Inflation

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." - Mark Twain

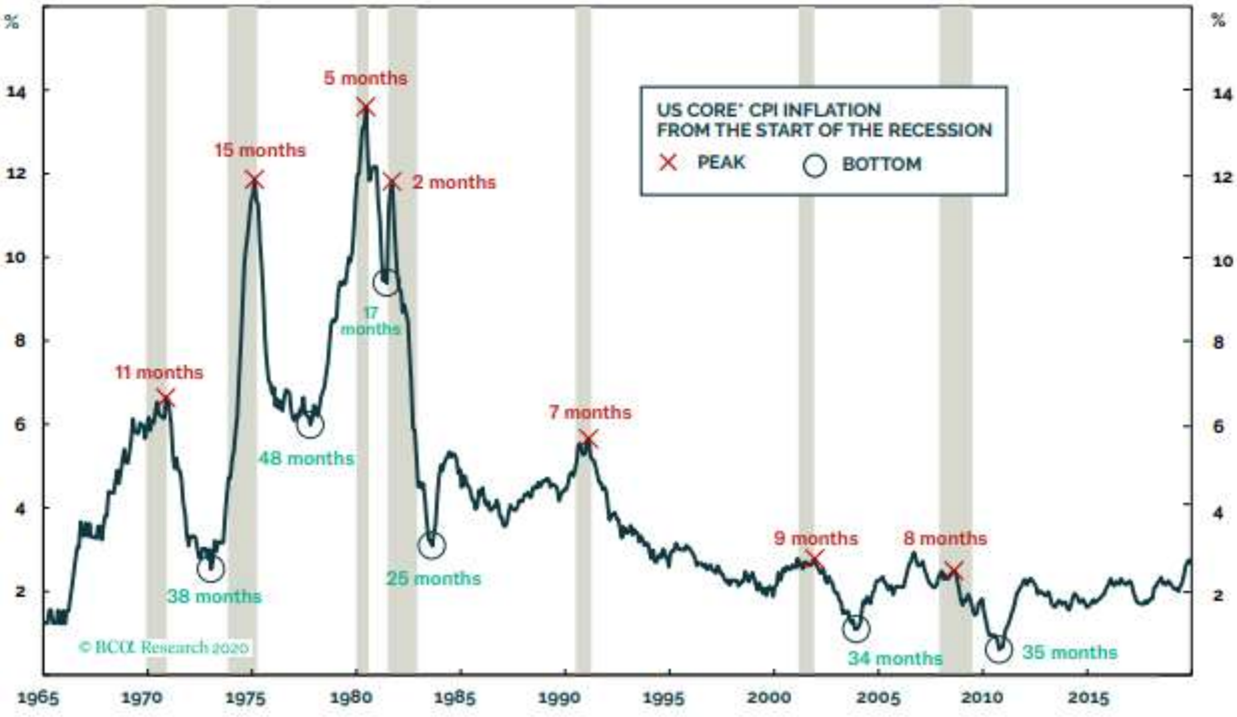
From Friday's Global Investment Strategy's Weekly Report, titled "Who's Afraid Of Low Unemployment?":

Inflation Is Not A Threat... Yet

For now, unit labor cost inflation remains reasonably well contained in the major economies. However, there is little evidence to suggest that the historic relationship between labor market slack and wage growth has broken down. Barring a major surge in productivity growth, inflation is likely to accelerate eventually as companies try to pass on higher labor costs to their customers.

We do not know exactly when such a price wage spiral will emerge. Inflation is a notoriously lagging indicator (**Chart 16**). Our best guess is that inflation could become a serious risk for investors in late 2021 or 2022. Thus, investors should remain overweight global equities for the next 12-to18 months, but be prepared to turn more cautious in the second half of 2021.

CHART 16
Inflation Is A Lagging Indicator



* EXCLUDING FOOD AND ENERGY.
NOTE: SHADED REGIONS DENOTE NBER-DESIGNATED PERIODS OF A RECESSION.

Underestimating Inflation Can Spoil Your Retirement Party

Oct. 27, 2019

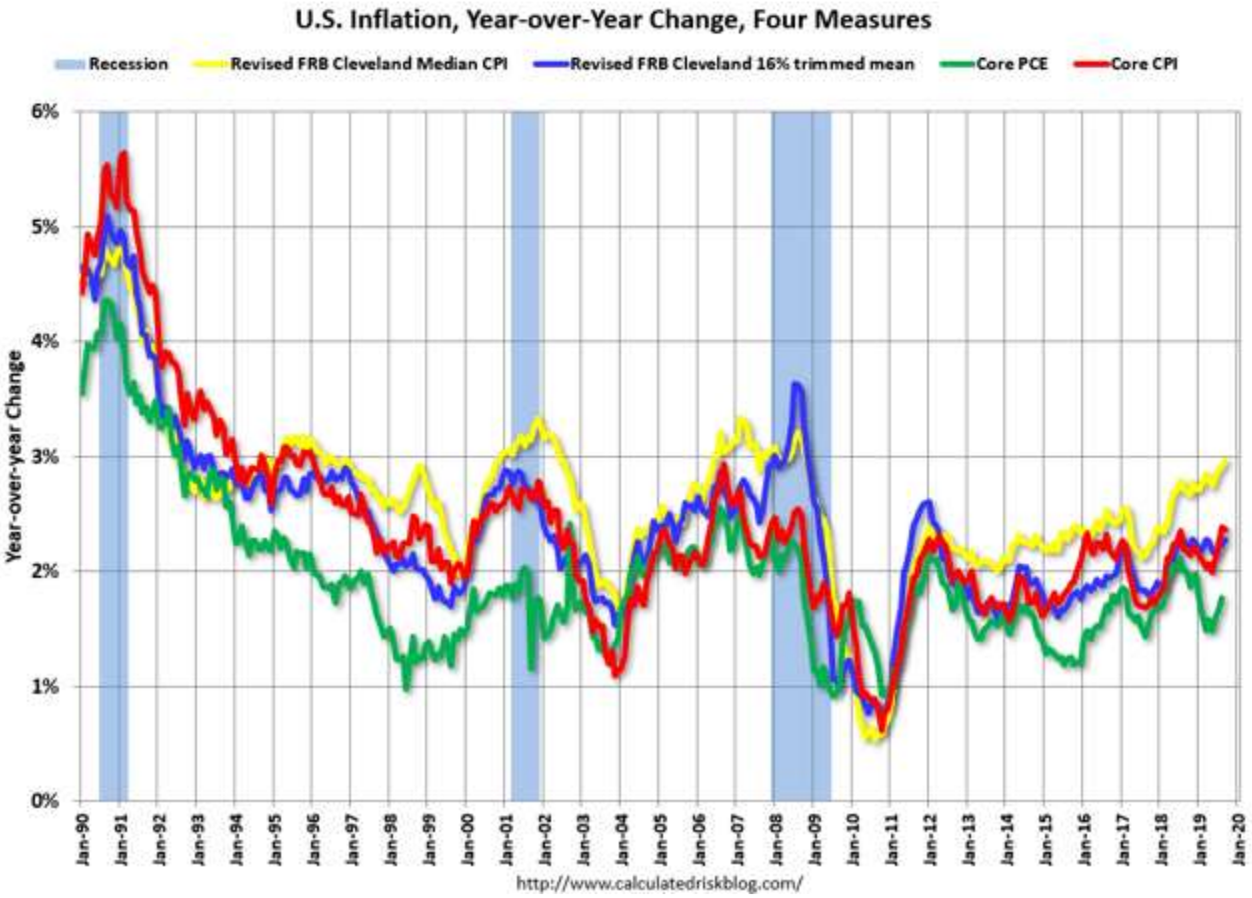
Rida Morwa

High Dividend Opportunities

... We are now in the tenth year of the current economic expansion that began in 2009. While inflation talk did make the news in late December 2018, the ongoing trade war with China alongside below average GDP growth has convinced everyone that as far as the eye can see, inflation is dead. But is it really? We are about to show you another side of the same story and then describe the impact on your retirement if the inflation genie is indeed out of the bottle.

Where are we really with Inflation?

Calculated Risk does an excellent job compiling 4 different measures of inflation. While they do not always move identically, they do trend in the same general direction over time. So it was particularly interesting to us that 3 out of those 4 measures are stronger and higher today than they were in December 2018 when everyone was actually worried about inflation.

