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BLOG POST

A Lurking Monster

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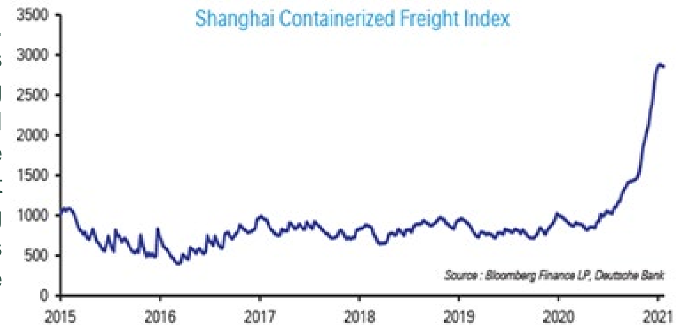
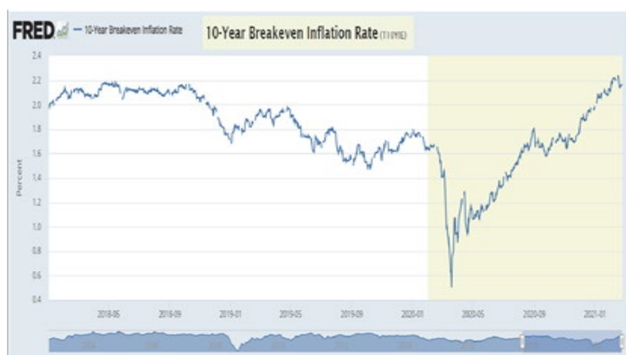
Somewhere in the darkness lurks a menacing threat to our economic and financial well-being. It tends to be insidious in its silence, yet its impact can be seen almost daily if you know where to look. Fighting this monster has proven to be futile, and in many cases no war is even waged against it until it is too late. Who is this monster with the power to strip people's wealth from them while making it difficult for countless people to make ends meet? It is inflation.

Doctors have referred to high blood pressure as the "silent assassin" because of its ability to slowly but surely weaken key organs and nerves, leading to strokes and heart attacks that kill or debilitate. Inflation works in the same manner, slowly eroding people's purchasing power until their financial future looks bleak. Inflation perhaps represents the greatest threat to the financial markets and investors, as it will force the Federal Reserve to change tact and fight this monster just as Paul Volker did in the 1970's.

There are many data points suggesting inflation is rising, and rapidly. One of my favorites is the Shanghai shipping index, which measures the cost of shipping containers originating in China. Because shipping costs are highly correlated to supply and demand, you get a real-world data point of economic activity that can lead to higher inflation. The current chart shows freight costs have more than tripled since last May. The latest "Prices Paid" survey from the ISM Manufacturing Index is at a 10-year high right now. The chart shows the St. Louis Federal Reserve Bank 10-Year Breakeven Inflation Rate is the highest since 2018, and climbing rapidly.





The traditional way to fight the inflation monster is with higher interest rates, as that slows demand for goods and services by making them more expensive to finance. Higher interest rates are then able to compete with the stock market for total return, and many investors choose the relative safety of bonds instead of owning potentially over-priced stocks. The reduced demand for risk assets leads to falling stock prices and a cycle of selling begins.

Not everyone is convinced we are on the precipice of an economic boom. Notable economist David Rosenberg identifies several reasons why he believes economic growth is going to languish in the coming years. Rosenberg notes that government benefits, or transfer payments, now account for almost 20% of aggregate personal income. He shows that one in four households were unable to pay monthly bills over the last year, and nearly 7% of all homeowners are in some type of loan forbearance. His data indicates that nearly 75% of government stimulus payments were used to pay down debt or add to savings instead of spending that increases economic activity. Rosenberg and his team believe the economic slump is years from being over, and inflation and interest rates will continue lower in the coming years.

Fed Chair Powell in recent testimony called higher prices transitory and suggested it would not impact the Fed's accommodative stance towards monetary policy. The question portfolio managers and investors are forced to answer is, at what level of interest rates does fixed income compete for allocations? Just as important is to understand what has historically worked best in periods of high inflation, if that is your expectation.

When inflation rises it tends to benefit cyclical and economically sensitive stocks at the expense of utilities (very high debt levels) and consumer staples (reduced margins). Financial stocks have historically performed best during periods of rising inflation as long-term interest tends to climb faster than short-term rates and banks profit on the spread. Financials have outperformed so far this year, particularly in February, where the S&P Bank ETF is up around 20% compared to a 4% rise in the S&P 500. Energy prices tend to be responsive to upticks in inflation, causing the sector to also perform well as a hedge against rising inflation. Lastly, Industrials are typically the most economically sensitive sector and often outperform during inflationary periods.

We will continue to dynamically allocate portfolios across equity sectors and factors and adjust our hedges for changes in market volatility. There are very smart people on both sides of the inflation debate, and our focus is to deliver consistent returns regardless of which camp prevails.