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Santa Fe Advisors

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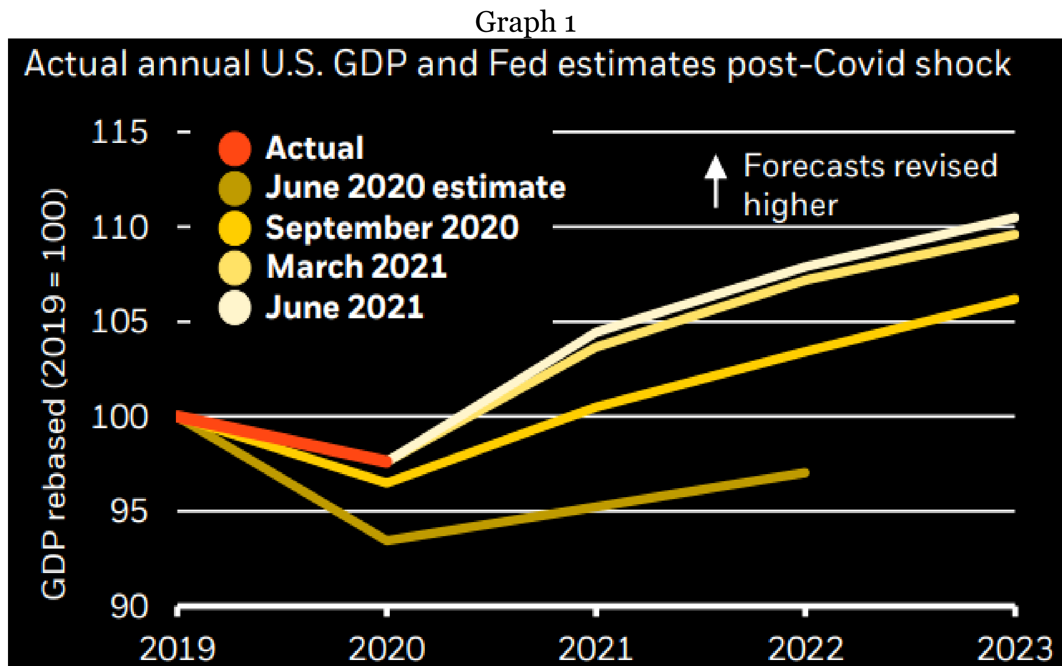
Inflated Worries?

Among the silver linings of the difficult past year have been the rapid recoveries in global economies and markets. In the US, corporate earnings and aggregate economic activity have now exceeded pre-COVID peaks. The speed of both recoveries have caused analysts and economists to regularly increase their growth forecasts (Graph 1), as events have significantly outpaced almost all predictions. Fueled by cheap money and a dearth of attractive investment alternatives, the US stock market has risen even more swiftly: as of this writing, the S&P 500 has almost doubled from COVID lows, and trades significantly above long-term historical average valuations. Ample policy driven liquidity has also allowed leveraged companies to shore up their balance sheets; as a result, corporate defaults have dropped rapidly over the past year, and are expected by most Wall Street strategists to be well below average levels for the next few years. Wages have risen rapidly (particularly for lower income workers), and home owners have benefitted from strong price increases: median national home prices have increased 23.6% over the past year, and average prices are up 14.9% in the 20 largest cities. So, there is much good news to celebrate, as the economy continues to rapidly recover and vaccination rates steadily increase.

Graph 1



Source: Blackrock, FRB, Reuters, Haver Analytics

Yet, just as there are always opportunities amidst crises, and risks masked by euphoria (see our January 2021 commentary "**If You Had a Crystal Ball**"), inflated asset values are not the only risk investors must consider in the current environment. While we often argue that the biggest risks are those that investors don't foresee (as such risks are therefore not reflected in market prices), one of the topics that has dominated investor concerns in recent months has been a considerable rise in general price levels, otherwise known as inflation. In addition to increases in housing costs and wages (as companies compete for workers), raw material prices and supply chain bottlenecks have contributed to price inflation over the past year. The June US Consumer

Price Index (CPI) rose by 5.4% above the June 2020 level (driven in large part by a tripling in oil prices), a rate markedly higher than the roughly 2% level that Federal Reserve policy had been targeting for several years. This rapid increase in prices has concerned investors, who wonder whether the increase might force the Fed to increase interest rates in response, potentially endangering the economic recovery.