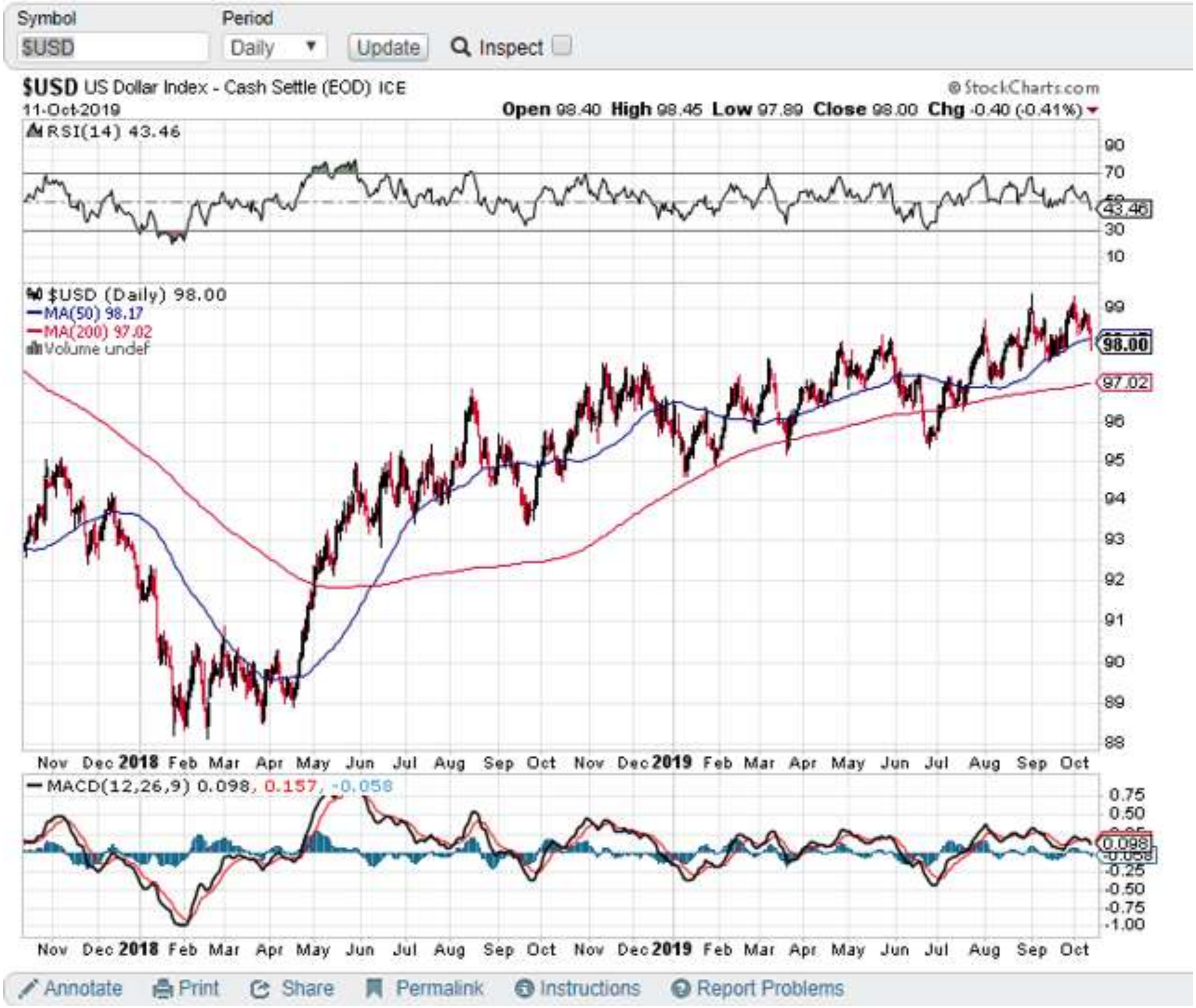


http://www.calculatedriskblog.com/

Revised Federal Reserve Board Median CPI hit a rather astounding 3% for the first time in this cycle. The other measures are moderate but none appear to be collapsing. We hear the retort you are forming: "The measures are looking at the past and as soon as we hit a recession, they will drop." We understand the logic and certainly it would be a remote possibility that the measures would continue up if we did hit a recession. But take a minute to see what has gone right for inflation to be at this level, and you will see why the risks for an upside surprise are rather significant.

A bull market in US Dollars

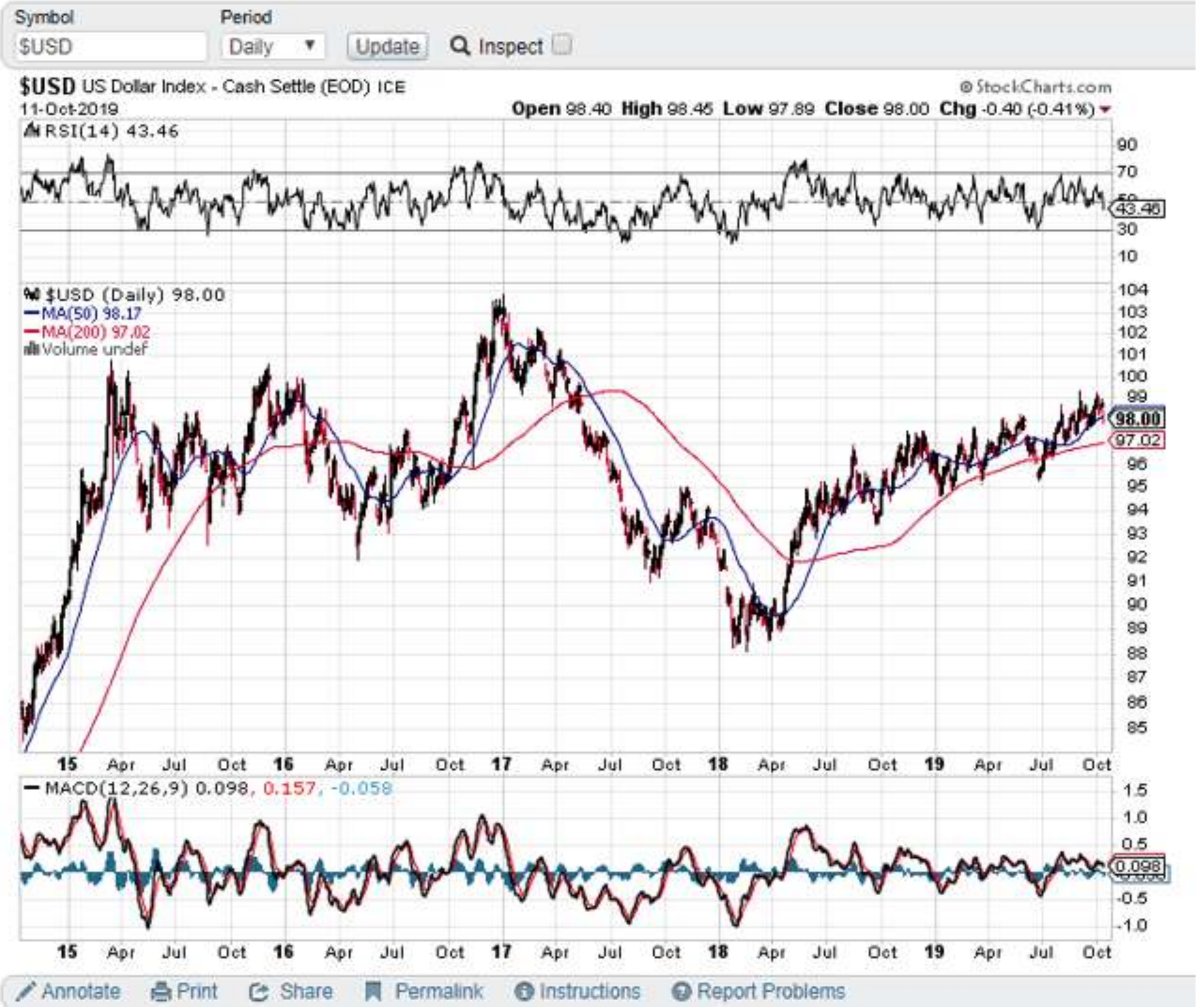
Since bottoming in 2018, the US dollar has been rather strong and has put a lid on imported inflation.



Source: Stockcharts

While we have had a bull market in US dollars, the index is still below its previous peak set in 2016.

But the broader US dollar index (shown below) excludes emerging market currencies and is weighted towards the weak Euro. The **trade-weighted** US dollar index, on the other hand, is heavily weighted on emerging market currencies. This accurately reflects the strength of the US dollar adjusted for trade conducted. This index just hit a new multi-decade high.



