Inflation: Lower For Longer Or Is A Surprise On The Horizon? September 2020

OVERVIEW

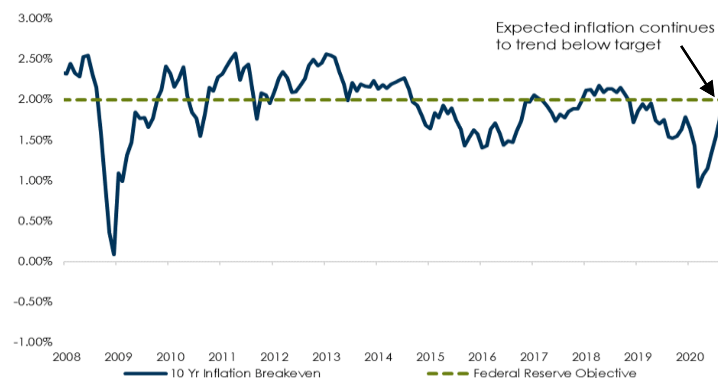
- **While inflation continues to trend below target, the possibility for unexpected higher inflation shouldn't be ignored**
- **A shift in Fed policy has resulted in a stance that lowers the likelihood of combatting inflation for the foreseeable future**
- **The impact of inflation on certain investment strategies should be considered during portfolio construction**

Background

Put simply, inflation is the increase in prices of goods over time. While there are many different ways to measure inflation (the consumer price index "CPI" and the personal consumption expenditures index "PCE" are commonly observed), the Federal Reserve's preferred measure as it relates to price stability is based on PCE. In January 2012, as part of a broader announcement on long-term goals and monetary policy strategy, the Federal Open Market Committee declared inflation at a rate of 2% as most consistent with its statutory mandate. However, over the last decade, core PCE has consistently fallen short of this targeted rate. As a result of the economy constantly evolving, the Federal Reserve recently completed a review of its 2012 policy decision and adopted changes to the framework. One of the changes is now to achieve an inflation rate that averages 2% over time. As a result, the revision could result in inflation running moderately above 2%, following periods persistently below 2%, before the Federal Reserve intervenes.

Inflation Expectations Continue To Trend Below Target

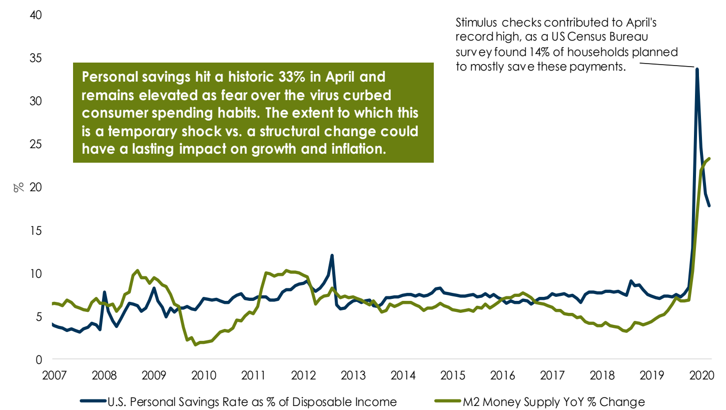
Low and stable inflation allows individuals to hold money without a material deterioration of purchasing power, while businesses can make more accurate long-term financial decisions about borrowing, lending and investment. Conversely, high inflation reduces the ability of businesses to make accurate long-term financial decisions. A below trend inflation rate increases the probability of deflation, which means prices and wages are falling and typically associated with weak economic conditions. Maintaining at least a small amount of inflation makes it less likely that the economy will experience deflation should economic conditions deteriorate for an extended period of time. The breakeven inflation rate represents a measure of expected inflation derived from various 10-year Treasury securities. The latest value implies what market participants expect inflation to be in the next 10 years on average. The 10-year breakeven inflation rate on August 31, 2020 was 1.8%. While the rate is well off the low of 0.63% set on March 17, 2020, it continues to trail the average inflation target rate set by the Fed. Technology, globalization and a changing labor market have all contributed to low inflation.



Source: Bureau of Labor Statistics (BLS), ACG Research

Inflation Considerations In Investment Portfolios

While inflation continues to trend below desired levels, the possibility of unexpected high inflation cannot be ignored. In response to the recession caused by Covid-19, there has been massive monetary and fiscal stimulus. Throughout history, increasing the money supply has often led to inflationary periods. However, during the current recession consumers have largely been saving, with the personal savings rate recently soaring. While policy response was necessary to bring balance back to the markets and the economy, once the recession is in the rearview mirror, the result could be a pickup in inflation. Inflation poses a threat to investment portfolios because it chips away at overall savings and portfolio returns. In order to increase long-term purchasing power, portfolios must first keep up with the rate of inflation. For example, in a 3% inflation environment, an investment that returns 2% before inflation will actually produce a negative inflation-adjusted return. Unexpected high inflation can therefore have materially negative consequences on certain asset classes, particularly those strategies with fixed rates of return.



ACG's Position

Recent history has been met with inflation that has fallen short of what the Federal Reserve considers to be necessary for price stability. With unprecedented monetary and fiscal stimulus in response to Covid-19 and the likelihood for continued dovish policy by the Fed, the potential for markets to encounter an inflation surprise remains a tail risk within portfolios. Importantly, maintaining a long-term strategic investment program is key to achieving goals and objectives. Assuming a moderate inflationary environment of 2%, asset classes including equities, real estate and inflation-linked fixed income assets (TIPS) have traditionally provided an inflation hedge.

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