May 29, 2018

Inflation Inflection Point

No Time to Be Complacent

Economic books define "inflation" as a broad increase in the prices of goods and services. However, one's opinion about what "inflation" truly is depends on their generation and personal experience. In the U.S., Americans from the G.I. and Silent Generation (1900-1945) remember consumer prices rising more than 20% per year. The impact of two World Wars, 10 recessions (between 1900-1945) and a "Great Depression" resulted in price controls, rationing of food and resources, excessive government spending and unpredictable monetary policy. Baby Boomers and Generation Xers (1946-1979) lived through a period labeled as "Great Inflation" when prices soared in the 70's and early 80's. The lingering effects of the Vietnam War, surging oil prices, fiscal and monetary irresponsibility, wage and price controls and the end of the gold standard contributed to the worst inflation period in the post WWII era. However, it was policy makers that were still learning from the mistakes made at the turn of the century, trying to balance their dual mandate (i.e. full employment with price stability) and facing intense pressure from government officials that made detrimental mistakes which nearly collapsed the U.S. economy. In fact, well renowned author and Wharton Business School Professor, Jeremy Siegal, called it "the greatest failure of American macroeconomic policy in the postwar period."[1] Jump forward to another inflection point in the U.S. economy where interest rates and inflation are rising from historic lows, the Federal Reserve is unwinding a massive balance sheet, tightening monetary policy and the Federal Government is increasing stimulus. As a result, there have been multiple opinions that the actions taken over the past 10 years to support the economy may eventually lead us towards grievous inflation. However, in this publication we would like to address the fears by delving into the current inflation environment, outline how this environment is different than past periods of "hyper" or "Great Inflation" and discuss ways that investors can protect their portfolios as the U.S. economy faces a higher but more normal rate of inflation.

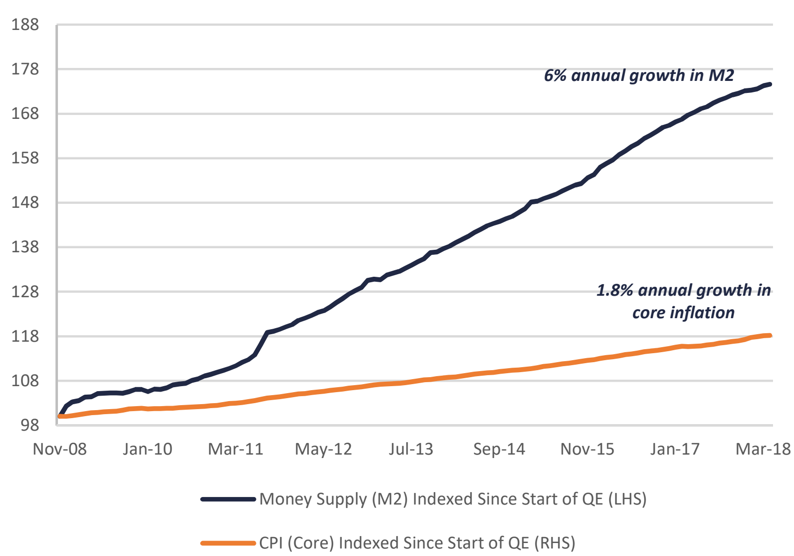
Current Environment: Stubbornly Low

There are several different ways to measure the level of prices in the American economy. The Federal Reserve prefers the Personal Consumption Expenditures Index (PCE) but investors likely hear more references to the Consumer Price Index (CPI). Both Indices are highly correlated, but the weightings of the underlying products differ. For example, the CPI is more weighted in shelter while the PCE Index is more skewed towards healthcare.

Both indices show inflation has been stubbornly low in the current expansion, especially given the length of the cycle, the massive monetary and fiscal stimulus and unemployment near an 18-year low. In fact, when looking at the money supply in the U.S. (M2), its growth has substantially exceeded the growth in inflation since the Federal Reserve started its first quantitative easing program (2008).[2] **(Chart 1)**.

