revenues tend to have a competitive foothold in their addressable market; this indicates they have some pricing power, meaning they can pass on price increases to the consumer in the case of an inflationary environment. As shown in the chart below, stocks have historically provided the most effective protection against inflation over long periods of time.



Source: Schwab Center for Financial Research with data provided by Morningstar, Inc. Indices representing each asset class are the S&P 500 Index (stocks), Ibbotson Intermediate U.S. Government Bond Index (bonds), and Ibbotson U.S. 30-day Treasury bills (cash investments). Gold is represented by the gold spot price. Historical inflation rates were used to adjust "Return After Inflation". Chart results assume a 49-year holding period. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. For additional information, please see Schwab.com/IndexDefinitions. **Past performance is no guarantee of future results.**

Regarding bonds, there are far fewer vagaries. Assets that are tied to a long-term fixed income stream (like most bonds), struggle during times of sustained or short-term inflation shocks. For this reason, we have consistently favored investment grade bonds, coupled with a laddered bond strategy. Currently, our bond portfolio has a shorter average maturity than most bond indices, which makes them less susceptible to the effects of rising interest rates and inflation.

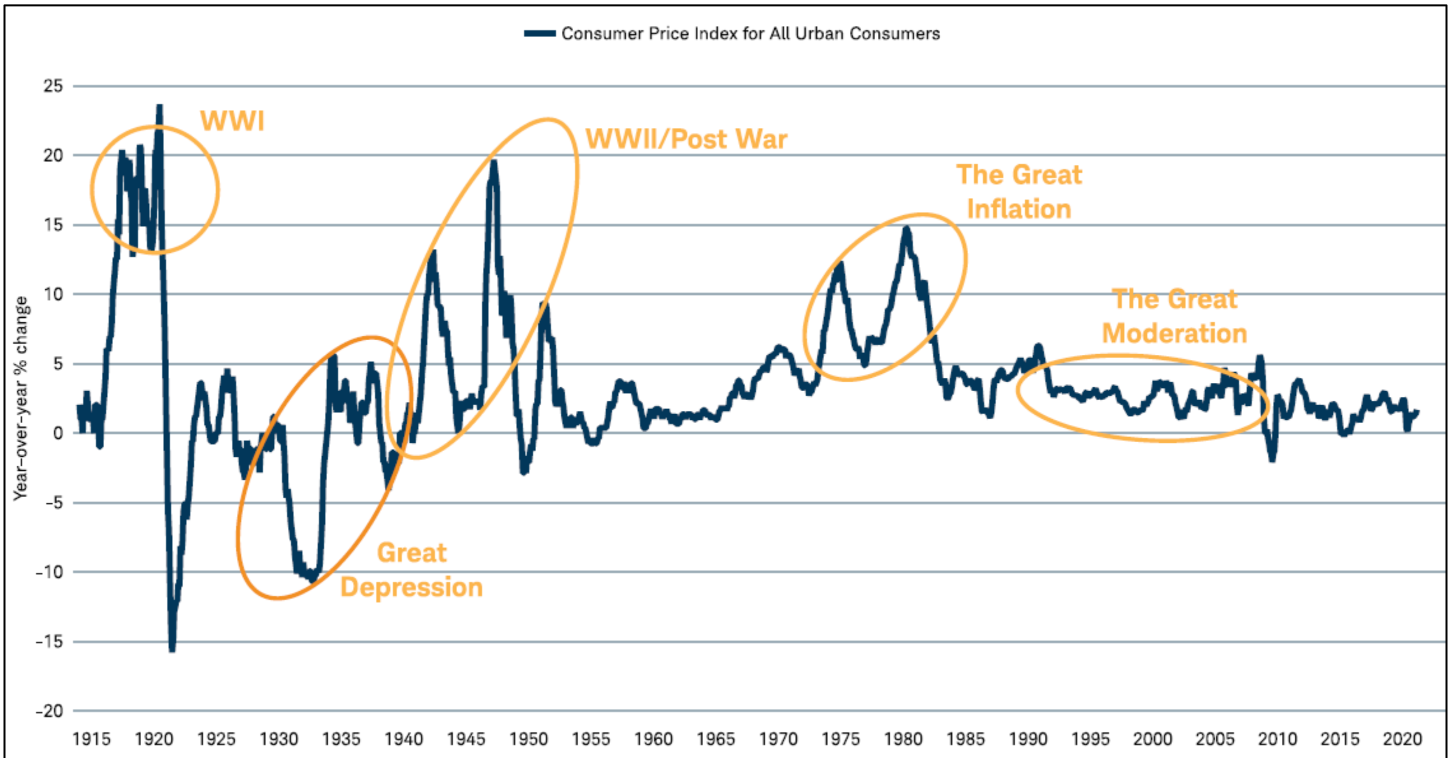
This is not the first time in the past decade that the inflation fears, and rising interest rates have captured the collective attention of the markets. In the April 2012 edition of *Investment Perspectives*, we wrote the following about our bond investments in the face of similar fears:

> We believe that high quality investment-grade bonds are essential for capital preservation even in a rising inflationary and interest rate environment. The future will deliver some unpleasant performance results occasionally; however, bonds will act as an important safety net because they can provide the stability that an all-equity portfolio often will not. In addition, the stream of income that bonds provide enhances returns if the principal is reinvested when a bond matures. As we have stated many times, we strongly believe that one of our most important responsibilities to each of our clients is to preserve their capital and to strive to continuously achieve a compounding growth of this capital. In our opinion, owning a high-quality bond portfolio will greatly minimize the downside risk in a portfolio over time and will significantly aid us in accomplishing our primary investment objective of consistently compounding returns while preserving capital.

While those fears never truly materialized nearly a decade ago, investors were preoccupied with the potential risk. While the underlying causes of our economic conditions this time around are truly unique, it reminds us of one of our favorite quotes, *"History Doesn't Repeat Itself, but It Often Rhymes"* – Mark Twain.

The fact of the matter is that long-term inflation has remained anchored by enduring trends. The short-term impacts of the COVID-19 pandemic notwithstanding, these long-term trends include population demographics, income inequality, globalization, and technology innovations. These influences have been decades in the making and are not easily undone.

Below is a chart shows where the Consumer Price Index (CPI) stands today, relative to history:



Source: Charles Schwab, MacroBond, using monthly data available as of 3/31/2021. U.S. CPI Urban Consumers YoY NSA (CPI YoY Index).

Conclusion

The recent responses put in place through both extraordinary monetary and fiscal stimulus are meant to close the output gap caused by the COVID-19 pandemic. Persistent higher inflation would need to involve additional factors, not least of which is sustained higher economic growth. However, we believe that while there may be short-term spurts of inflation, we do not see runaway inflation on the horizon. Inflation and rising inflation expectations are nothing new, and we remain cognizant and vigilant of the dynamics at play. From an equity standpoint, our focus is owning companies with strong pricing power which are less susceptible to the risks that inflation presents. In our bond portfolio, we focus on owning high-quality investment grade bonds with a laddered approach, essential to capital preservation in a rising interest rate and inflationary environment. Both processes allow us to generate an inflation adjusted cash flow stream, and ultimately sustain your lifestyle throughout your working and retirement years.