A Perspective on Inflation

Today, everyone has a table-pounding opinion about inflation. It is the current "risk du jour" that many fear will be the catalyst to finally burst the asset price bubble.

Some, like the Fed and other central banks, say the recent elevated level of inflation is not a serious threat to price stability; they claim higher inflation levels are "merely transitory." Inflation will, they argue, abate once the post-COVID demand bulge works its way through the economy.

Meanwhile, other investors point to surging home prices, acute shortages of workers and related escalating wage demands, spiking commodities prices, a creaky global supply chain, and the rise of cryptocurrencies as proof that inflation is not only upon us but severe and probably durable. They claim that, unless central banks and governments reverse course immediately and stop stimulating economic growth, we are on the verge of spiraling wage-price inflation.

So, who is right? To some degree, we would argue both sides.

We think that those who believe inflation is an acute problem are generally focusing on its impact over the next six months to two years. Surging demand created from a rapid return to pre-COVID normality, combined with ongoing hyper-easy monetary policy and aggressive fiscal stimulus, is creating a supply-demand imbalance. This imbalance between rapidly returning demand and slowly expanding supply has and will continue to drive up the cost of consumer goods. This forces workers to demand increased wages which will, in turn, compel companies to raise prices. The cycle becomes self-perpetuating.

This wage-price spiral was, in fact, the ouroboros of the 1970s that former Fed Chair Paul Volcker finally tamed beginning with a massive rate hike in the "Saturday Night Massacre" of October 1979. And while few claim that the current (possibly incipient) wage-price spiral will match the ferocity of the 1970s, the mere threat of it is legitimately sobering since there has been virtually *no* problematic inflation in the last 30 years.

The insidious thing about inflation is that it's a matter of both objective reality ("my orange costs more today than last week") and *perception* of future reality ("I'm worried about my orange costing more next week"). It's true that there are signs of problematic real inflation now—jewelry, art, houses, and even used cars are seeing truly stunning price changes. But while these spicy markers are interesting, the reality is that the broader CPI and PCE stats—as deeply imperfect as they are—don't tell a tale of runaway current prices.

In our view, today's primary risk is the rising perception of future inflation rather than the reality of current inflation. This means that actions central bankers take will be harder to understand, absorb and predict. This "risk of an inflation accident" is at the heart of arguments we find very compelling—see for example the points James Mackintosh at the WSJ has recently made regarding how prior-year base effects increase the probability of high inflation prints of 4% to 5% through early next year.

Even if the Fed is right that what we're seeing is "transitory" it will likely scare the "you-know-what" out of people and could a) trigger inflation perceptions that become self-perpetuating and/or b) force the Fed to act in a "surprising" manner. A huge rate hike like Volcker's brave but highly controversial actions in the late '70s is improbable, however in the context of generally tiny, 5-10 basis point moves in the funds rates observed over the last thirty years, a single percentage point-level move may prove shocking.

Let's now consider the views of those who are skeptical about sustained inflation. It's hard to make a blanket statement, but we *think* that this crowd probably agrees with a lot of what the "inflation surprise" folks are thinking, it's just that they don't believe the near-term inflation spike will be sustained and cause a long-term wage-price spiral.

Skeptics point to central bankers' futile decades-long attempts to try and raise the rate of inflation to a target of 2%. Declining population growth, increasing productivity, technological advancements, lower labor intensity, globalization and massive amounts of growth-stunting debt have all been cited as reasons why inflation has been so difficult to reignite.

What has changed since Covid-19? Has population growth increased? No, in fact the rate of population growth is decelerating more rapidly in many parts of the world (in some developed economies population is actually falling). Has rising middle class participation created more disposable income? No, rising middle class participation has fallen due to Covid. Has productivity declined? No, in fact productivity has recently increased as AI and robotics and remote work have all driven down labor costs. Have workers been able to demand higher wages through collective bargaining? No, in fact the percentage of workers represented by organized labor is down from over 25% in the 1970s to well under 10% today.

As to the recent rise in inflation, skeptics argue that the best cure for high prices is high prices. Ultimately, as has been the case with all prior supply-demand imbalances, price equilibrium is restored either as supply slowly rises to meet demand and/or rising prices reduces marginal demand.

We continue to find these longer-term considerations compelling. And in the U.S., we'd add in the friction effects that have already arisen, and may accelerate, from the Biden administration's more muscular regulatory and tax regime. Those actions will also likely restrain growth (and prices) before and/or beyond Fed action.

So, what to do? As often, we like to start by respecting that most of our clients are truly long-term investors. And that means that we don't have to lurch violently in terms of asset allocation – a near impossible way to notch consistently good outcomes. Traditional stocks, bonds, real estate and other real assets have all performed quite well in sustained inflationary environments. We believe that many corporations will be able to raise the prices of their goods and services to restore profit margins. Bond investors will certainly suffer over the short term if interest rates rise due to higher inflation but, eventually, they will benefit from higher coupon rates on the new bonds that replace their maturing ones. The bottom line is that we don't see a reason for radical shifts in strategic portfolio design assumptions.

We do believe that "surprising" inflation spikes will be present at least through early next year and very well may harm securities prices, especially high-growth equities and expensive long-duration bonds. We think the right way to attend to these risks is through thoughtfully working the "tactical" ranges that we set around major asset classes, and by shifting some strategy allocations within asset classes. We are currently leaning into certain kinds of favorably inflation-sensitive bonds (e.g., floating rate direct loans and TIPS) and some dynamic commodities and real estate that should have a good ability to pass on costs and adjust rents more quickly.

In short, for our long-term-oriented clients, we think it makes sense to stay the course by working within existing strategic asset allocation frameworks. For those who by necessity have shorter investing time horizons, perhaps because they are actively deploying large balances of cash into markets now, engaging in some defensive tactical positioning may make sense. For these families, we suggest some combination of (1) shortening the target duration of their bond portfolios, (2) tilting their equity portfolios toward value-oriented stocks like financials, energy and cyclicals, (3) adding floating-rate debt (like leveraged loans or TIPs) in lieu of some portion of traditional fixed rate bond holdings and (3) consider adding some commodities exposure.