Symbol: $USD

Period: Daily

$USD US Dollar Index - Cash Settle (EOD) ICE

11-Oct-2019

Open 98.40 **High** 98.45 **Low** 97.89 **Close** 98.00 **Chg** -0.40 (-0.41%)

RSI(14) 43.46

$USD (Daily) 98.00

MA(50) 98.17

MA(200) 97.02

Volume undef

MACD(12,26,9) 0.098, 0.157, -0.058

Update
Inspect
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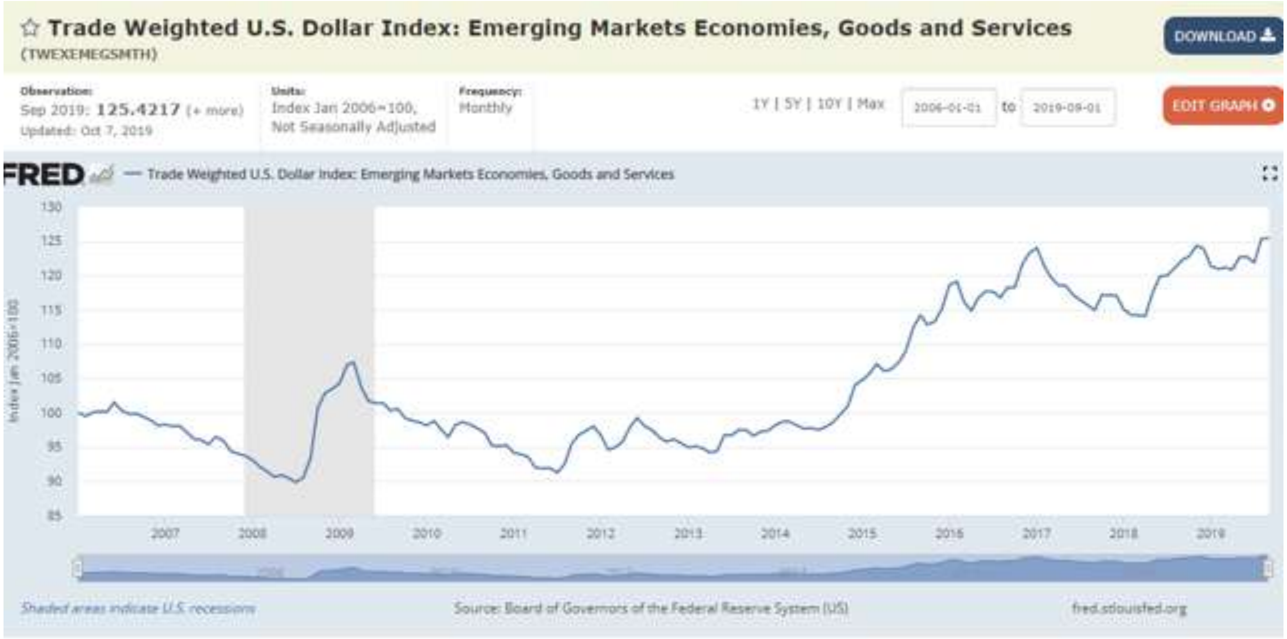
Source: Stockcharts



☆ **Trade Weighted U.S. Dollar Index: Emerging Markets Economies, Goods and Services**
(TWEXEMEGSMTH)

Observation:
Sep 2019: **125.4217** (+ more)
Updated: Oct 7, 2019

Units:
Index Jan 2006=100,
Not Seasonally Adjusted

Frequency:
Monthly

1Y | 5Y | 10Y | Max 2006-01-01 to 2019-09-01

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EDIT GRAPH
FRED
— Trade Weighted U.S. Dollar Index: Emerging Markets Economies, Goods and Services
Index Jan 2006=100
130
125
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2019
Shaded areas indicate U.S. recessions
Source: Board of Governors of the Federal Reserve System (US)
fred.stlouisfed.org

Source: FRED

What the above chart shows is that the US dollar has had a big role in dampening imported inflation. So in spite of a rather strong, **inflation neutering currency**, we have had moderate inflation as seen in the numbers.

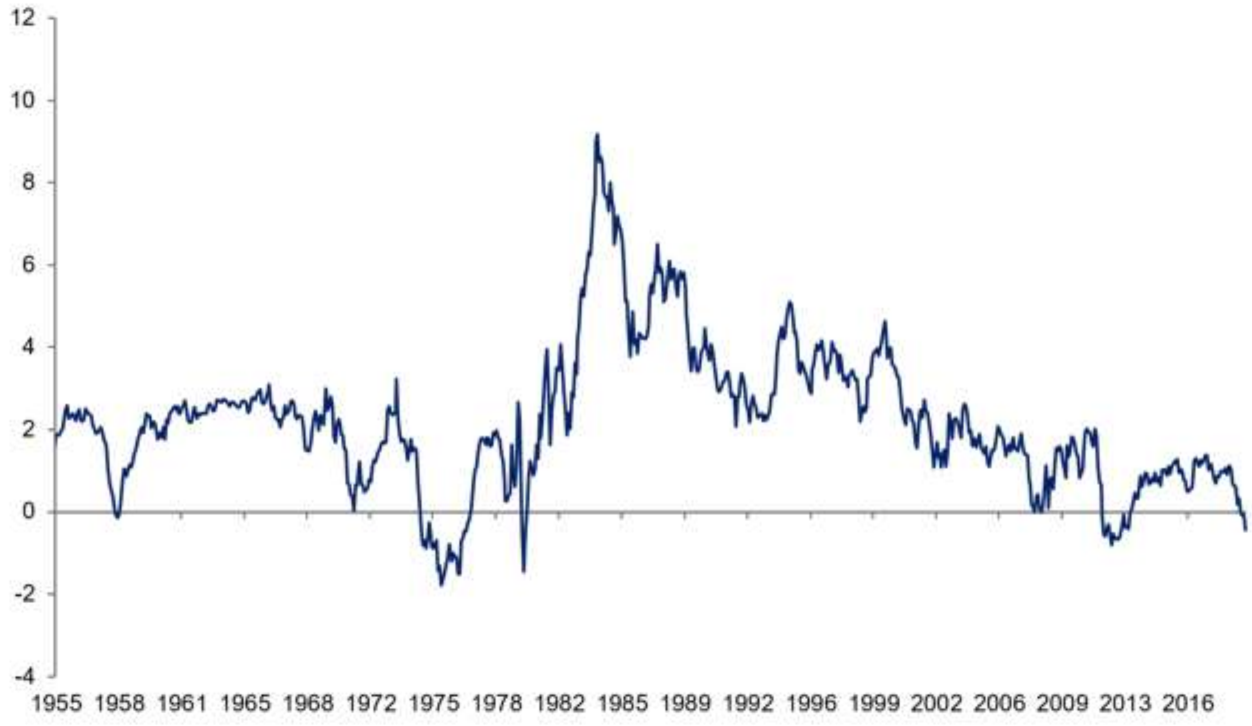
The rate cycle

The other factor we would like to bring up here is that rates were being raised in 2018 whereas now are being cut. These impacts take several months to pass through. We are still feeling the impacts from those last rate hikes and it will be some time until the recent rate cuts flow through the system.

Hence if inflation has remained stubbornly above 2% while we are feeling the impacts of rate hikes, what does happen when rates are cut? We have already seen two rate cuts and probabilities for 1-3 more rate cuts are really high. (The Fed is actually on hold after its 3rd cut on October 30th.) This could allow the developing inflation trends to become more entrenched**.**

Having real rates so low can significantly increase inflation and ultimately bond yields.