Chart 1: Growth in Money Supply Not Translating into Inflation

Data is monthly and the time period reflects November 2008 to April 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



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The persistently low level of inflation can be explained by several factors:

- The economic recovery is one of the longest since the Great Depression but also the slowest in terms of magnitude which does not allow corporations the luxury of raising prices.
- While the unemployment rate is at an 18-year low, there is still slack in the labor market as seen by the labor force participation rate near the lowest level since the 1970's.
- Structural changes in the U.S. economy including technology, the sharing economy (e.g. Airbnb, Uber) and aging demographics have kept price increases limited.
- Globalization continues to be a factor as competition and cheap labor dynamics ultimately keep prices contained.

However, it is also important to note that not all inflation is created equal and that structural changes (e.g. disruptors, technology) in many areas of the economy may be artificially depressing the overall inflation picture. For example, the price of televisions has fallen nearly 80% since 2010, the price of computers is down 48% and the cost of a cell phone is down 25%. However, items that are mandatory and often regular purchases for Americans have increased at a discouraging pace (e.g. shelter +23%, child care costs +25%, college tuition +34%, medicine +25% and doctor visits +28%).

It is important to remember that not all inflation should be feared. In fact, a moderate level of inflation is good for an economy as it should translate into better wages, higher corporate earnings, a predictable interest rate environment and a healthy pace of economic growth. At Verdence, we see the current environment as an inflection point where the abnormally low level of inflation is behind us and inflation should move to more normal levels. **(Chart 3).** There are several leading indicators that suggest inflation is on its way higher:

- Wage pressures are brewing.
- Broad commodities are rising.
- Consumer inflation expectations are rising.
- Slack in labor market is fading.
- Fiscal stimulus.
- Above trend economic growth.

Chart 2: Not all Inflation Created Equal

Data is monthly and is indexed from December 2009 to April 2018.
Source: Bloomberg Finance LP, Bureau of Labor Statistics, Verdence Capital Advisors.

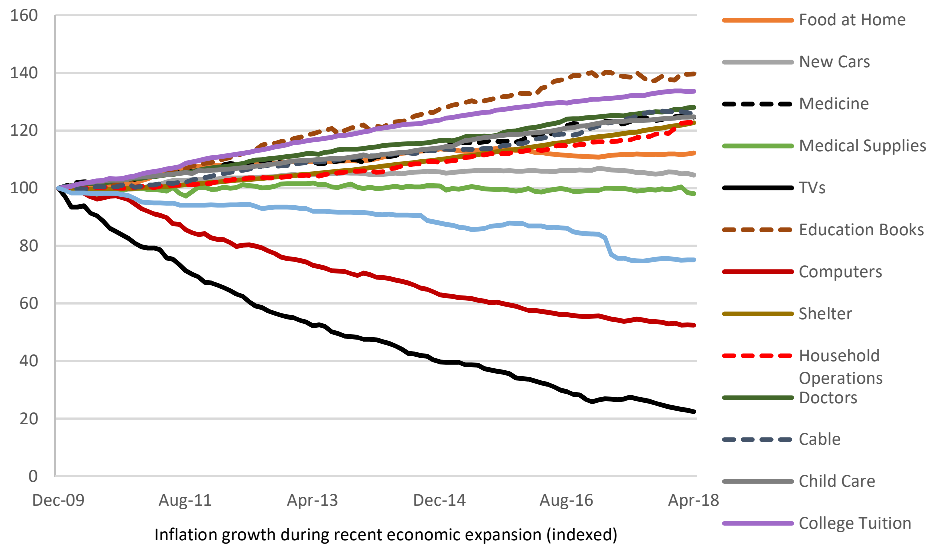
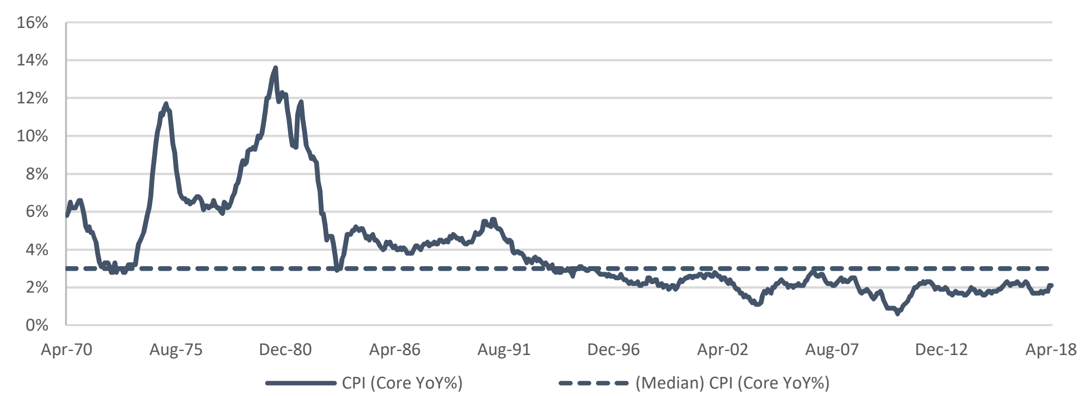


