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WEALTH MANAGEMENT

February 8, 2022

Monthly Insight

Inflation, the Economy, and the Markets

To say that inflation has been in the financial headlines lately would be a bit of an understatement. Consider just a few recent examples:

- *New York Times*, January 28: “Inflation Continued to Run Hot and Consumer Spending Fell in December
- *Wall Street Journal*, January 29: “What CEOs Are Saying about Inflation: ‘The World Has Changed’”
- CNBC, January 28: “Key Inflation Gauge Rises 4.9% from a Year Ago, Fastest Gains Since 1983”
- Axios: “New Data: Inflation Pressures Stayed High in Late 2021”

No doubt, any quick search of recent news stories would turn up similar items, and in greater numbers. The financial markets certainly seem to be taking note. Since the beginning of the year, the Dow (DJIA) has gone from 36,585 to 34,725; a loss of 5%. Similarly, the broader market, as represented by the S&P 500, has gone from 4,796 to 4,431, shedding 7.6% of its value. And both of these readings, amounting to annualized rates of -60% and -91% respectively, include the dramatic rally of Friday, January 28. If we had taken their measure on the day before, the losses would have been considerably steeper.

It’s no secret that inflation is ramping up. Following years of tame readings in the wake of the Great Recession, prices of goods and services as measured by the Consumer Price Index (CPI) are headed north. As the economy continues to expand from pandemic-imposed restrictions, increasing costs of labor—when it can be found—and supply chain snarls that drive up the cost of harder-to-obtain materials and products are contributing to the highest inflation levels in decades. And even though the Federal Reserve continues to insist that it will do whatever is needed to prevent a return to the hyperinflation and "stagflation" of the 1970s and early 1980s, each signal from the Fed of tightening monetary policy—especially the prospect of higher interest rates—seems to provoke another series of gyrations on Wall Street. Indeed, many investors have painful memories of years like 1974, when the inflation-adjusted return for US stocks was -35%

What should investors be doing? As with any other measure of financial or economic activity, research suggests that it is impossible to predict the future course of inflation with better than random accuracy. So, attempts to "time the market" by selling or buying with reference to anticipated moves in inflation are not likely to be successful in the long term.

It might be helpful to review some history with regard to the markets and inflation. Consider the following financial headlines:

Date and Source	**Comment**	**S&P 500 Annualized Returns Since Publication**			
		1 year	**3 years**	**5 years**	**10 years**
May 17, 1970;	"Behind the	32.23%	13.01%	5.05%	7.04%

New York Times, Thomas E. Mullaney, "Inflation Spurs Growing Gloom on the Markets"	pervasive bearishness was the same litany of problems that has depressed the markets for almost a year and a half—concern over inflation, tight money, the uncertain economic picture, social unrest, wariness over the war in Indochina, and other international tensions"				
June 18 1973; Time, "Nixon's Other Crisis: The Shrinking Dollar"	"The economy's inflationary temperature climbed to its highest point in two decades. The situation has helped create near-chaos in stock and dollar-exchange markets."	-13.79%	2.6%	2.85%	9.58%

August 4, 1983; *New York Times*, Milton Friedman, quoted in "Which Way Interest Rates?"	"Interest rates will rise as an inevitable consequence of the monetary explosion we've experienced over the past year."	-2.92%	18.29%	15.28%	14.73%
September 1992; *Bankruptcy 1995*, Harold E. Figgie Jr. and Gerald Swanson	"In 1995, the USA as we know it today will cease to exist. . . We'll get a taste of both hyperinflation and panic."	15.21%	13.85%	19.77%	10.39%
February 1996; *Worth*, Jim Rogers, "The Specter of Inflation"	"Thus, in the 1990s, we have worldwide low production capacity, worldwide growth in demand, worldwide low inventories, and a worldwide surge in liquidity. To anyone trained in global economic patterns	26.34%	28.55%	11.75%	8.99%