With constant media attention to imaginary deflation, we have had a massive bubble in treasury bonds. This has been facilitated with the trade war as China has been forced to peg its currency lower and buy Treasury bonds at inflated prices. **The net results we see are that real rates offered by bonds are at one of the lowest points ever. Below we see that real rates (10 Year bond yields minus CPI rates) are in the bottom 5 percentile of all readings since 1955.**

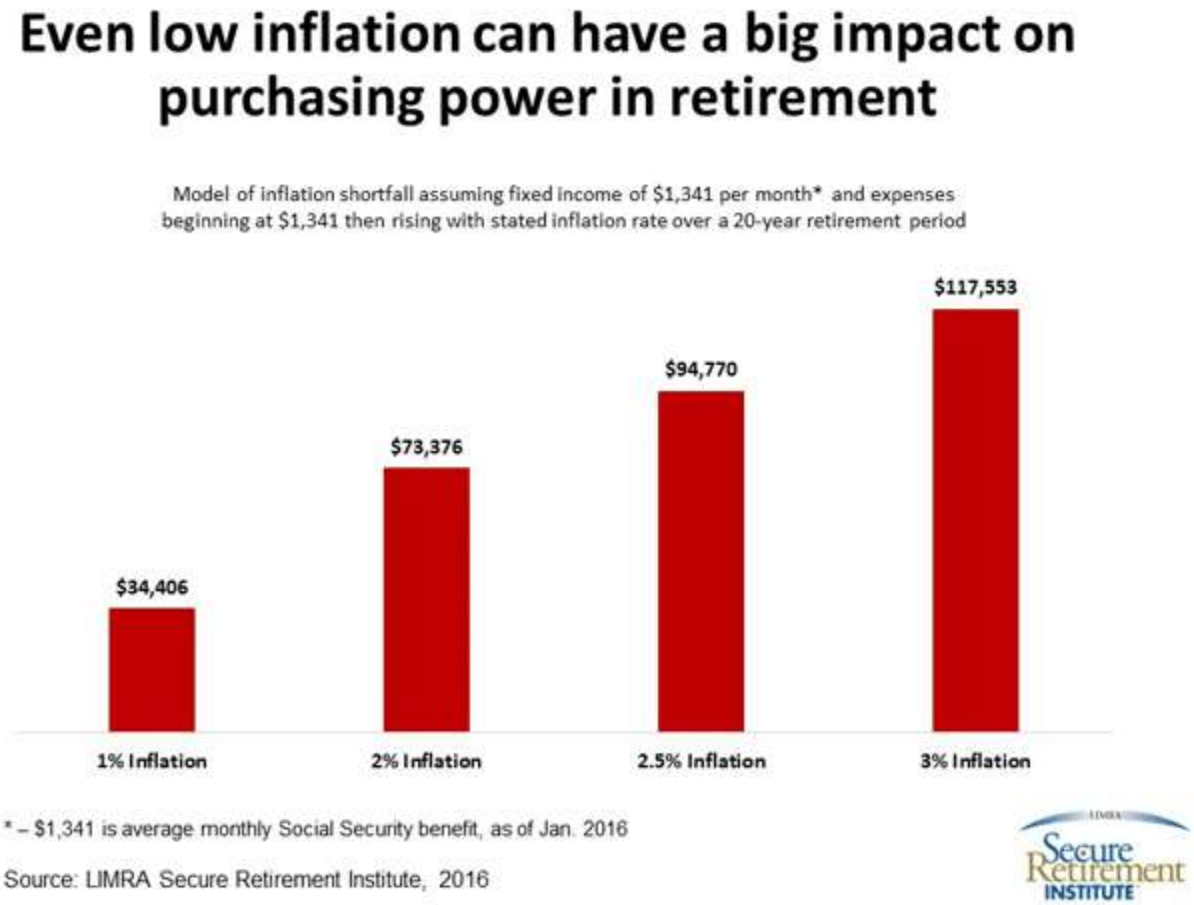


Source: AQR: Bonds Are Frickin Expensive

Rates this low are by themselves inflationary. Yes, we are aware of negative rates in Europe and Japan and those experiments have just as high a probability of ending badly as we do of having higher inflation.

Impact on retirement

While the media may be celebrating the rate cuts and continued low inflation, the current environment is turning decidedly negative for retirees. We are seeing the worst of both worlds where inflation remains stubborn and bonds offer incredibly low yields. Underestimating the impact of inflation can devastate your retirement plans. This is even truer at low inflation rates. Just see the impact below of assuming zero inflation versus the stated numbers on net retirement shortfall.



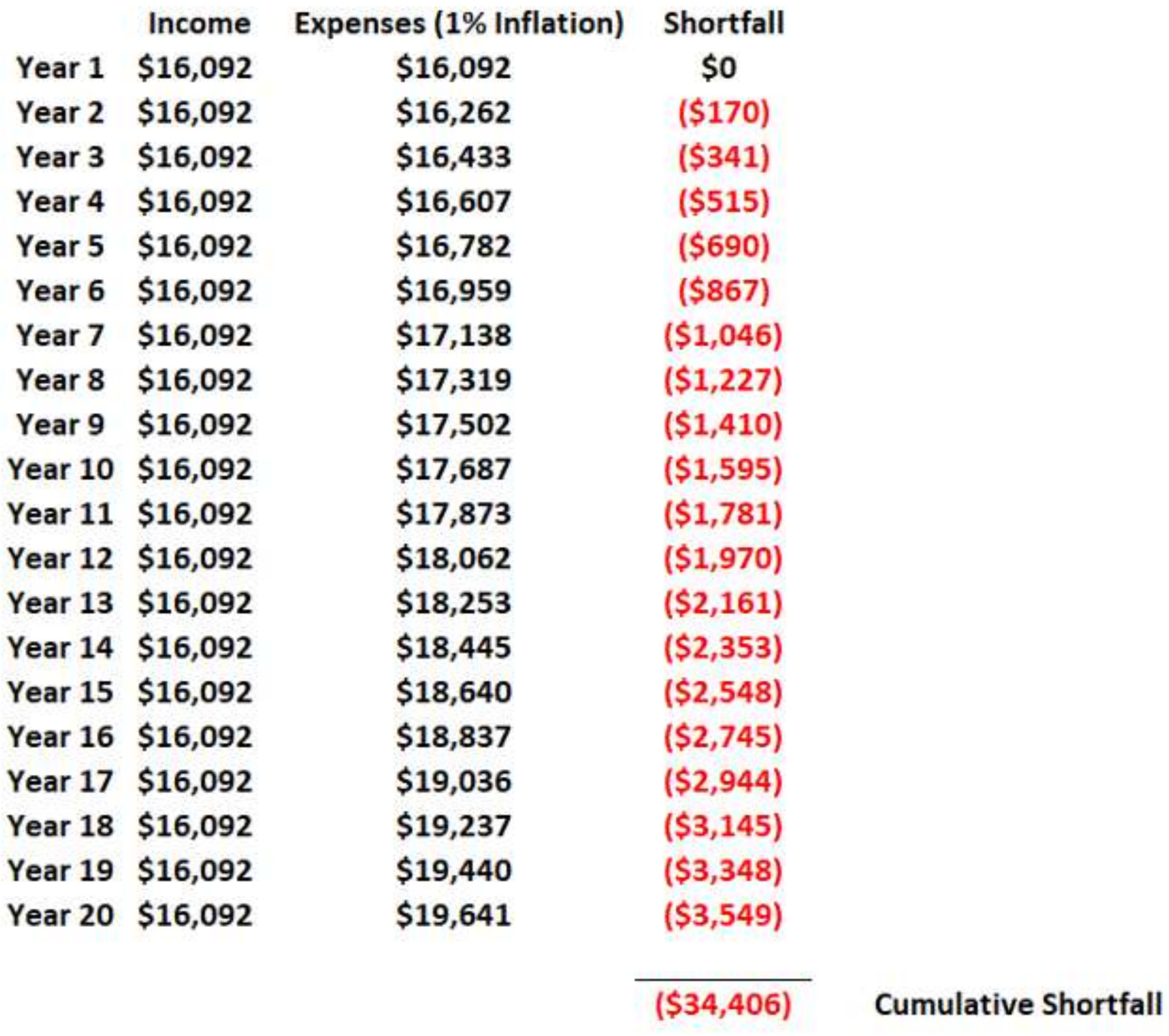
Even low inflation can have a big impact on purchasing power in retirement

Model of inflation shortfall assuming fixed income of $1,341 per month* and expenses beginning at $1,341 then rising with stated inflation rate over a 20-year retirement period

* – $1,341 is average monthly Social Security benefit, as of Jan. 2016

Source: LIMRA Secure Retirement Institute, 2016

A 1% inflation rate difference can result in a $34,406 shortfall over the course of 20 years. This is so even when assuming that a person spends just $1,341 a month. We show the workings of that below. The shortfall starts off small but compounding wins in the long run.