Chart 3: Expect a More Normal Inflation Environment

Data is as of April 2018. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Is this Time Different?

The current level of economic growth, unemployment and fiscal spending do not support the low level of inflation we have enjoyed for the past 10 years. However, we do not foresee a "hyper" or "Great Inflation" environment like those that have plagued the U.S. economy in the past for the following reasons:

- **Fed has tools in its tool shed:** The real Fed Funds rate is flat. **(Chart 4)**. As a result, the Fed has plenty of tools including a more aggressive reduction in their balance sheet or rate hikes if inflation runs rampant. This is different than history when monetary policy error and lack of flexibility fueled inflation.
- **Stable U.S. dollar:** Currency devaluation is one quick way to spur dangerous inflation. When the U.S. government abandoned the gold standard (1971), it invoked volatility in the dollar, spooked international investors, sent the dollar plunging and inflation soaring. However, with growth accelerating, the world entwined in global trade and dependent on the dollar (~60% of global FX reserves are in USD), devaluation now is unnecessary and unlikely.
- **No economic calamity on horizon:** War has been a historical driver of "hyper" inflation as it has resulted in massive government stimulus and haphazard expansion in the money supply. Despite the ongoing geopolitical risks, we do not expect a major economic calamity like war.
- **Policy error:** The parallels drawn between the Fed's actions taken in the past 10 years and prior times of "money printing" may be a misperception. It is important to understand "QE."[3] "QE" is not a program where the Treasury turns on the printing press and actual cash falls from the sky. The Fed buys bonds from banks and in exchange gives them additional reserves at the Federal Reserve. It is more like adjusting a ledger than creating cash. Those reserves sit at the Federal Reserve until the bank is willing to lend them. If they lent all the reserves, then inflation could become problematic. However, regulatory headwinds, risk-return trade-offs and lingering fears about leverage (after 2007-2009 Great Recession) have kept this from happening. In fact, demand for commercial and industrial loans continues to move lower and is now basically non-existent. **(Chart 5).** In addition, it is unlikely to accelerate significantly at this stage of the economic cycle (late cycle). This differs from the drastic expansion of credit in the 1920's which fueled inflation and ultimately led to the "Great Depression."

Chart 4: Fed Has Many Tools in its Tool Shed

Data as of April 2018. Real Fed Funds Rate uses core PCE (YOY) as of March 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

