Vestor Capital

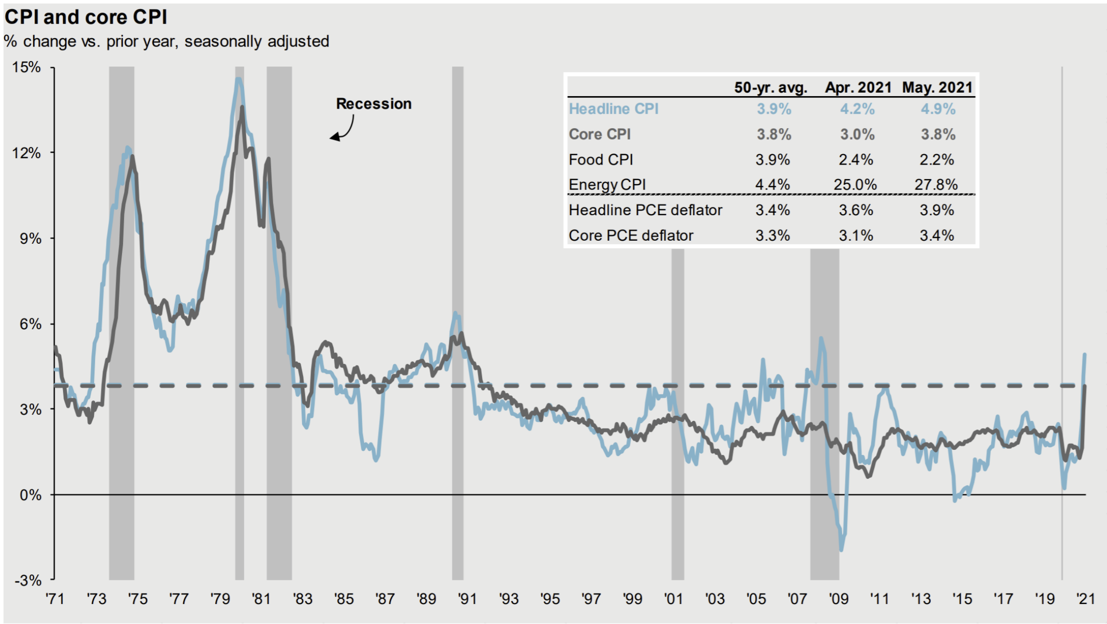
INVESTMENT & WEALTH MANAGEMENT

Inflation Thoughts & Investment Implications

June 28, 2021

Current State of Inflation

Inflation has been very subdued over the last decade, generally rising less than 2% annually. However, as the graph below illustrates, the May 2021 Consumer Prices Indicator (CPI) was 4.9%, which is considerably higher than anything we have seen in recent memory. There are many reasons as to why inflation has picked up. Inventories dropped dramatically during the COVID pandemic as businesses did not want to be stuck with excess inventory. Demand has come roaring back in 2021, and companies who were caught off guard are now scrambling to catch up, causing prices to rise. Supply chain bottlenecks have caused shortages and price increases. Finally, oil prices were very depressed in early 2020, trading in the low $30s, and have risen to over $70 as demand for oil increases with the economic recovery.



Source: JPMorgan Guide to the Markets (6/24/2021)

Federal Open Market Committee Interest Rate Response to Higher Inflation

The Federal Open Market Committee (FOMC) has historically grown concerned when inflation rises over 2% and has raised interest rates when inflation rises over this threshold. However, the FOMC has changed their view on interest rate responses when inflation rises over 2%. Specifically, because inflation has been below 2% for much of the last decade, they are willing to let inflation run higher for a while before they consider raising rates. The FOMC has a dual mandate to control prices and have full employment. Until employment returns to pre-COVID levels, the FOMC will let inflation run higher.

Our View on Inflation Going Forward

Before the COVID crisis hit last year, inflation had been subdued for an extended period. The primary reason is that there are several disinflationary pressures which have persisted for many years. Sourcing goods from countries in Asia has had a profound impact on prices falling over the past decade. An aging population has resulted in lower population growth, resulting in less demand while supply continues to grow from Asia. These basic drivers of low inflation have not disappeared, they have only been temporarily paused due to unplanned effects from the COVID pandemic. We expect that inflation will revert to pre-pandemic levels in 2022 once demand cools and temporary supply issues are resolved.

Investment Implications

Equities have historically performed well during inflationary periods. Companies can raise prices to compensate for higher input costs by increasing prices at higher rates than cost increases, thereby leading to higher margins. Commodity stocks, such as energy and basic materials, tend to perform well due to higher price realizations, assuming supply growth discipline which we are currently seeing. Many companies have had limited pricing power in recent years and are welcoming higher inflation.

Fixed income has historically provided returns above inflation. In fact, high grade short-term money market funds have also generated returns above inflation in the past. With interest rates at generational lows and inflation running hot, high grade fixed income investments are currently not providing enough yield to compensate for inflation. However, we expect this to be temporary once inflation begins to cool.

Conclusion

Recent inflation readings are much higher than we have seen in previous years. The FOMC will likely not be raising interest rates due to higher inflation, as they are more concerned about reaching full employment. High quality fixed income investments will struggle to generate returns above inflation if current inflation trends persist, although we do not believe inflation levels will remain elevated. Equities should perform well in this environment due to the ability to pass on higher costs.

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