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CAPITAL ADVISORS

Quarterly Whitepaper
THIRD QUARTER 2021

Are Inflation Fears Inflated?

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Inflation: It's like your eccentric uncle who rarely visits. You keep asking him to come to stay, but then once he does, you become worried that he will stick around too long.

The Federal Reserve (and most economists) want a moderate level of inflation, and the Fed Chairman has repeatedly stressed that the Fed will tolerate a certain acceleration of post-pandemic prices, as long as it does not stick around too long. A moderate level of inflation is considered a normal part of a healthy economy. When inflation is, say, 2% or even 3%, that's a lot better for the economy than if there is deflation (falling prices over time). It's a bit counterintuitive, but falling prices tend to cause consumers to hold off on big purchases in the hopes that they will be cheaper in the future. Without that consumption, the economy struggles.

However, the pandemic supply disruptions, coupled with the Federal Reserve's moves to inject money into the economy, have pushed the 12-month inflation rate as of June to 5.4% -- a rate we haven't seen since 2008[1]. Even though this was totally expected – and transitory in the Fed's view – it yields sensational headlines. The Federal Reserve has been struggling since 2008 to get inflation up to its target levels. Also, the economy has experienced tepid growth for most of those 12 years. On the other hand, sustained high inflation is very problematic for a whole host of reasons, even if it does tend to goose the economy in the short run. Thus, we are always seeking the "Goldilocks's inflation rate": not too hot, not too cold, while still getting out before you get mauled by three bears.

So, this quarter, we are going to tackle the polemical subject of inflation (honestly, it is more of a glancing blow than a tackle). We have rarely seen one subject generate so much disagreement among the financial muckety mucks as the subject of "will there or won't there be a sustained bout of higher inflation?" – as if this was a binary question. The answer is 'no', in our view, but no one can know for sure. We at Sulzberger Capital believe it is unlikely that we will see 1970s-style, persistent high inflation as we outline below. Yet in the absence of certainty on how much inflation will stick around, the question really is "Do I need to invest and save any differently if there is the possibility of a prolonged period of high consumer inflation?"

For the sake of argument, we'll try to make the case both for, and against, a <u>sustained</u> bout of high inflation.

[1] *Unless noted otherwise, all figures for this article are taken from Bloomberg data.*

Arguments ‘for’:

- Increasing Inventories. The pandemic laid bare the limitations of just-in-time inventory management (keeping your storage room lean and mean). When supply disruptions started to hit, manufacturers found themselves short of certain parts and raw materials, meaning they could not produce at normal levels. Therefore, many companies are working to increase their inventories, and this ultimately becomes more expensive for consumers. We’ve got to pay for companies keeping a fatter larder;

- On-shoring. A closely related pandemic effect has been a shift toward multiple supply sources so as not to be as exposed to supply disruptions. Producing closer to home (e.g., in the U.S. rather than China) can cost more money, and that is likely to put some upward pressure on prices;

- Demographics. The U.S. population is getting older on average, and this means there are fewer workers to fill positions. Productivity improvements and immigration have mostly staved off this demographic reckoning, but the pace of both is very much in doubt for reasons that we will cover in a future white paper;

- A Butt-Load of Money Added. Between the Federal Reserve’s injections of liquidity (i.e., creating money and buying bonds) and the federal government’s stimulus programs, there has been a butt-load (the technical term) of extra money in the economy – measured in the trillions of dollars. More money in the hands of consumers is likely to increase demand, and if supply does not keep up, prices inevitably rise.

So here is the case ‘against’ sustained inflation:

- What the Fed Giveth, the Fed Can Taketh Away. The Federal Reserve created a lot of money and is still buying in excess of $120 billion a month in bonds, but the Fed is just not going to tolerate 1970s-style inflation. It may overshoot the mark and see an inflation-wage spiral getting too out of hand, but there is no reason why the Fed can’t just raise interest rates and reverse the bond purchases (thus taking money out of the economy). So the argument should not really be about whether we will have sustained inflation, but rather, will the Fed need to choke off this period of easy money earlier than the markets think.