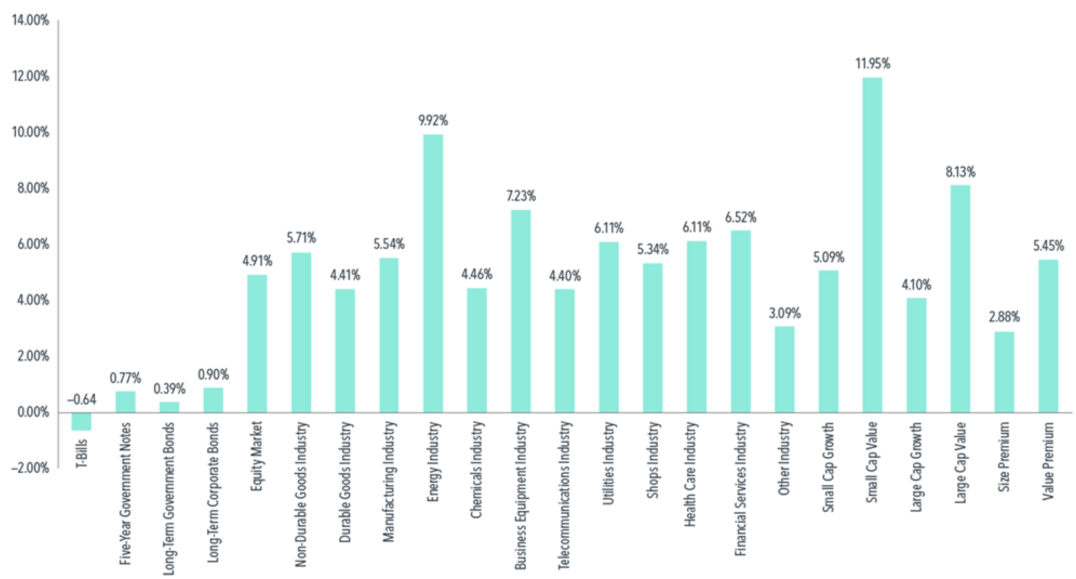
	this mixture can have only one outcome."				
January 20, 2003; *Barron's*, Jonathan R. Laing, "The Debt Bomb"	"Curiously, however, one reads almost nothing about what may be the biggest bubble of them all—the huge ballooning of total debt in the US."	28.69%	14.39%	12.83%	7.10%
March 31, 2013, *New York Times*; David A. Stockman (former dir. US Ofc. of Mgmt. & Budget), "Sundown in America"	"Eight decades of borrowing, spending, and money-printing by the government have bankrupted America."	25.37%	10.75%	1473%	--
April 1, 2018, *Fortune*; Shawn Tully,	"Government deficits are on the verge of swamping the economy."	9.5%	16.78%	--	--

"Deep in Debt"					
March 21, 2019, *Wall Street Journal*, Martin Feldstein (chair, US Council of Economic Advisors 1982–84), "The Debt Crisis Is Coming Soon"	"The most dangerous problem facing America's federal government is the rapid growth of its budget deficit and national debt."	8.19%	--	--	--

SOURCE: Dimensional Fund Advisors, 2021. Past performance is no guarantee of future results; indexes are not available for direct investment.

It's easy to see from these comments that concerns about inflation, associated government policy, and their combined effects on the economy and the markets are hardly new. And in fact, in each of the above cases and in our present situation, the financial markets take these concerns and factor them into the prices at which assets are being bought and sold. The future of market pricing, inflation, and everything else is always uncertain. But as economist Frank Knight observed 100 years ago in his book *Risk, Uncertainty, and Profit*, willingness to bear uncertainty is the key reason investors have the opportunity for profit.

With regard to equity investments, there is good reason to believe that over time, they will continue to grow at a rate that outpaces inflation. Review the following chart, which shows average annual real returns (net of inflation) for stocks in various industry groups during years when inflation was running at or above its median rate of 5.5% from 1927 to 2020.



SOURCE: Dimensional Fund Advisors. Past returns, including simulated returns, do not guarantee future results.

For the industry groups shown, the lowest average annual rate of return was 2.88% (large-capitalization stocks), while the highest was 11.95% (small-capitalization stocks). The fixed-income sector did not fare as well, with one-month Treasuries displaying a negative return of -0.64%, and the highest return exhibited by long-term corporate debt, at 0.9%.

