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WEALTH MANAGEMENT

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Monthly Insight

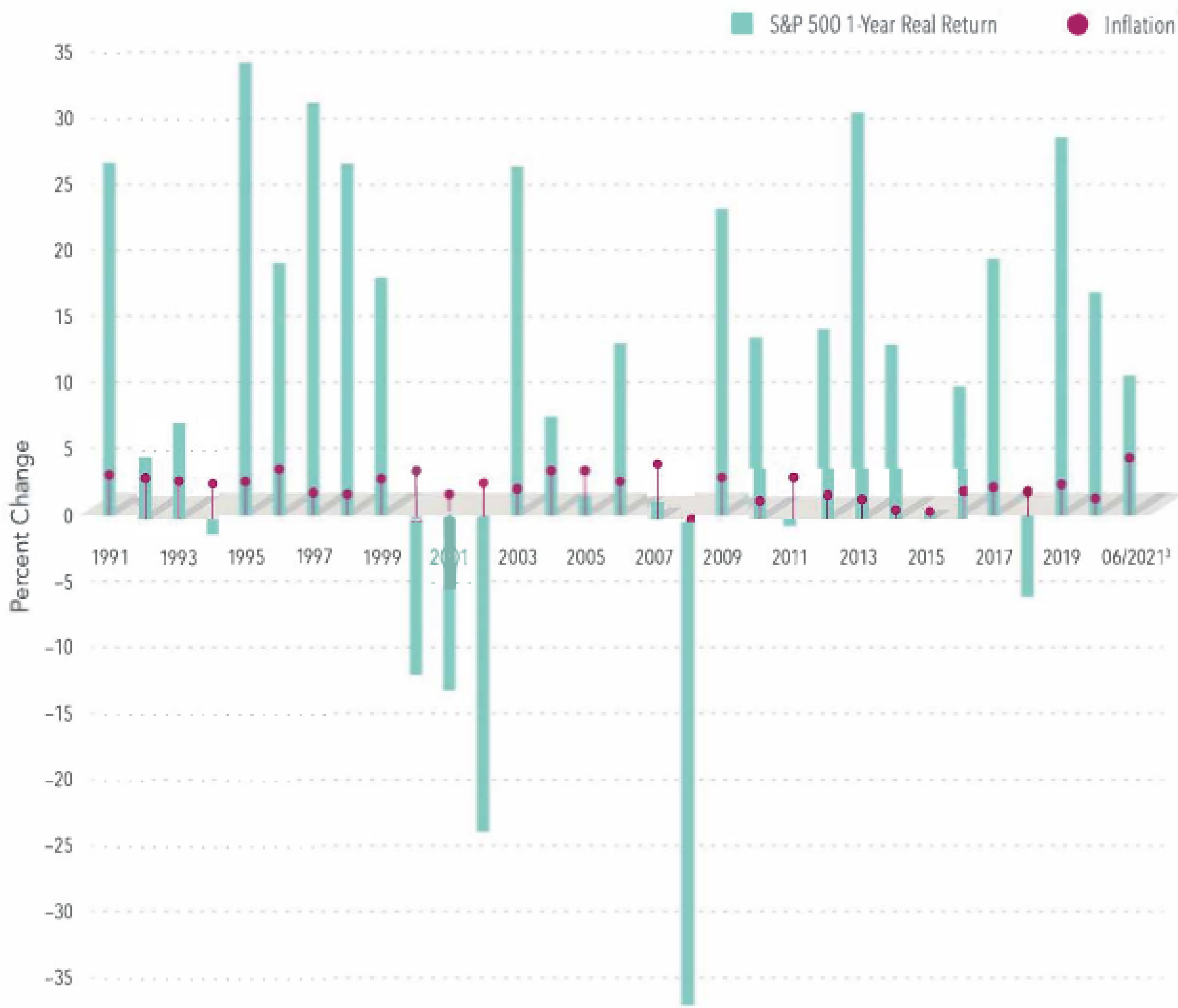
Inflation and Your Stock Portfolio: The News Isn't Necessarily Bad

In a previous newsletter, we took a look at inflation: what it is, how it affects the economy, and how the US Federal Reserve uses various tools to try and keep it under control. The most recent inflation reading for the US economy was 5.4% on an annual basis, according to the Bureau of Labor Statistics (BLS). That rate is up considerably from readings in 2020 and the early part of this year, when inflation, as measured by the Consumer Price Index (CPI) was running at an annual rate of about 1.5–2.0%. In fact, for much of the time since the onset of the Great Recession in 2008, inflation remained near or below 2.0%. Only in March of 2021 did inflation rise appreciably above that level, but it has been on the increase since that time.

