April 2022

INVESTMENT PERSPECTIVES

From Inflation Expectations to Inflation Reality

With inflation at the highest levels we've experienced in four decades and interest rates on the rise, investors are weighing the potential risks to their investments. With the potent combination of higher interest rates and inflation, volatility in both stocks and bonds has been quick to follow. If this backdrop wasn't challenging enough, the war in Ukraine will only add to the pressures.

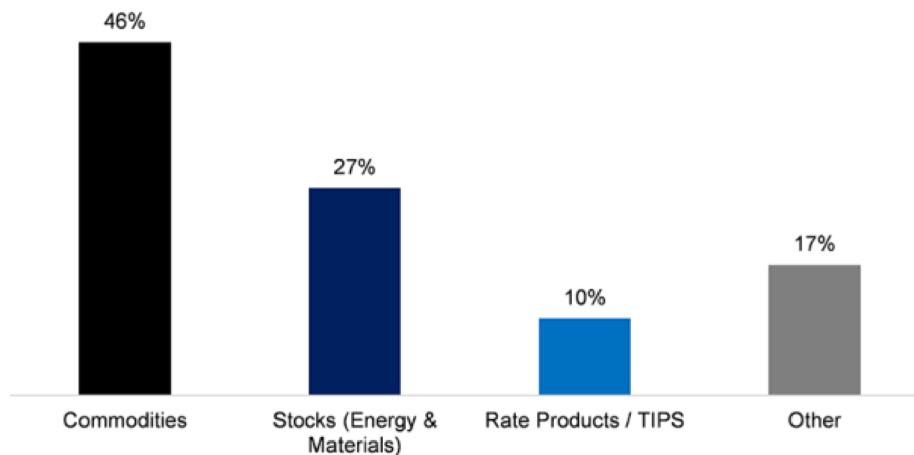
What has it led to? The Consumer Price Index (CPI) reading of 8.5% in March, represents the highest headline inflation level since 1981. I am sure this hasn't gone unnoticed! The COVID-19 induced fiscal and monetary policies have powered this surge. The unprecedented economic conditions it brought on constrained the supply of goods and drove consumer demand, as many people had money to spend. Ongoing disruptions and cracks in numerous global supply chains have worked to exacerbate this imbalance. The supply chain disruptions experienced by many industries has led to a reversal in a longstanding trend towards globalization. Companies in diverse industries are actively exploring ways to 'onshore' critical parts of their supply chain. A few years ago, this would have seemed out of the realm of possibility.

So how does inflation impact your portfolio allocation, both positively and negatively? And more importantly, do investors need to change their stripes? We'll explore below.

Commodities

Inflation has dominated investing conversations over the past year and a half, and rising inflation has been built on the back of a long period of low and relatively stable prices. As noted above, COVID-19 restrictions poked holes in the strength of global supply chains, putting upward pressure on the price of consumer goods, and that pressure has been further exacerbated by the war in Ukraine. The conflict sent essential commodity prices such as oil, wheat, and natural gas surging as market participants reacted to production disruptions and reduced supply. It's impossible to forecast how long these elevated commodity prices will continue, so how can investors best hedge against inflation risk? According to a 2021 JPMorgan conference survey, 47% of respondents believe commodities are the most effective security against inflation compared to only 27% who chose equities. In many ways, this result is unsurprising. The case for commodities during rising inflation seems more cut-and-dried, as exemplified by commodity price moves over the past few months.

Investor Survey 2021: What is the Best Way to Hedge Inflation?



Source: JPMorgan, FactorResearch

The short-term benefits of investing in inflation ‘themes’ such as commodities can disappear quickly. The continuation of the current environment is a far cry from certain and comes with a great deal of risk. We prefer to focus on investment opportunities that can perform well in a multitude of market environments.