What history may suggest is that equity investors who have built well diversified portfolios structured in accord with their goals and tolerance for risk may expect to see their asset values perform well with respect to inflation, as long as they remain disciplined, patient, and focused on their long-term objectives.

But what about fixed-income investors and others who may be more dependent on current income or for whom the volatility inherent in the equity markets is problematic? There are several alternatives that merit consideration. One is building a fixed-income portfolio that captures the dimensions of expected return in the overall fixed-income market: credit quality, time to maturity, and the currency of the issuer. A fixed-income portfolio diversified along these lines may be expected to perform better versus inflation than one concentrating solely on short-term securities or cash and will typically exhibit less volatility over time than that experienced by investing in any single fixed-income sector. However, the increased volatility associated with long-term, lower-quality, and foreign-currency debt may still be too much for some fixed-income investors.

Consider, then, inflation-protected securities issued by the United States Treasury—either Treasury inflation-protected securities (TIPS), or I-series bonds. For some investors, these may be considered for a portion of the fixed-income portfolio as a way to hedge against inflation while still enjoying the lower volatility of assets backed by the full faith and credit of the US government.

TIPS feature a principal amount that increases with inflation and decreases with deflation. They may be bought either directly from the Treasury or on the secondary market, using a brokerage account. When the bond matures, the investor is paid the inflation-adjusted principal or the original principal, whichever is greater. The US Treasury offers TIPS that mature in 5-, 10-, 20-, and 30-year timeframes. The current coupon rates for TIPS are:

- 5-year: 0.13%
- 10-year: 0.13%
- 20-year: 2.13%
- 30-year: 0.13%

I-series bonds may only be purchased and redeemed directly from the US Treasury, and there is no secondary market. I-bond purchases are limited to $10,000 annually per individual for bonds held in a free Treasury Direct account, plus an additional $5,000 annually per individual for paper bonds, which may be purchased only with a federal income tax refund. Series I bonds being issued currently carry an initial interest rate of 7.12%, if purchased between now and April

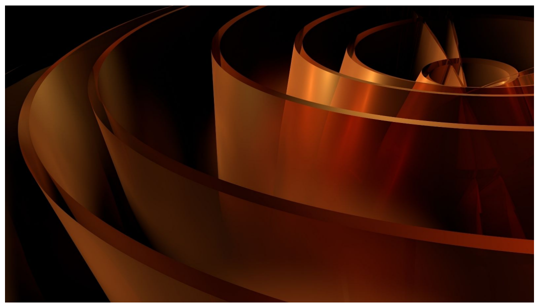
2022. Interest rates on Series I bonds are reset every six months by the Treasury based on the current rate of inflation but can never go lower than 0% (in other words, in addition to any interest earned, the holder of a Series I bond has return of principal guaranteed by the full faith and credit of the US government). If the CPI goes up, so does the interest rate on the Series I bond; if it goes down, the rate follows. Series I bonds must be held for a minimum of 12 months before redemption, and if the bond is redeemed sooner than five years after purchase, there is a three-month interest penalty.

At Empyrion Wealth Management, we believe it is essential for clients to understand the economic and market forces that impact their portfolios. When investors have accurate, evidence-based information, they are able to make decisions about long-term financial and investing strategies that are based on facts, rather than emotion. To learn more about the importance of having the right information, please click here to read our white paper, “The Informed Investor.”

SOCIAL MEDIA DIGEST

In case you missed them, here is a roundup of my latest posts on social media:

In my guest article for Advisor Perspectives, I explain that some of the most important support financial advisors can offer young widows is not directly related to their finances.



Aligning your portfolio design and asset allocation with the suitable "dimensions" can, over time, provide superior returns without incurring excessive trading or management costs. Learn more.

Retirement is a time in life when people are finally able to prioritize their time and energy based on what is most important to them. What's your retirement mission statement?

In U.S. stock market history, bear

markets happen roughly every four years and eight months. With a couple of recent down days in the markets, we may or may not be in the early stages of a new one.

KIMBERLY FOSS

President, CFP®, CPWA®,
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