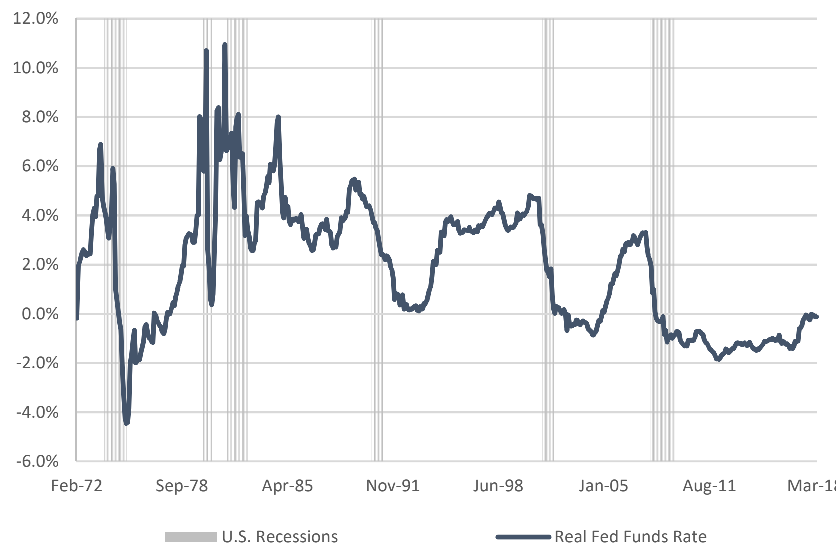
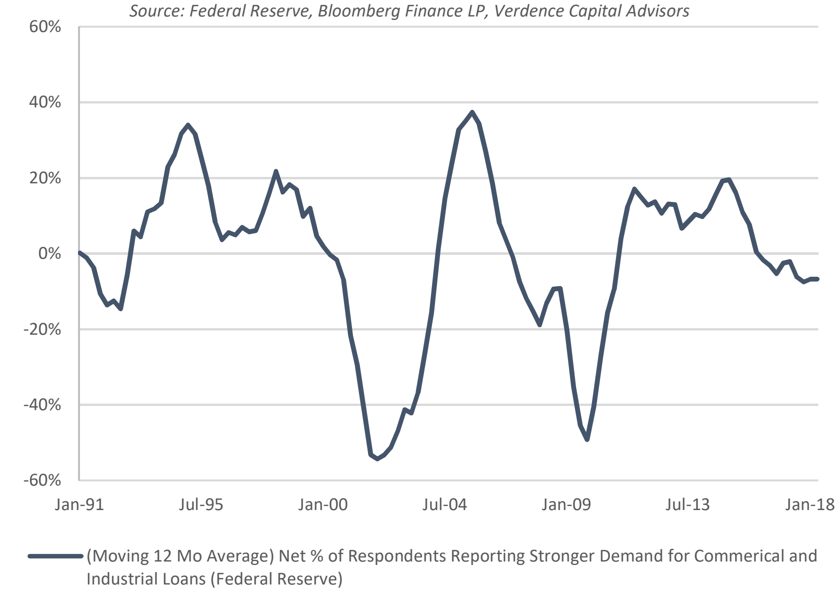


Chart 5: Loan Demand Remains Lackluster

Data is as of April 2018.
Source: Federal Reserve, Bloomberg Finance LP, Verdence Capital Advisors



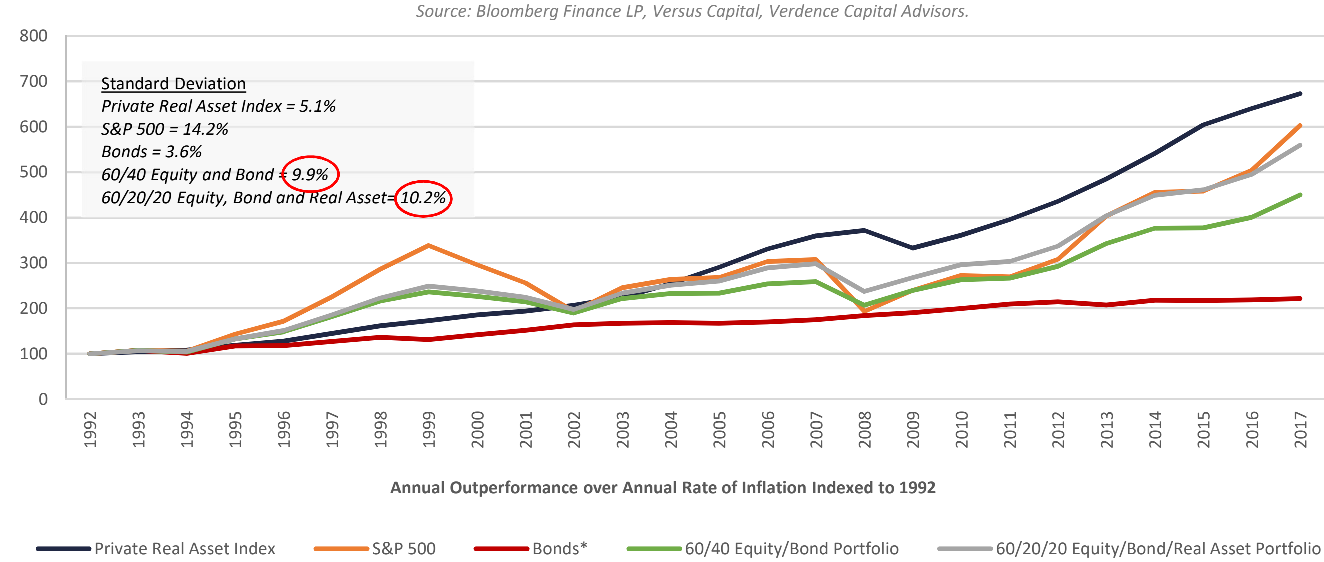
Verdence Recommends:

