MARKET MONITOR

ROYAL ASSET MANAGERS, LLC FEBRUARY 2022 VOLUME XVII ISSUE 1

In the Long Run Stocks are Good Inflation Hedges

BY: MICHAEL ALEXENKO, CFA

Financial advisors preach that you have to invest in stocks for the long run because they provide the capital growth necessary to offset the diminished purchasing power caused by inflation. This instruction perhaps has us scratching our heads right about now, because everything that we are witnessing is that inflation is hammering stocks. So, who is right? The financial advisor or the skeptical client who sees the value of her portfolio shrinking while listening to the advisor seemingly contradicting himself with the explanation that "it's a result of inflation"? Well, while they are both correct, the advisor may have the better answer.

When you carefully listen to economists, they often refer to economic results as "in the long run," and financial advisors borrow this concept when they talk about expected investment performance. If you reread the first sentence of this article, you'll notice the use of the phrase, *the long run,* and it is the lynchpin when it comes to the benefit of owning stocks to defeat inflation. Since 1926, inflation in the United States has averaged 2.91% and stocks have had an average rate of return of just over 10%. This simple proof has been backed by simple math for nearly a century, and stocks have dominated inflation by building purchasing power.

Nevertheless, "the long run" results may not offer the most comforting news to us when we are losing money in the here and now. No one knew this better than the erudite economist, John Maynard Keynes who said, "*in the long run we will all be dead*." This famous quote from Keynes surely resonated with those who lived through the 1970s inflation period. A time from 1973-79 when inflation averaged an annual rate of 8.21%, and stocks offered marginal relief with average returns of 5.39%. Finally, in the 1980s we emerged from a dreary period that felt like a lifetime of suffering for most investors.

For those who lived through that period of inflation and low economic growth, which became known as stagflation, the concerns regarding the risks of falling back into another gloomy intermediate phase of inflation and a slow economy are understandable.

As we navigate this predicament, knowledge is power. We know that the Federal Reserve increased its balance sheet by over $5.2 trillion from March 2020 to January 2022. We also know that over the same period of time the Federal Government added $5.4 trillion over its normal spending to combat Covid. Added to the loose monetary policy of the Federal Reserve and the profligate government spending, leaders decided it was best to pay people more not to work rather than incentivize them by paying them more to work to help keep an economy going. This is what would be known to economists as exacerbating two types of inflation at the same time.

This has created an environment where we are unlucky to be dealing with two types of inflation. The first is called *demand pull.* Demand pull inflation has much to do with a popular definition of inflation that says inflation happens when there is too much money chasing too few goods. If all other factors are held constant in an economy (which is a fantasy economists like to use to get their models to work), then when you flood an economy with expansionary monetary policy that balloons a nation's money supply you end up with more cash, with the same amount of goods to purchase and a classic form of demand pull inflation ensues.

The second type of inflation is known as *cost push.* Cost push inflation can come from a natural disaster like an earthquake, hurricane or you guessed it, a pandemic. Cost push is associated with a shock to supply chains that comes about when things like natural disasters occur and it's difficult to continue to produce things because production capacity gets damaged and shuts down. Another contributor to cost push inflation is government policy that causes expenses for businesses to go up, forcing them to charge more for the products they supply. Under the current situation, we have an impaired labor market because of the pandemic, plus we experienced a de facto increase in the minimum wage because the government paid people to sit on the sidelines which forced employers to pay them more to come back to work. Under present conditions two powerful forces are concurrently agitating cost push inflation and we are regrettably seeing the results play out in real time.

Considering how these two distinct types of inflation occur, it's hard to ignore that that all of the necessary conditions currently exist in our economy to cause both types of inflation to happen simultaneously, which is exhibited in the hypothetical graph of supply and demand curves for the hot dog market.

This simple illustration is a good proxy for prevailing market circumstances in the restaurant industry. Demand is high

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Forces Are in Motion to Push Down Inflation

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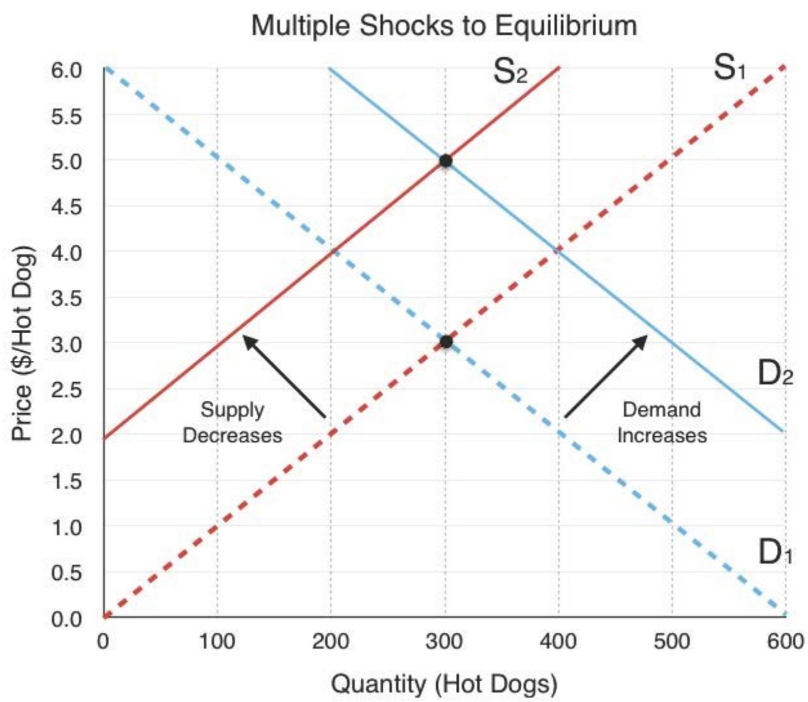
because people have cash to spend, but wages for workers and the cost of food, especially meat, have gone up because supplies are short. You'll notice how a drop in supply and an increase in demand forces the most undesirable change in a market by increasing the equilibrium price to the maximum level of $5 from what was $3.

Even though it doesn't feel like it, good news is on the way – but in the long run. To unwind the knot we have created, the Federal Reserve has begun to talk tough about reducing money supply which would lower demand pull inflation.

Furthermore, policymakers have hit a political logjam that is reducing their ability to continue to spend at high levels. Essentially, forces are in motion to push down inflation on both the supply and demand side. Until things move back to normal, in the long run, it's best to keep a diversified portfolio in place that helps to protect against shorter term inflationary pressures so you can enjoy defeating inflation in the long run.



Market Snapshot:

Inflation and Low Interest Rates are Two Taxes Worse for Savers Than Investors

By: Michael Alexenko, CFA

Just as there are economic factors causing two forms of inflation, there are also two concurrent forces hitting savers. These factors work like taxes to help governments finance debt, and to a lesser extent, investors to earn profits. The current environment is similar to the recovery from the financial crisis in 2009, when interest rates went down and stayed low for at least a decade, and some might argue until now. This was achieved by the Federal Reserve policy of buying government bonds to keep rates low and to inflate asset prices. Under this scenario it is savers who are hurt the most as they are unable to keep preferable bank deposits that pay a reasonable level of interest. Now, the same savers (assuming they have any cash left because they were forced to spend principal rather than interest payments in order to buy food) are being hit with 7% inflation and negative real interest rates.

It's hard to tell how long the "long run" will be to solve this imbalance, but, as the virus dwindles, we reduce our money supply and workers return to their jobs, we can then expect inflation to subside. This transition is creating headaches for stocks, but even though savers might have a longer road ahead, market investors should experience relief well before year end.

Publication courtesy of:

Royal Asset Managers, LLC

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