- Waning Influence of Unions. To create an inflationary spiral, workers need to be anticipating future price rises and demanding higher wages to compensate. But union membership is much lower than it was in the 1970s, so unions wield much less influence in wage negotiations. If contracts do not include major increases in wages to compensate for higher inflation, there is unlikely to be a cascade of higher prices leading to higher wages which lead to higher prices.

A QUICK PRIMER ON INFLATION

To understand inflation, let’s start by unpacking the basket: the basket of goods, that is. The Consumer Price Index (CPI) is a deeply arcane government measure of price changes on a ‘basket’ of consumer goods (unless you expect to be able to lug your Ford SUV in the basket, it is clearly more of a metaphorical basket than a grocery store basket). While this basket does include common grocery store items, it also includes everything from rents to used cars to gasoline prices and everything in between. The basket is supposed to be a proxy for changes in living expenses, and even the way the CPI is calculated is hotly contested because of its influence on automatic changes to Social Security payments, pension fund payouts, and lots and lots of other things. However, it is important to stress that this is an average index of notional living expenses, and it does not mean that your expenses are going to go up by the same amount. A sustained inflationary spiral can occur if interest rates are low and workers start demanding higher wages to compensate for rising prices.

- Temporary Disruptions. The COVID pandemic has been a bit of an economic anomaly. Lots of businesses had to shut down or reduce production, and it has been wreaking all sorts of economic havoc in a way that is unique to the pandemic. When headlines are written about used car prices being up 30-40% or lumber prices quadrupling since January, these inevitably lead to the kind of anecdotal stories that feed a narrative of inflation fears. But most of these disruptions are reversing themselves as supply comes back online. Lumber prices fell back from their soaring highs and have now dropped below where they started 2021. Chip shortages show signs of easing in the second half, which will untangle production problems with everything from electronics to automobiles. Temporary shocks typically work themselves out, but it can take some months for it to succeed.

- The Base Effect. Twelve-month inflation statistics have another pandemic distortion: the base against which we are currently comparing prices was depressed because it was measured at the height of the pandemic. In other words, prices in many categories had fallen by early summer 2020 in the height of the pandemic, so comparing the basket of goods in June 2020 with June 2021 is going to overstate the effects of inflation. Yet from an inflation expectation standpoint, that same statistical distortion will begin to reverse itself as we catch up to the period when prices were rebounding back to normal.

- Phase-out of Enhanced Unemployment Benefits. To the extent that some employers think the enhanced unemployment benefits of $300 per week is discouraging workers from coming back at the wages being offered, the end of these benefits in September will reverse this trend. Less money in people's pockets can mean less room for retailers to raise prices. With unemployment still at an official 5.4% as of July (compared with ~3% pre-pandemic), there are a lot of consumers out of work, and this usually puts downward pressure on prices and wages.

- Watch the Bond Market. The bond market is not signaling the expectation of sustained inflation, and those experts get it right more often than consumers do. Admittedly, the Fed is putting a thumb on the scales by buying in excess of $120 billion of bonds per month. However, the private sector would still set the overall pricing, and those bonds are not showing an expectation that inflation will get out of control. With 10-year treasury yields at about 1.3%, that's hardly a hardy harbinger of inflation.

According to Bloomberg Intelligence, in the headline-grabbing June inflation number, "55% of the higher than expected 0.9% month over month increase came from six components -- used cars, rental cars, vehicle insurance, lodging, airfares, and food away from home": all of which are considered 'reopening-sensitive'. On balance, these factors make us believe that the hype over hyper-inflation is, well, ... maybe over-hyped.

Yet this is not a binary question. There remains a risk of higher prices, so a prudent investor should probably invest in a way that would likely hedge against this risk without going all-in on gold bars stacked in a basement vault with canned goods.

What are the Impacts of Inflation on You?

For simplicity, let's break down the inflation impact into two categories: the "cost implications" and the "investment implications".