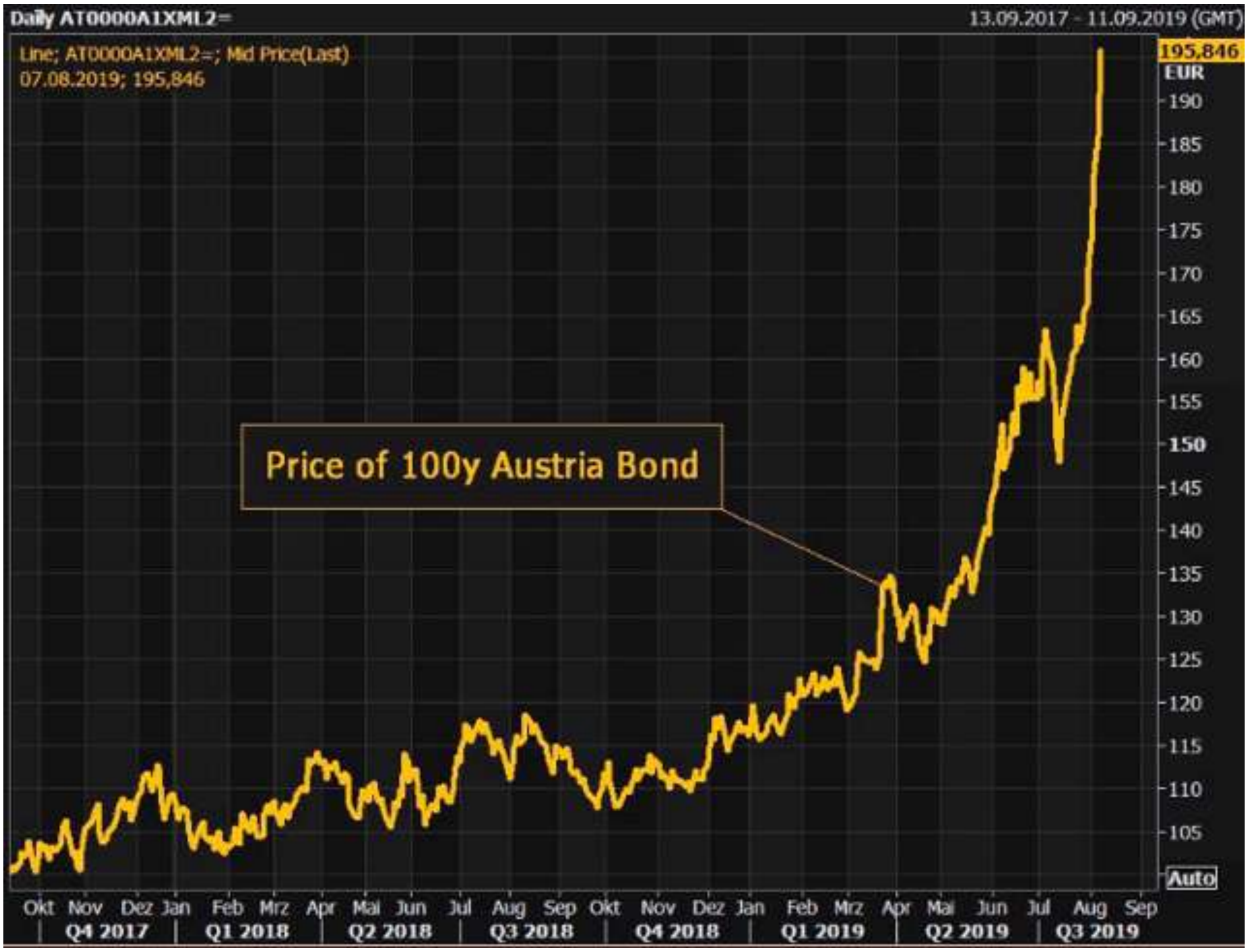


	Income	Expenses (1% Inflation)	Shortfall	
Year 1	$16,092	$16,092	$0	
Year 2	$16,092	$16,262	($170)	
Year 3	$16,092	$16,433	($341)	
Year 4	$16,092	$16,607	($515)	
Year 5	$16,092	$16,782	($690)	
Year 6	$16,092	$16,959	($867)	
Year 7	$16,092	$17,138	($1,046)	
Year 8	$16,092	$17,319	($1,227)	
Year 9	$16,092	$17,502	($1,410)	
Year 10	$16,092	$17,687	($1,595)	
Year 11	$16,092	$17,873	($1,781)	
Year 12	$16,092	$18,062	($1,970)	
Year 13	$16,092	$18,253	($2,161)	
Year 14	$16,092	$18,445	($2,353)	
Year 15	$16,092	$18,640	($2,548)	
Year 16	$16,092	$18,837	($2,745)	
Year 17	$16,092	$19,036	($2,944)	
Year 18	$16,092	$19,237	($3,145)	
Year 19	$16,092	$19,440	($3,348)	
Year 20	$16,092	$19,641	($3,549)	
			($34,406)	Cumulative Shortfall

Source: Author's calculations

Obviously the impact of inflation is rather serious and we are just using a 1% mismatch versus expectations. Yes, inflation could come down from these levels and may even go significantly lower if we have a recession. But most investors are planing for very low inflation outcomes and surprises are likely to be on the upside over the next two decades.

On the flip side, we are seeing a massive bubble in bonds that happens at the tail end of the cycle. Investors are rushing into bond assets as if we will never ever have inflation. We see below the price of the Austrian 100-year bond exemplifying this.



Source: Bloomberg, Data from Sep 11, 2019

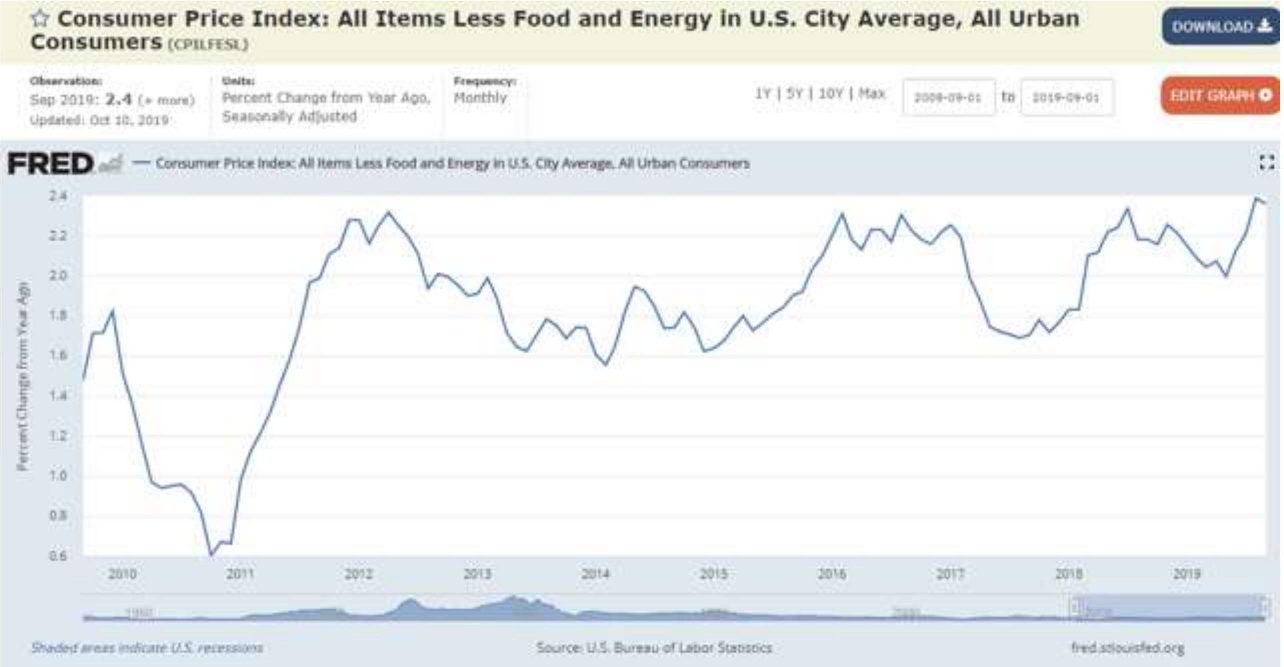
We believe we are at the end of a long bull market in bonds and that has caused inflation threats to be underestimated.

What you need

The most important thing from our perspective is not to underestimate the devastation this can cause on your portfolio and retirement, precisely when the risks are being downplayed. The second thing one can do is control the impact of future inflation where possible. Finally, it really helps to have assets that will do well in case of mild to moderate inflation levels and provide you with increasing income. In the next part, we will explore these possibilities and show you how to strengthen your portfolio and pick these inflation hedges just when they are being given away for cheap.

Conclusion

We are ***not*** predicting a return to the heady inflation days of the 1970's. Inflation is likely to remain low. But at the same time, we think the current inflationary data is higher than most would like to believe, in spite of rather brisk headwinds against inflation (US dollar strength, recent rate hike cycle, weak GDP).



☆ Consumer Price Index: All Items Less Food and Energy in U.S. City Average, All Urban Consumers (CPILFESL)

Observation: Sep 2019: 2.4 (+ more) Updated: Oct 10, 2019

Units: Percent Change from Year Ago, Seasonally Adjusted

Frequency: Monthly

Source: FRED, Core CPI at 10 year highs

Should these factors dissipate and we avoid a recession, the risk of 3% plus inflation is very possible. Protecting your nest egg and income from inflationary impacts will be key in such an environment.