As an investor, it is important to understand the negative effects that inflation can have on your portfolio. If your portfolio return does not keep up with the rate of inflation than you are left with a negative real rate of return. This is especially important for retirees that are relying on income from their investments to keep pace with inflation. While we have detailed the reasons why we do not see an early 1900s or 1970-80s inflationary environment, investors should always be positioned to protect their portfolios from even a gradual move higher in inflation. It is important to have exposure to traditional and nontraditional assets that may not only offer an inflation hedge but also add an additional layer of diversification. We suggest the following actions that may protect portfolios from inflation:

- **Defensive in fixed income:** While fixed income is an integral part of a broad asset allocation, bonds and inflation are like oil and water. Since traditional bonds pay a fixed coupon rate, as inflation increases, it erodes the purchasing power of your fixed interest payments. In a period of rising inflation, investors should be underweight fixed income and primarily focus on short duration and floating rate bonds. Be careful of the misconception that traditional Treasury Inflation Protected Securities will hedge your portfolio against inflation. These products carry an underlying real interest rate that is sensitive to moves in nominal rates and investors may experience price depreciation given the low level of nominal yields.
- **Equities should rise with inflation:** As long as inflation is rising for the right reasons (better economic growth as opposed to a supply shock), equities have traditionally been viewed as an inflation hedge. Ideally, companies should be able to pass the higher prices onto consumers, therefore boost earnings and ultimately push stock prices higher. However, it is also important to remember that many equity styles and sectors are overvalued, and active management is important to find value. Within equities, those sectors that have high dividend yields (e.g. utilities, telecom) may be hampered by rising rates. However, there is value in stocks that have proven to consistently raise their dividend. A company that is increasing its dividend is more important than a company that trades with just a high dividend yield as an increase in the dividend may help to keep pace with inflation. Active managers can help to search out the best value in dividend stocks. Small and mid-cap stocks tend to outperform large caps in periods of rising inflation. Large companies have a harder time passing on higher prices than smaller companies, therefore margins come under pressure.
- **Real assets**: Real assets are a broad category and are investments that are tangible and physical. These investments include but are not limited to, commodities, real estate, land, timber and infrastructure and have historically outpaced inflation. In addition, they have traditionally been uncorrelated to traditional equity, so they add another layer of diversification for investors. These products are offered in both the public and private markets. **Chart 6** shows that over time a portfolio that incorporates real assets into its overall allocation has outpaced inflation at a more rapid pace than a portfolio in only stocks and bonds and has only had to take on minimal additional risk.

Chart 6: How Different Investments and Blended Portfolios Outperform Inflation

*Data is yearly and as of 2017. *Bonds is the Bloomberg Barclays Aggregate Index, Standard deviations are as of 1992-2017.*
Source: Bloomberg Finance LP, Versus Capital, Verdence Capital Advisors.



[1] *Jeremy Siegal, Stocks for the Long Run: A Guide for Long Term Growth."*
[2] *M2 money supply includes cash and checking deposits, as well as money markets, mutual funds, time deposits and savings deposits.*
[3] *QE stands for quantitative easing.*

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