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At Santa Fe Advisors, we do not have a consensus view on the magnitude of current inflation risks (disclosure – the author feels that such concerns are overblown and the pace of the recovery will cool, causing price rises to ebb). Graph 2 shows one economic growth forecast, and illustrates that inflation generally closely follows GDP growth. In any case, we do not forecast future economic data, believing that predicting future events is largely an exercise in futility. Instead, what we do is assess risks, and construct portfolios that should fare well across a range of potential outcomes. The rest of this commentary will examine what historical data can tell us about likely market outcomes in the event of a continued rise in general price levels. As often occurs, the data is somewhat inconclusive.

Graph 2

Source: PIMCO, Haver Analytics

Many market observers (ourselves included) look to bond markets as figurative "canaries in the coal mine", in the belief that they often give the earliest clues about risks and future trends. This is because stresses in available financing start in debt markets and then tend to ripple through other asset classes. Graph 3 shows the 10 year average CPI inflation rate implied by the price of 10 year Treasury Inflation Protected Securities (TIPS). On one hand, inflation expectations (which often heavily influence actual inflation) have risen at a very rapid rate. On the other hand, the recent rise in inflation remains quite moderate by historical averages, and may well stall near current levels if/as the economy cools. Additionally, although prices have risen rapidly over the past year, this increase is from the depressed COVID baseline of last summer – current prices are far more moderate when compared to pre-COVID levels. Again, the recent spike in inflation is inconclusive in signaling whether the trend will continue.

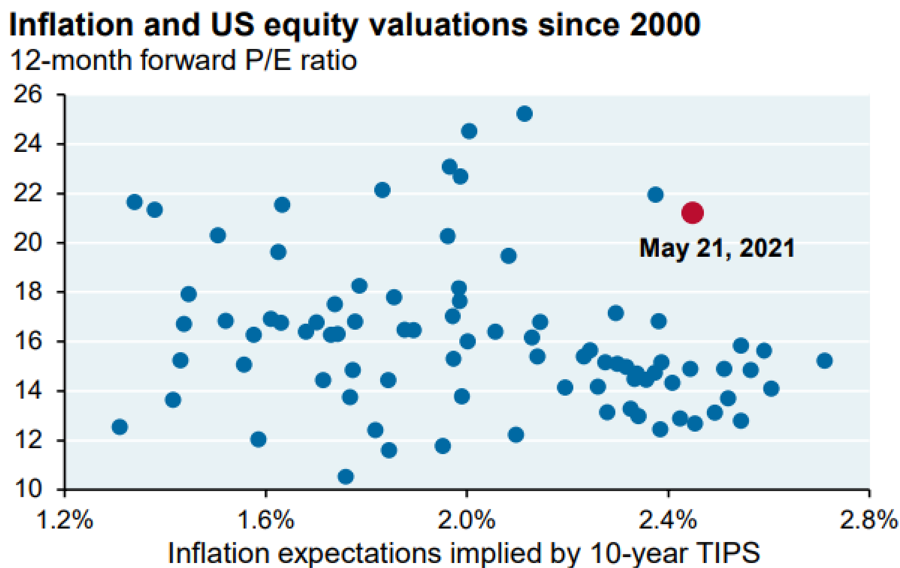
Graph 3

Source: JPM, BBG

An important risk management question is what markets are likely to do if there is, in fact, a significant further pickup in inflation. With high quality bonds, that question is easy; since bonds have a fixed coupon and limited potential for capital appreciation, inflation increases (which directly reduce purchasing power) have a very high negative correlation with bond prices. Said differently, as inflation rises, bond prices go down. However, the fact that the 10 year Treasury bond has experienced significant price appreciation in recent weeks is a strong indication that bond markets expect inflation to remain benign.

Discerning the likely impact of further inflation on stocks is more difficult. Graph 4 shows a 20 year history of stock valuations relative to implied inflation, and shows no discernable correlation between the two. There is a tremendous body of work on the topic, and the only conclusion that seems apparent is that stocks tend to do quite well in environments of low, moderate, and high inflation…and perform poorly only during periods of extreme inflation or deflation (neither of which we have now).

Graph 4



Source: JPM, BBG

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In conclusion, we cannot predict with a high degree of confidence either future levels of inflation, nor what markets (particularly stocks) might do in the event of future increases. As a result, we are not presently adjusting our portfolios based on the current inflation discussion (though we are contemplating adding floating rate bonds, which would benefit from rising inflation and interest rates).

One final consideration: while the Fed, with policy interest rates at 0%, has limited capacity to ease further in the event of economic weakness or deflation, it has considerable capacity to *raise* interest rates if necessary to combat further price increases. Of course, this would present a risk to the economy and be quite unwelcome to the US Treasury during this period of extreme deficit spending and debt accumulation. Such are the trade-offs that policymakers, and portfolio managers like us, have to consider every day.

Thank you for your support, and please don't hesitate to contact a SFA team member with any questions.

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