The Cost Impact

The classic cliché in the press when sensationalizing the impact of inflation is interviewing a retiree on a fixed income who worries about having to choose between her medication, rent, and higher priced groceries. However, her medication prices may be more influenced by pharmaceutical company profits than overall inflation. Her rent increases could be due to a hot local housing market. Her groceries probably are impacted by inflation, but in modern America, groceries are a much lower percentage of most people's budgets compared to 30-40 years ago. So, yes, anecdotal headlines can often sow more fear than reflect reality. Being honest here, if you have a fixed-rate mortgage and would struggle like George H.W. Bush did in 1992 to estimate the cost of a gallon of milk, then you probably are not a person who will be seriously exposed to the cost side of the inflation ledger.

The Investment Implications

So where does that all leave us? It is not as complicated as financial journalists tend to make it. If you are concerned about inflation eating into your future retirement proceeds, you should be seeking to invest in an asset mix that can outgrow your own inflation exposure. Right now, low-risk, government bonds are actually losing value to inflation, as are many investment-grade corporate bonds. On the other hand, stocks average about 9% per year, and in all but the most absurd inflation scenarios, over the long-term stocks will outpace inflation. However, you have to tolerate a lot of volatility in any given year, and if you are already retired or might need the money sooner, the stock market can be a bit unnerving. There are other asset classes that tend to keep pace with inflation – or outgrow it -- such as real estate, precious metals, inflation-indexed bonds, etc. So, there is more than one way to skin that cat.

The classic way to outgrow inflation was to construct a portfolio that was a mix of stocks and bonds (60% stocks; 40% bonds has been a staple). If inflation expectations increased, one could just tweak the stock allocation a bit higher to compensate. The problem with this strategy in the current environment is that interest rates are so low that (1) government bonds are actually losing money to inflation, and (2) if inflation (and thus interest rates) go up faster than is currently being projected, then the current value of those bonds will actually fall (bond prices fall as interest rates go up). They are largely paper losses, but most people are not disciplined enough to look past those toward the eventual bond repayments. And who can blame them? You are already accepting returns that are lower than inflation, but watching your bonds lose value on paper tends to undermine the other reason to hold bonds: the peace of mind.

That begs the question "why, then, would anyone hold bonds right now?" Of course, if you are already retired or close to it and have a lot of fixed costs that do not increase with inflation (e.g., a fixed-rate mortgage), then it can be quite reassuring to have the security of a 'laddered' bond portfolio to pay out cash when you need to pay those fixed costs. And while the classic portfolio of 60% stocks and 40% bonds may not provide the near-term stable growth that it has over much of the last couple decades, it still provides less volatility than, say, an all-stock portfolio.

However, if you don't need current liquidity and steady income, there is a good argument for tweaking the portfolio to have a lower bond weighting. With 10-year US Treasury bond yields scraping along at about 1.3%, there are certainly investment asset classes that can average more than that if you can tolerate some greater volatility.

What about Growth verses Value?

Another confusing aspect of the inflation debate is that both 'value' fund managers and 'growth' fund managers are vying for the title of best inflation-fighting superhero. As a refresher, value stocks are supposed to be stocks of relatively mature, low-growth companies which pay out significant dividends and are lower priced relative to their current earnings (we are oversimplifying, but let's run with it).

Growth stocks, by contrast, are meant to be companies that are earlier in their development, which are reinvesting most of their cash flow in expansion of their operations in order to grow at a very fast pace. So which is better at vanquishing the inflation super villain?

Well, it depends on how long you plan to hold it (I bet Batman never says "it depends…"). We should start by emphasizing that growth has outperformed value stocks in all but two of the last 12 years. If you are trying to outgrow inflation, it would also seem logical that you would want to hold stocks that grow at a faster pace than other companies, all but ensuring you will outgrow the inflation rate. So what's wrong with that logic?

Actually, nothing is really wrong with that logic, but there is a big caveat on near-term effects of inflation expectations and what they will do to the price of growth stocks. As we said, the debate is really about whether inflation will get enough out of control that the Federal Reserve will raise interest rates faster than forecast. This matters for a variety of reasons, but we are focusing principally here on the effect of discounting future payouts of growth stocks back to today's dollars (i.e., 'discount rates': see the Geek's Corner).