Beat Inflation, By Not Buying Gold

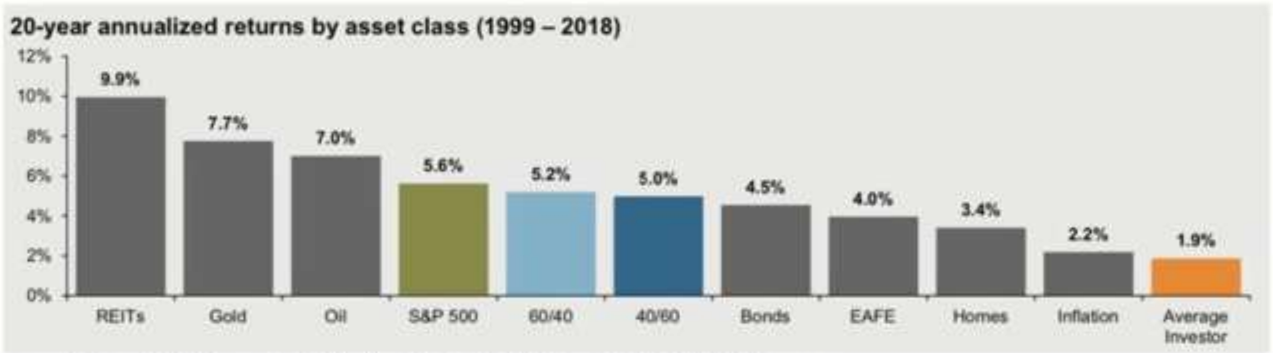
Nov. 13, 2019

... Investors that ran into the safety of Treasury bonds are going to find out just how little they will get for that entry. But leaving aside the media's incorrect reporting, what can an average investor do to hedge the inflation risk? Today we will examine one broad category of investments and explain why it holds the best bet against inflation.

The Real Precious Investment

Both on Seeking Alpha and in the broader internet community, there is no investment that evokes as much passion as Gold. Whether you are thinking about end of days or currency devaluations, Gold has always been at the forefront of investment ideas. Gold also is known to be a rather strong protector against inflation. While we do believe that Gold does have some inflation correlation, investors who like getting paid (versus paying someone to store the metal), should ignore Gold and focus on a much better investment class for inflation protection. Real Estate Investment Trusts or REITs.

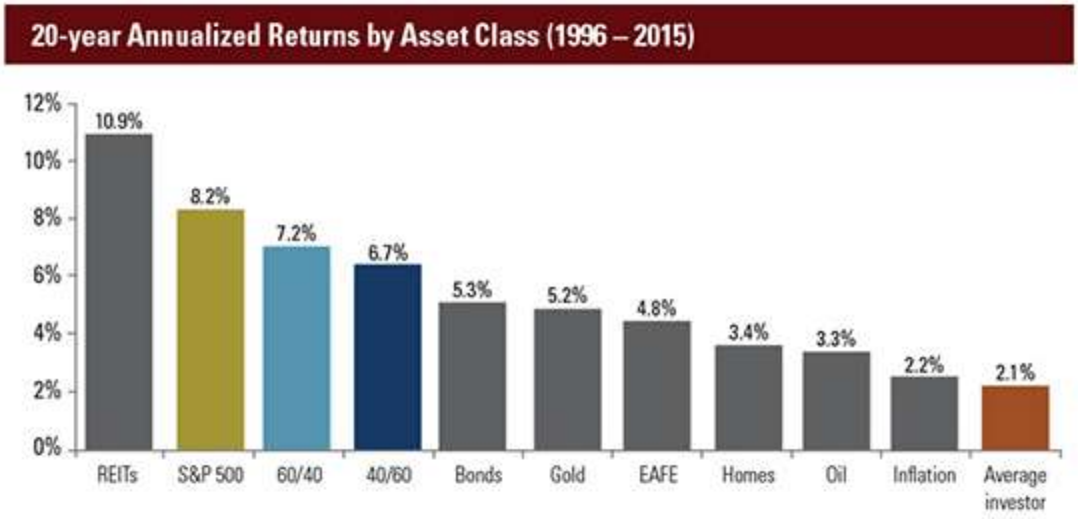
At a broader level REITs have done exceptionally well over large time frames. The 20 year period below shows REITs delivering the best performance among all asset classes.



Source: J.P. Morgan Asset Management; (Top) Barclays, Bloomberg, FactSet, Standard & Poor's; (Bottom) Dalbar Inc.
Indices used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Bloomberg Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy oz., Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high-quality U.S. fixed income, represented by the Bloomberg Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/18 to match Dalbar's most recent analysis.
Guide to the Markets – U.S. Data are as of March 31, 2019.

J.P.Morgan
Asset Management

Gold did come in second, but here is the thing, if you shift the time frame back 3 years, things become rather different. REITs still come out on top while Gold falls quite a bit.

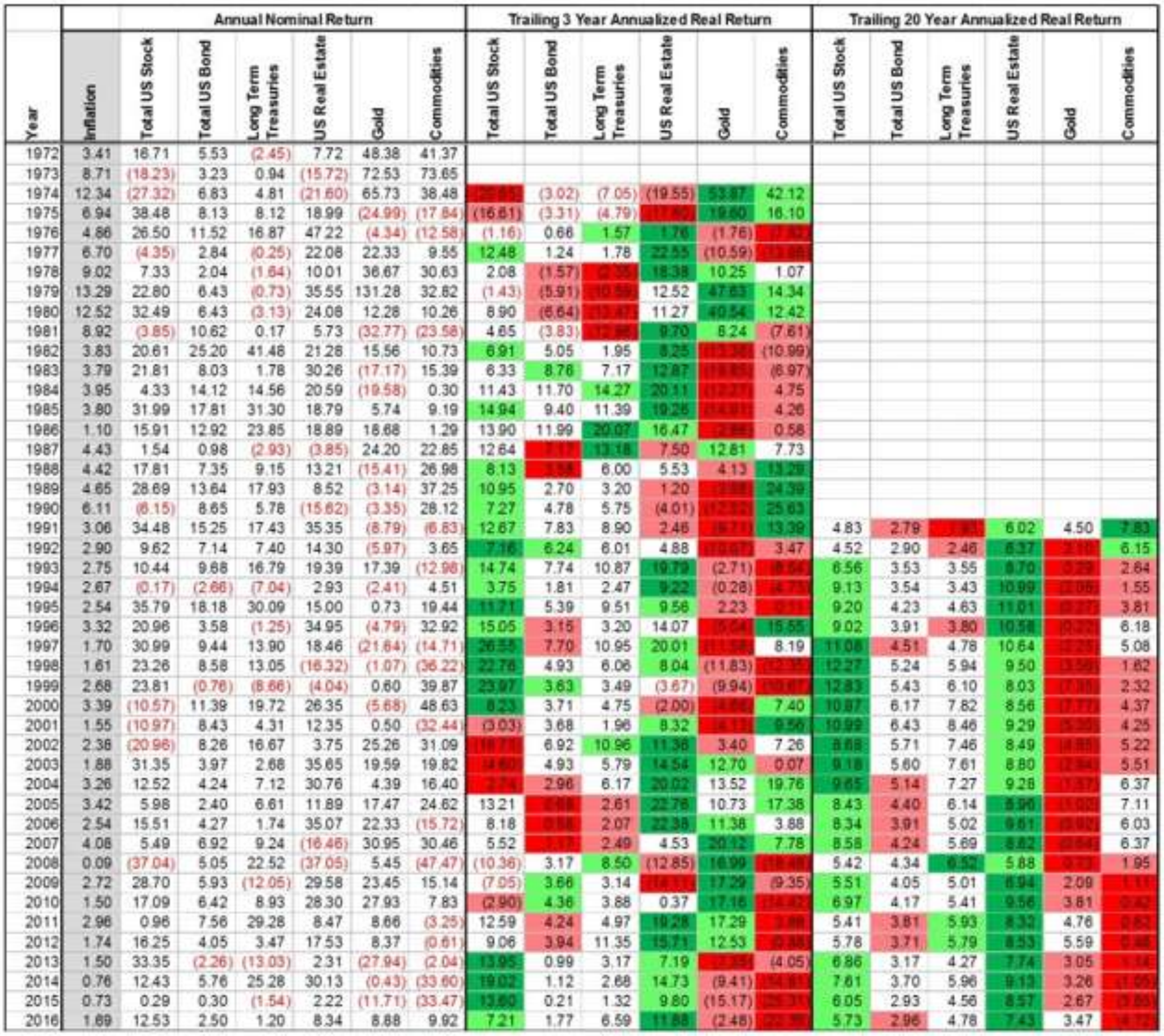


Sources: J.P. Morgan Asset Management, Barclays, FactSet, Standard & Poor's, Dalbar Inc.