Stocks and Inflation

How have stocks fared amid rising inflation? The case for stocks is more nuanced. Unlike many previous periods of high inflation, the consumer is in a position of relative strength and thus far, has shown a willingness to pay up for goods and services, giving companies pricing power. The other side of the equation is that many companies will also look for ways to reduce costs by investing in processes or technology that drive cost efficiencies in their businesses. We see this as an ongoing area of focus for many companies and a positive for stocks. In our *Investment Perspectives* one year ago that also addressed inflation, we wrote:

> *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.*

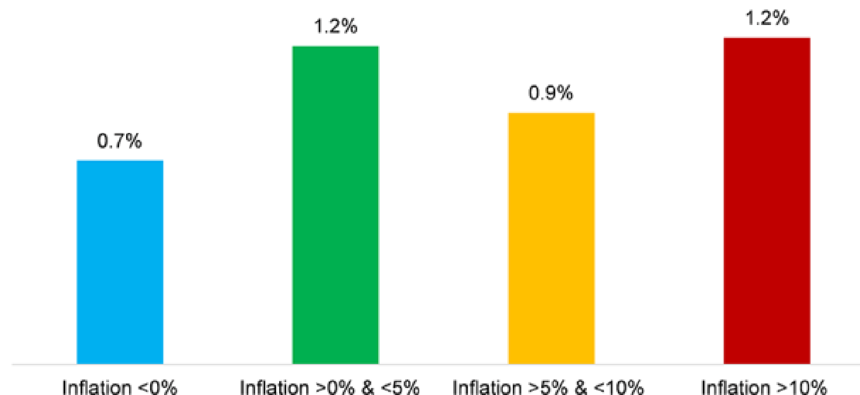
This belief is a core tenet of our investing strategy, regardless of where we are in an economic, inflationary, or interest rate environment. We believe stocks remain one of the best asset classes to own in a rising inflation environment. Companies may struggle to adjust to rising prices in the short-term, but good management teams are able to reposition and manage their businesses effectively in the long run.

While markets grapple with uncertainty of less accommodative monetary policy, escalating geopolitical tensions, and the highest inflation in four decades, it’s timely to look back at how stocks have performed during periods of varying inflation. In the period following World War II, the average annual US inflation rate was 3.4% between the year 1947 and 2021. Taking a deeper look at the variation within the period yields the following:

- 15% of the time inflation stood below 0% (deflation)
- 57% of the time inflation ranged between 0% and 5%
- 21% of the time inflation ranged between 5% and 10%
- 7% of time inflation exceeded 10%

In these different environments, average monthly equity returns vary widely by sector, but remain positive across the board, as shown below. The bar chart shows the nominal returns of US equities during each period, but even after adjusting for inflation, all four periods had a positive real return. Unsurprisingly, the lowest returns occurred in periods of deflation, which usually correlates with periods of economic recession. On the other side of the spectrum, periods above 10% also yielded positive stock market returns. The graphic below is a reminder that, in the history of the market, stocks have moved upward two-thirds of the time. We do not invest based on a current theme, and wholesale strategy changes to position against macro-driven shocks, such as higher inflation or yield curve moves, can come at great peril.

Monthly US Equity Returns by Inflation Regime, 1947 to 2021



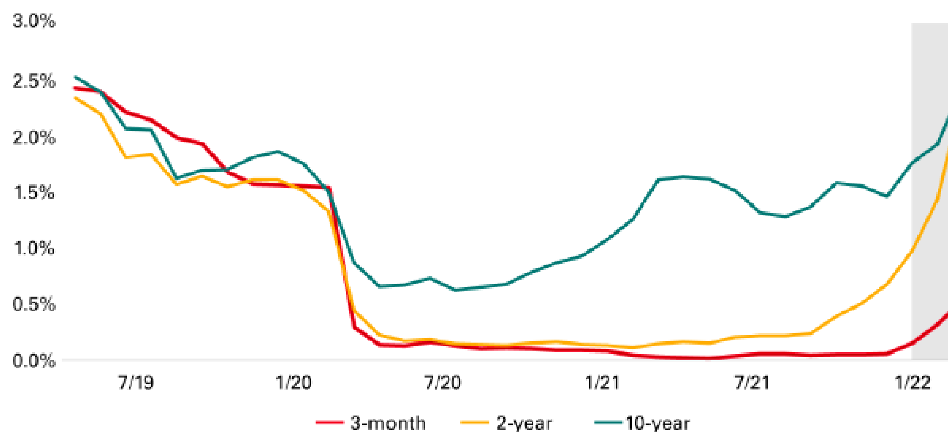
Source: FRED, Kenneth R. French Data Lib

