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Inflation, Purchasing Power, and Stock Market Returns

Why Equities Are a Good Defense Against Rising Consumer Prices

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Over the past year, inflation has taken center stage as the major economic issue facing us, and with good reason. For the three decades from 1990 to 2020 we had generally low inflation in the U.S., averaging 2.4% per year. We grew accustomed to that even as the Federal Reserve Bank repeatedly called for higher inflation which it considered necessary for healthy economic growth.

By comparison, swiftly rising inflation now seems alarming to us and, in fact, is a challenge in the near-term. Inflation effectively forces us to work harder in order to maintain the same purchasing power for our money. It throws our best laid plans for future spending into doubt, including spending during our retirement years. For serious investors, it begs the question, how should we invest for the long-term to stay ahead of inflation?

The nature and duration of inflation now has economists asking how high prices of goods and services will rise, and for how long? Will gasoline prices rise more than the 50% they have already risen from 2020 to late 2021? What about used car prices, will they rise more than the 37% they have already increased during the same period?

In truth, there is no consensus on how high inflation will rise or how long it will last. We can only speculate.

In a recent investment letter, I indicated that I was in the “transitory” camp on inflation, believing that many of the temporary supply chain issues we faced then, as now, contributed to rising prices. I still believe that.

However, what we have also seen since then is that wages are also rising and may be stickier. Unlike commodity or manufactured goods prices, once wage increases are granted, they are hard to take back. That is especially true in the current employment market where artificial labor shortages have been created by workers themselves. In many cases they have chosen to stay away from the labor market for a variety of well-documented reasons. These include fear of the pandemic, low wages, voluntary retirements, entrepreneurial endeavors, and government support payments, among others. According to the Bureau of Labor Statistics, there is now an excess of 7 million unemployed workers who have not returned to their pre-pandemic jobs, while at the

same time employers have 11 million job openings that need to be filled. In other words, workers now have the upper hand and can demand wage increases.

What we can say with a degree of certainty about inflation is that at least some percentage of the factors contributing to its recent rise, such as the supply and price of goods, is very likely to subside as international and domestic production capabilities and transport links inch toward normalcy over time. We have already seen this to some extent with two important commodities, lumber, the price of which has declined 40% from its recent peak, and iron ore, a key ingredient in the production of steel, for which the price has fallen by 45% after spiking last year.

Below is a table of the latest inflation figures from the Bureau of Labor Statistics. The numbers to the far right are the yearly increases to December 2021, the latest reading.

Table A. Percent changes in CPI for All Urban Consumers (CPI-U): U.S. city average

	Seasonally adjusted changes from preceding month							
	June 2021	July 2021	Aug. 2021	Sep. 2021	Oct. 2021	Nov. 2021	Dec. 2021	Un-adjusted 12-mos. ended Dec. 2021
All items..................	.9	.5	.3	.4	.9	.8	.5	7.0
Food......................	.8	.7	.4	.9	.9	.7	.5	6.3
Food at home.............	.8	.7	.4	1.2	1.0	.8	.4	6.5
Food away from home (1)..	.7	.8	.4	.5	.8	.6	.6	6.0
Energy....................	1.5	1.6	2.0	1.3	4.8	3.5	-.4	29.3
Energy commodities.......	2.6	2.3	2.7	1.3	6.2	5.9	-.6	48.9
Gasoline (all types)....	2.5	2.4	2.8	1.2	6.1	6.1	-.5	49.6
Fuel oil (1)............	2.9	.6	-2.1	3.9	12.3	3.5	-2.4	41.0
Energy services..........	.2	.8	1.1	1.2	3.0	.3	-.1	10.4
Electricity.............	-.3	.4	1.0	.8	1.8	.3	.3	6.3
Utility (piped) gas service..............	1.7	2.2	1.6	2.7	6.6	.6	-1.2	24.1
All items less food and energy.................	.9	.3	.1	.2	.6	.5	.6	5.5
Commodities less food and energy commodities....	2.2	.5	.3	.2	1.0	.9	1.2	10.7
New vehicles............	2.0	1.7	1.2	1.3	1.4	1.1	1.0	11.8
Used cars and trucks....	10.5	.2	-1.5	-.7	2.5	2.5	3.5	37.3
Apparel.................	.7	.0	.4	-1.1	.0	1.3	1.7	5.8
Medical care commodities (1)......	-.4	.2	-.2	.3	.6	.1	.0	.4
Services less energy services..............	.4	.3	.0	.2	.4	.4	.3	3.7
Shelter.................	.5	.4	.2	.4	.5	.5	.4	4.1
Transportation services	1.5	-1.1	-2.3	-.5	.4	.7	-.3	4.2
Medical care services...	.0	.3	.3	-.1	.5	.3	.3	2.5

1 Not seasonally adjusted.

Sustained Inflation Erodes Purchasing Power

A 1950s American musical may seem an odd place to look for clues about inflation and its effects on purchasing power, yet this pop culture comparison shows how dramatically things have changed in less than a lifetime, and why having investments that stay ahead of inflation matters.

In the iconic 1957 movie, The Pajama Game, unionized workers on strike at a pajama factory are offered a 7½ cent an hour pay increase to settle their labor dispute with management. At first the workers scoff at the deal, complaining that "7½ cents doesn't buy a heck of a lot! 7½ cents doesn't mean a thing!"

But when union leaders point out that the accumulated wealth from a few pennies per hour can eventually allow workers to afford some of the middle class luxuries of the day, their scoffing turns to jubilation.