Indexes used are as follows: REITs: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy ounce, Inflation: CPI. 60/40: A balanced portfolio with 60 percent invested in S&P Index and 40 percent invested in high quality U.S. fixed income, represented by the Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and period ending 12/31/15 to match Dalbar's most recent analysis.

Guide to the Markets — *U.S. data are as of June 30, 2016.*

In fact over 40 years REITs beat Gold by a rather resounding margin, even if you ignore storage costs that you would have to pay to access this asset class via ETFs like **SPDR Gold Trust ETF** (GLD) and **iShares Gold Trust ETF** (IAU). REITs are incredibly consistent and you can best see that by visualizing 20 year returns vs Gold.



	Annual Nominal Return							Trailing 3 Year Annualized Real Return						Trailing 20 Year Annualized Real Return					
Year	Inflation	Total US Stock	Total US Bond	Long Term Treasuries	US Real Estate	Gold	Commodities	Total US Stock	Total US Bond	Long Term Treasuries	US Real Estate	Gold	Commodities	Total US Stock	Total US Bond	Long Term Treasuries	US Real Estate	Gold	Commodities
1972	3.41	16.71	5.53	(2.45)	7.72	48.38	41.37												
1973	8.71	(18.23)	3.23	0.94	(15.72)	72.53	73.65												
1974	12.34	(27.32)	6.83	4.81	(21.60)	65.73	38.48	(25.65)	(3.02)	(7.05)	(19.55)	53.87	42.12						
1975	6.94	38.48	8.13	8.12	18.99	(24.99)	(17.84)	(16.61)	(3.31)	(4.79)	(17.80)	19.80	16.10						
1976	4.86	26.50	11.52	16.87	47.22	(4.34)	(12.58)	(1.16)	0.66	1.57	1.76	(1.76)	(7.82)						
1977	6.70	(4.35)	2.84	(0.25)	22.08	22.33	9.55	12.48	1.24	1.78	22.55	(10.59)	(13.86)						
1978	9.02	7.33	2.04	(1.64)	10.01	36.67	30.63	2.08	(1.57)	(2.35)	18.38	10.25	1.07						
1979	13.29	22.80	6.43	(0.73)	35.55	131.28	32.82	(1.43)	(5.91)	(10.59)	12.52	47.63	14.34						
1980	12.52	32.49	6.43	(3.13)	24.08	12.28	10.26	8.90	(6.64)	(11.47)	11.27	40.54	12.42						
1981	8.92	(3.85)	10.62	0.17	5.73	(32.77)	(23.58)	4.65	(3.83)	(12.96)	9.70	8.24	(7.61)						
1982	3.83	20.61	25.20	41.48	21.28	15.56	10.73	6.91	5.05	1.95	8.25	(11.38)	(10.99)						
1983	3.79	21.81	8.03	1.78	30.26	(17.17)	15.39	6.33	8.76	7.17	12.87	(19.85)	(6.97)						
1984	3.95	4.33	14.12	14.56	20.59	(19.58)	0.30	11.43	11.70	14.27	20.11	(12.27)	4.75						
1985	3.80	31.99	17.81	31.30	18.79	5.74	9.19	14.94	9.40	11.39	19.26	(14.81)	4.26						
1986	1.10	15.91	12.92	23.85	18.89	18.68	1.29	13.90	11.99	20.07	16.47	(2.86)	0.58						
1987	4.43	1.54	0.98	(2.93)	(3.85)	24.20	22.85	12.64	7.17	13.18	7.50	12.81	7.73						
1988	4.42	17.81	7.35	9.15	13.21	(15.41)	26.98	8.13	3.58	6.00	5.53	4.13	13.29						
1989	4.65	28.69	13.64	17.93	8.52	(3.14)	37.25	10.95	2.70	3.20	1.20	(7.88)	24.39						
1990	6.11	(6.15)	8.65	5.78	(15.62)	(3.35)	28.12	7.27	4.78	5.75	(4.01)	(12.32)	25.63						
1991	3.06	34.48	15.25	17.43	35.35	(8.79)	(6.83)	12.67	7.83	8.90	2.46	(8.71)	13.39	4.83	2.79	1.87	6.02	4.50	7.83
1992	2.90	9.62	7.14	7.40	14.30	(5.97)	3.65	7.16	6.24	6.01	4.88	(10.67)	3.47	4.52	2.90	2.46	6.37	2.10	6.15
1993	2.75	10.44	9.68	16.79	19.39	17.39	(12.98)	14.74	7.74	10.87	19.79	(2.71)	(8.54)	6.56	3.53	3.55	8.70	0.29	2.84
1994	2.67	(0.17)	(2.66)	(7.04)	2.93	(2.41)	4.51	3.75	1.81	2.47	9.22	(0.28)	(4.75)	9.13	3.54	3.43	10.99	(2.06)	1.55
1995	2.54	35.79	18.18	30.09	15.00	0.73	19.44	11.71	5.39	9.51	9.56	2.23	(2.11)	9.20	4.23	4.63	11.01	(0.27)	3.81
1996	3.32	20.96	3.58	(1.25)	34.95	(4.79)	32.92	15.05	3.15	3.20	14.07	(5.04)	15.55	9.02	3.91	3.80	10.58	(0.22)	6.18
1997	1.70	30.99	9.44	13.90	18.46	(21.64)	(14.71)	26.55	7.70	10.95	20.01	(11.58)	8.19	11.08	4.51	4.78	10.64	(2.25)	5.08
1998	1.61	23.26	8.58	13.05	(16.32)	(1.07)	(36.22)	22.78	4.93	6.06	8.04	(11.83)	(12.35)	12.27	5.24	5.94	9.50	(3.56)	1.62
1999	2.68	23.81	(0.76)	(8.66)	(4.04)	0.60	39.87	23.97	3.63	3.49	(3.67)	(9.94)	(10.67)	12.83	5.43	6.10	8.03	(7.65)	2.32
2000	3.39	(10.57)	11.39	19.72	26.35	(5.68)	48.63	8.23	3.71	4.75	(2.00)	(4.66)	7.40	10.87	6.17	7.82	8.56	(7.77)	4.37
2001	1.55	(10.97)	8.43	4.31	12.35	0.50	(32.44)	(3.03)	3.68	1.96	8.32	(4.13)	9.56	10.99	6.43	8.46	9.29	(5.30)	4.25
2002	2.38	(20.96)	8.26	16.67	3.75	25.26	31.09	(18.71)	6.92	10.96	11.36	3.40	7.26	8.68	5.71	7.46	8.49	(4.85)	5.22
2003	1.88	31.35	3.97	2.68	35.65	19.59	19.82	(4.60)	4.93	5.79	14.54	12.70	0.07	9.18	5.60	7.61	8.80	(2.94)	5.51
2004	3.26	12.52	4.24	7.12	30.76	4.39	16.40	2.74	2.96	6.17	20.02	13.52	19.76	9.65	5.14	7.27	9.28	(1.57)	6.37
2005	3.42	5.98	2.40	6.61	11.89	17.47	24.62	13.21	0.88	2.61	22.76	10.73	17.38	8.43	4.40	6.14	8.96	(1.02)	7.11
2006	2.54	15.51	4.27	1.74	35.07	22.33	(15.72)	8.18	0.88	2.07	22.38	11.38	3.88	8.34	3.91	5.02	9.61	(0.92)	6.03
2007	4.08	5.49	6.92	9.24	(16.46)	30.95	30.46	5.52	1.17	2.49	4.53	20.12	7.78	8.58	4.24	5.69	8.82	(0.64)	6.37
2008	0.09	(37.04)	5.05	22.52	(37.05)	5.45	(47.47)	(10.36)	3.17	8.50	(12.85)	16.99	(18.48)	5.42	4.34	6.52	5.88	0.73	1.95
2009	2.72	28.70	5.93	(12.05)	29.58	23.45	15.14	(7.05)	3.66	3.14	(14.11)	17.29	(9.35)	5.51	4.05	5.01	6.94	2.09	1.11
2010	1.50	17.09	6.42	8.93	28.30	27.93	7.83	(2.90)	4.36	3.88	0.37	17.16	(14.42)	6.97	4.17	5.41	9.56	3.81	0.42
2011	2.96	0.96	7.56	29.28	8.47	8.66	(3.25)	12.59	4.24	4.97	19.28	17.29	3.88	5.41	3.81	5.93	8.32	4.76	0.82
2012	1.74	16.25	4.05	3.47	17.53	8.37	(0.61)	9.06	3.94	11.35	15.71	12.53	0.88	5.78	3.71	5.79	8.53	5.59	0.48
2013	1.50	33.35	(2.26)	(13.03)	2.31	(27.94)	(2.04)	13.95	0.99	3.17	7.19	(12.55)	(4.05)	6.86	3.17	4.27	7.74	3.05	1.14
2014	0.76	12.43	5.76	25.28	30.13	(0.43)	(33.60)	19.02	1.12	2.68	14.73	(9.41)	(14.81)	7.61	3.70	5.96	9.13	3.26	(1.05)
2015	0.73	0.29	0.30	(1.54)	2.22	(11.71)	(33.47)	13.60	0.21	1.32	9.80	(15.17)	(25.31)	6.05	2.93	4.56	8.57	2.67	(3.86)
2016	1.69	12.53	2.50	1.20	8.34	8.88	9.92	7.21	1.77	6.59	11.88	(2.48)	[illegible]	5.73	2.96	4.78	7.43	3.47	(4.72)