All of this could lead investors to wonder, if higher inflation is going to be a fact of life for an extended time, how their equity investments will be affected. After all, too much inflation is not good for the economy, and what is bad for the economy is going to be bad for the businesses that make up the stock market, right?

As it happens, the picture is not quite so dire. In fact, if we look at the performance of stocks over the last thirty years, laying it alongside inflation during the same period, it is difficult to find a direct correlation—positive or negative—between the rate of inflation and the returns on stock investments.

STOCKS VS. INFLATION



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

In this chart, which illustrates the annual total return from the S&P 500 (the green bars) with the rate of inflation (the red dots), it's pretty easy to see that the two factors don't move in tandem to any discernable extent. From 1991 to the end of June 2021, inflation moved in a range from about -0.1% (the onset of the Great Recession) to the current rate of about 5.4%. At the same time, total returns on the S&P 500 ranged from a low of about -37% (the Great Recession, once again) to a high of about 34% in 1995: a considerably wider range than inflation, with movement that sometimes went in the opposite direction. Notice also that on several occasions, when inflation decreased, stock returns actually fell (counterintuitive, if inflation is supposed to always be bad for stocks). In fact, the chart indicates that some of the weakest returns occurred during periods of low inflation, and in 23 of the 30 years studied, returns on equities were positive, even after adjusting for the effects of inflation (such as during the first six months of 2021).

During the period charted above, in fact, the S&P 500 generated an average annualized return of 8.5%, after adjusting for inflation. If you go all the way back to 1926, stock returns have outpaced inflation by an average annual rate of 7.3%

But what if we take a broader look at how other asset classes have performed, with respect to inflation? Consider the following chart.

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

In this chart, returns net of inflation are shown for a wide variety of asset types. The rates shown are averages for the years from 1927 to 2020 and only include periods during which inflation was running at or above its current rate of about 5.4%.

Only one of the asset groups in this study failed to grow faster than the rate of inflation: US Treasury bills, which are short-term obligations. Intermediate- and long-term (5-year and 10+ year obligations) outgrew inflation by 0.77%

and 0.39%, respectively. Long-term corporate bonds did a little better, at 0.9%.

By contrast, the worst comparison for performance versus inflation among the equity asset classes is among the "size premium" stock group, which includes companies with smaller market capitalizations. Those assets outpaced inflation (during periods of above-average inflation, remember) by 2.88%. Certain asset classes, such as small-capitalization value stocks, outperformed by larger margins, as did stocks in the energy sector and the business equipment sector.

All of this suggests that over the long term, equity investments have tended to outperform inflation by higher margins than fixed-income assets. That is important for investors who will need their assets to continue to grow in purchasing power over a longer period of time, because inflation erodes purchasing power. For example, think about how much gasoline cost per gallon, just ten years ago. You need several more dollars to fill your tank at today's prices than you did back then. This is just one example of the importance of making sure that your long-term investments are positioned to grow at a rate faster than inflation.

Now, that is not to say that every investor should have all their funds invested in equities. After all, stock prices can be volatile, and for certain investors, that volatility is a cause for great concern. That, in fact, is the reason to build a diversified portfolio, balanced to the level of risk appropriate for each investor's goals and level of tolerance. But for all investors, it is imperative to keep in mind the effects of inflation and to take appropriate countermeasures to protect the long-term value of the portfolio.

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annuity investing and interest rates.

With congress debating some potential changes to tax laws that could take effect as early as the end of this month, learn why these changes could look like more of a “trick” than a “treat” for high–net worth individuals and families.

KIMBERLY FOSS

President, CFP®, CPWA®, CFT-I™ Candidate

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each need their own plan for wealth management."

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