Lest We Forget Bonds

On the fixed income side of the equation, we believe that high quality investment-grade bonds are an essential building block of many portfolios. We often call bonds the ballast of a portfolio, meaning they provide balance to the more volatile stock component. The market will deliver unpleasant equity returns periodically and bonds will often (but not always) help to dampen those drawdowns. Case in point, in the first quarter of 2022 both stocks and bonds had negative returns- this has been a far less common experience for investors. Although the values of existing bonds decline as rates rise, our laddered bond approach will allow us to reinvest maturing bonds at higher, more attractive rates. Central banks will have to do the necessary work to bring inflation back toward target levels in the coming years. If successful, it could usher in a long-awaited end to an era of negative real interest rates.

Increase in Interest Rates has Led to Higher Current Yields on Fixed Income

U.S. Treasury securities yields since mid-2019



Notes: Chart depicts the 3-month U.S. Treasury security yield, as represented by the market yield on U.S. Treasury securities at 3-month constant maturity; The 2-year U.S. Treasury security yield, as represented by the market yield on U.S. Treasury securities at 2-year constant maturity; and the 10-year U.S. Treasury security yield, as represented by the market yield on U.S. Treasury securities at 10-year constant maturity.

Sources: Vanguard analysis of Federal Reserve Bank of St. Louis data, as of March 28, 2022.

A Note on Mortgages

Over the past two years, many people refinanced fixed-rate mortgages, taking advantage of historically low interest rates ushered in by COVID-19 and accommodative monetary policy. While this may not get as much attention as the stock, bond or commodity markets, these low rates are a natural hedge against inflation. You get to repay the loan in ever-cheaper dollars, which eases the cost of borrowing. As the Federal Reserve officials continue to signal future rate hikes to fight inflation, the price of owning a home is becoming increasingly more expensive. It has been a great time to lock in low fixed rates, and the lasting benefits to the consumer should not be overlooked.

Taking the Long View

Most of history has shown that staying committed to your investment plan has served investors well. Staying the course doesn't always mean there is no action to be taken. Oftentimes, this means rebalancing to underperforming assets or taking advantage of the market volatility to add great long-term assets to the portfolio. On a company level, management teams generally have been able to manage higher costs, exhibiting pricing power and a willingness to invest in cost saving measures to push their businesses forward. That said, inflation and rates are clearly driving higher volatility in stocks and bonds. All of this makes investing trickier but not impossible. In the short-term, it's very challenging to predict where inflation will head next, but investors stack the odds of investment success in their favor when they stay the course and take a long-term view. This long-term focus should allow us to take advantage of short-term volatility as investors react to the newest economic data.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of March 31, 2022, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	3/31/2022 Closing Price
Berkshire Hathaway Inc Class B	7.29%	$352.91
Apple Inc	6.50%	$174.61
Bank of America Corp	6.10%	$41.22
Markel Corp	5.49%	$1,475.24
Progressive Corp	5.46%	$113.99
Microsoft Corp	4.89%	$308.31
Robert Half Intl	4.80%	$114.18
Store Cap Corp Com	4.49%	$29.23
Jacobs Engineering Group Inc	4.41%	$137.81
CVS Health Corp	3.97%	$101.21

For a complete list of holdings, please see our most recent 13F filing on the following SEC website:
http://www.sec.gov/edgar/searchedgar/companysearch.html
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