Source:* *Engineered Portfolio

In fact if you bought Gold in any year between 1974-1988, you had negative total 20 year returns...before counting storage costs. Let that sink in. REITs on the other hand were consistently a good performer regardless of your entry. But we bring up REITs today to show that it can actually be a decent hedge to inflation.

How REITs move with inflation

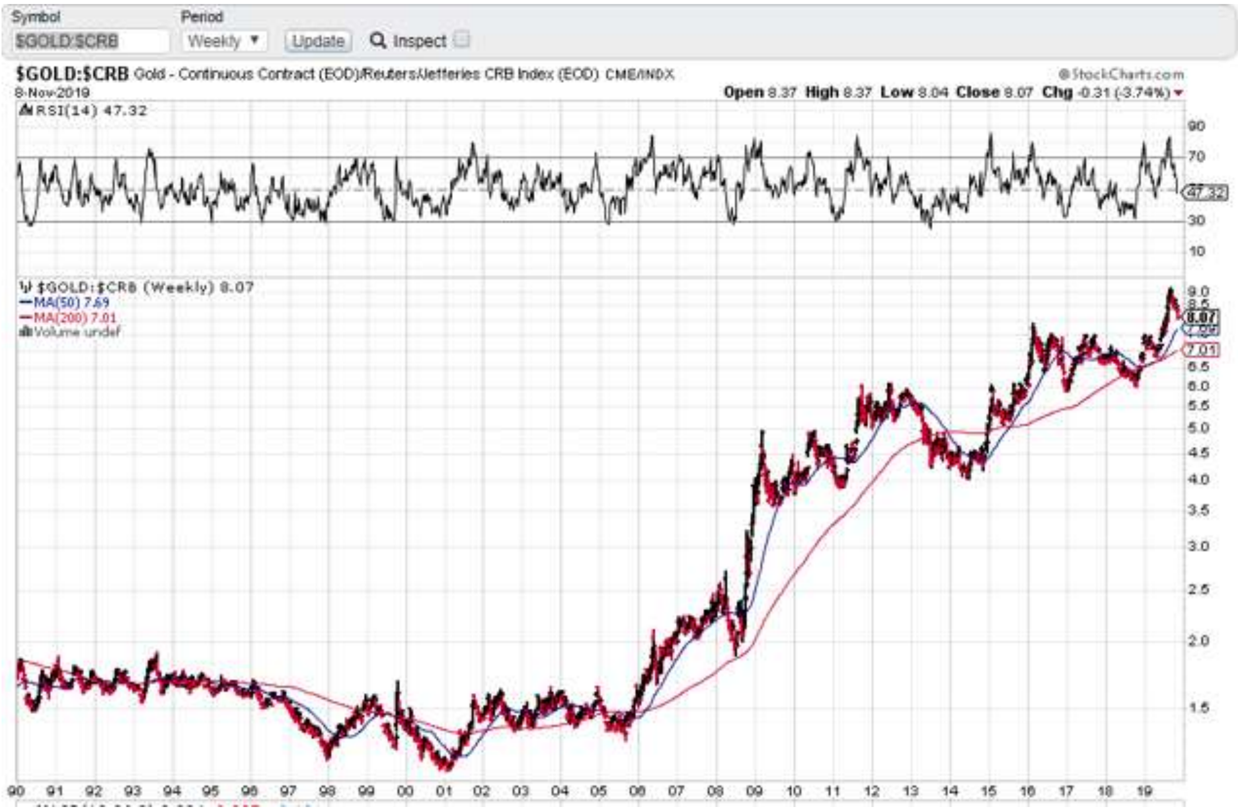
Real Estate in general appreciates alongside inflation. There are many reasons for this. Firstly, since nobody is building any more "land", real estate goes up in value as the value of currencies decreases. The second reason is that inflation increases the replacement cost value of assets as higher labor and raw materials are required to build similar assets. Third, rents are exceptionally well tied to inflation. Many triple net lease REITs ... actually use the official CPI measure in their annual rent adjustments for tenants.

At the same time, REITs use leverage and that leverage requires debt and interest payments. To the extent interest rates rise with inflation, it can dampen the increases from higher rents. ...

Inflation is already here

Unlike what the media is telling you, inflation is already here and quite robust. Should the economy dodge a recession, which is our base case today, we believe even higher inflation lies ahead. This is the time to look for hedges and find the right investments that will create a buffer over time. Broadly speaking though, most REITs are expensive today and most deserve a little correction before we would even wade into the waters. ...

Gold on the other hand is a speculative asset class and one that has long periods of underperformance. The constant storage and insurance costs are a further drain and it produces no income. Even if your heart is set on holding some direct commodities, we would recommend looking outside of Gold as it continues to be incredibly expensive versus every other commodity out there.



Our thoughts

Unexpected inflation is especially deadly for growth stocks. From Investopedia:

Inflation's Impact on Stock Returns

By KRISTINA ZUCCHI Updated Jan 13, 2020

Growth vs. Value Stock Performance and Inflation

Stocks are often broken down into subcategories of value and growth. Value stocks have strong current cash flows that will slow over time, while growth stocks have little or no cash flow today, but are expected to gradually increase over time.

Therefore, when valuing stocks using the discounted cash flow method, in times of rising interest rates, growth stocks are negatively impacted far more than value stocks. Since interest rates are usually increased to combat high inflation, the corollary is that in times of high inflation, growth stocks will be more negatively impacted. This suggests a positive correlation between inflation and the return on value stocks and a negative one for growth stocks.

Interestingly, the rate of change in inflation does not impact the returns of value versus growth stocks as much as the absolute level. The thought is that investors may overshoot their future growth expectations and upwardly misprice growth stocks. In other words, investors fail to recognize when growth stocks become value stocks, and the downward impact on growth stocks is harsh.

Income-Generating Stocks and Inflation

When inflation increases, purchasing power declines, and each dollar can buy fewer goods and services. For investors interested in income-generating stocks, or stocks that pay dividends, the impact of high inflation makes these stocks less attractive than during low inflation, since dividends tend to not keep up with inflation levels. In addition to lowering purchasing power, the taxation on dividends causes a double-negative effect. Despite not keeping up with inflation and taxation levels, dividend-yielding stocks do provide a partial hedge against inflation.

Similar to the way interest rates impact the price of bonds—when rates rise, bond prices fall—dividend-paying stocks are affected by inflation: When inflation is on the upswing, income stock prices generally decline. So owning dividend-paying stocks in times of increasing inflation usually means the stock prices will decrease. But investors looking to take positions in dividend-yielding stocks are allowed to buy them cheap when inflation is rising, providing attractive entry points.

The Bottom Line

Investors try to anticipate the factors that impact portfolio performance and make decisions based on their expectations. Inflation is one of those factors that affect a portfolio. In theory, stocks should provide some hedge against inflation, because a company’s revenues and profits should grow at the same rate as inflation, after a period of adjustment. However, inflation’s varying impact on stocks confuses the decision to trade positions already held or to take new positions. In the U.S. market, the historical proof is noisy, but it does show a correlation to high inflation and lower returns for the overall market in most periods.

When stocks are divided into growth and value categories, the evidence is clearer that value stocks perform better in high inflation periods and growth stocks perform better during low inflation. ...