Here's the tricky part. If the Fed has to increase interest rates more than is currently expected to control inflation, then theoretically the price of both growth stocks AND of value stocks would fall due to an increase in their discount rates (that is, the required return): but growth stocks would fall by more. This is because growth stocks expect more of their total profits to be in the distant future (think Amazon in the 1990s), and the further out those profits are, the lower the value of those payouts would be valued in the price today.

Think of it this way: $100,000 in 1981 was worth a lot more to you than $100,000 today. If someone offered you a bond that would pay you $100,000 next year and another person offered you a bond that would pay you $100,000 in 40 years' time, which one would you pay more for today all other things equal? So, you could think of the growth stocks as kind of like the payout in 40 years' time – it is going to be more affected by inflation. Growth stocks are supposed to grow faster than value, but you should be willing to hold them long enough to ride out the near-term volatility. If you need the money next year, then growth stocks may be too volatile as those inflation expectations shift around.

Of course, all of this is in a perfect world where the planets of financial theory line up in precise harmony. The real-world markets are more complicated. Traders and active fund managers are trying to anticipate these interest rate moves. For instance, they might decide to sell some of their growth stocks to buy value stocks. That may actually increase the price of the value stocks in the short term and reduce the price of growth even though that reaction to inflation should theoretically reduce the value of both.

GEEK'S CORNER

We discussed discount rates in our January note (sure, sure, we know you read it). Remember how your grandfather showed you how a dollar deposited into a bank account could become a whopping $1.53 dollars through time and the magic of compounded interest? Stock valuations are supposed to work the same way (in theory), except the riskier and more volatile a stock is, the higher the discount rate (i.e., percentage return) is that people require in order to invest in it.

Discount rates are the compounding of interest applied in reverse to derive the value today of cash paid to you in the future by these companies. The more uncertain a company's future profits are, the more return we 'expect' that is embedded in the discount rate. Every stock's discount rate is meant to be greater than a 'risk-free rate' that you could get if you just invested in very safe government bonds. In other words, why would you invest in Acme Anvil Droppers Inc. at a price that would provide you the same compounded interest as a US government bond paying 1.3% (unless you expected a huge increase in coyotes buying anvils)? You would want a lower price for the same cash flow.

Financial journalism tends to conflate the short-term trading effect on stocks with the long-term investing effect. So, let's distill this into a few key takeaways:

- Growth Beats Value Long Term. By definition, growth is going to beat value in the long term, and thus it will be better at outpacing future inflation than value stocks.

- However, In the Short Term, Pricing Pressures May Weigh More on Growth. For all the reasons we discussed, an expectation of future inflation will conversely put more downward pressure on the price of growth stocks today as compared to value. Even if traders are wrong about higher sustained inflation, they can drive down the price of growth stocks just by taking bets against them.

- That Doesn't Mean You Should Sell All Your Growth Stocks. Even if inflation fears drive the price of growth stocks lower in the near term, it will still grow at a faster pace than value – just from a lower starting price. If you have a longer-term horizon, these stocks will tend to outgrow any near-term price declines.

- A Mix of Both is a Better Approach. As always, the best solution as long-term investors is not to get caught up in the day-to-day vacillation between different styles of stock investing but to have a mix of both ("Holy portfolio, Batman! We can fight the Joker with diversification!"). A diversified portfolio is always a better plan. For people who are closer to retirement, the share of value stocks in the mix may be higher (they are less volatile and pay dividends). Yet if you really remain concerned about inflation after reading all of this, then accumulating a bit more growth stocks in your portfolio would probably be a better way to outgrow that risk if you have a long enough runway.

The quadruple bottom line, though, is that we do not think inflation is likely to be a serious long-term risk. Unless you are already retired with a lot of expenses that are subject to inflation pressures in the short term, then it is probably a bad idea to get too caught up in the trading frenzy about inflation effects.

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