The leaders highlight that after 5 years, those hourly 7½ cents, with overtime, grow to $852.74, allowing workers to afford an automatic washing machine, carpeting for the living room, a year's supply of gasoline, a vacuum cleaner, and a 40 inch television set. And after 10 years, their accumulated $1,705.48 allows each worker to buy a trip to France "across the seas", a foreign car, a motor boat, water skis, and a ping pong set with paddles made of gold.

At a time when the average hourly wage in America was just $0.75, a 7½ cent pay rise could have made all of that possible.

Today, only a fraction of those 1950s middle class "luxuries" can be bought with those 5 and 10 year sums. Since 1957 inflation has eroded purchasing power by a total of 889%, or an average of approximately 3.5% per year, meaning that the same worker today would need to earn about $7.50 per hour to have the same purchasing power. By contrast, in the last year alone purchasing power has declined by 7% year-over-year, or double the average rate of the past 64 years. It is no wonder then that consumers have recently felt the effects of inflation more keenly than they have for decades, and why investors are now seeking viable strategies to counter inflation's effects in their portfolios.

Stocks as an Asset Class are Well Suited for Inflation

As odd as it may sound, inflation is actually a normal component of stock market returns. When CEOs talk about their companies' ability to raise prices on their products and services, they are really saying they have the power to create some degree of inflation that benefits their companies and their shareholders. That ability is seen as a positive by Wall Street. Every stock represents a company, and most companies have the ability to raise their prices to their customers over time. If they can't, they eventually go out of business.

A company's ability to raise prices is especially possible during a relatively tame period of inflation such as the one we have had for the past three decades. In that time, inflation has averaged about 2.4% per year. Price increases are less noticeable to consumers in periods of low inflation than high. If, for example, a hamburger has been selling for $3.50 and its price is increased to

$3.58, a 2.4% increase, the effect is barely noticed by consumers. But if the price rises from $3.50 to $3.75 in a 7% inflationary environment, then the difference is more noticeable. This is what we are experiencing now.

By comparison, bonds and other fixed income securities are unable to cope with inflation as effectively. Their coupon rates and interest payments tend to be fixed. The corporations, municipalities, agencies, and governments that issue them, are committed to paying only the contractual amounts in principal and interest, and no more. These are, at the end of the day, debt instruments and no one wishes to pay more on debt than is necessary.

Treasury Inflation Protected Securities, or TIPS, are often mentioned as a solution for the usual lack of flexibility that characterizes traditional bonds. The returns on TIPS are pegged to the general rate of consumer inflation in the economy. While they are better suited to deal with inflation than traditional bonds, TIPS do experience short-term volatility like stocks, making them a type of hybrid that is neither truly bond, nor truly stock.

Their long-term performance relative to stocks is not attractive. Since the start of the current equity bull market in 2009, TIPS have underperformed the U.S. stock market by 11.6 percentage points per year, on average, with stocks being up +16.67% annually over that time span, and TIPS moving higher by +5.04% annually. Since the end of 2019, just prior to the start of the pandemic, TIPS have underperformed stocks by 17.5 percentage points, with stocks being up +25.59% annually versus +8.06% for TIPS. Perhaps this is not an entirely fair comparison - it is comparing bond apples and stock oranges. But if your concern is getting enough metaphorical vitamin C protection against inflation, then it makes sense to say oranges have more of it than apples.

Other major asset classes such as government bonds, gold, and the U.S. dollar are also less effective at countering the effects of inflation. They may keep up with it over time, but are not likely to exceed it by any meaningful degree. According to Jeremy Siegel, professor emeritus of finance at the Wharton School, over the past 200+ years treasuries have delivered after-inflation returns of +3.6% per year, while gold has given us +0.7% per year, and the U.S. dollar has declined -1.4% annually. If the goal of long-term investing is to stay well ahead of inflation so that purchasing power increases over time and wealth is created, these assets are typically not sufficient for that goal.

Beyond the merits of stocks as an inflation hedge, and the current debate about inflation, last month the Federal Reserve indicated that over the course of 2022 they will be tapering asset purchases and initiating interest rate increases to tamp down inflation. The Fed said that they may enact as many as three interest rate hikes during the year, while tapering asset purchases at the same time. These two measures would effectively reduce the rate of inflation by making borrowing more expensive, while simultaneously draining a portion of the money supply from the economy.

It is conceivable that in a year’s time rising inflation will no longer be an issue for either consumers or investors. We will have to wait and see.

The Benefits of Individual Stock Investing, Beyond Inflation

Increasingly, what sets Waterstone's approach to investment management apart is the use of individual stocks to construct diversified portfolios. According to Cerulli & Associates, a Boston-based consulting firm, 90% of investment advisors in 2010 used individual stocks to create portfolios for their clients. By 2019 that figure had fallen to 69%, with further declines expected in the years ahead. Individual stocks had been replaced by mutual funds and exchange traded funds (ETFs).

From the establishment of the first stock exchange in Amsterdam in 1611 until about the 1980s, individual stock selection was the norm for portfolio construction wherever stock markets existed. The widespread adoption of mutual fund investing in the late 20th century changed that. Mutual funds promised "instant" diversification and "easy" choices, especially for do-it-yourself (DIY) investors, and successfully delivered those features.

In the U.S. the proliferation of mutual funds was mostly a reaction by the investment industry to the increasing adoption of 401Ks and IRAs as primary retirement accounts for workers. National legislation allowing employers to offload their traditional defined-benefit pension management responsibilities onto their employees meant that employees now had to shoulder the burden of managing their own investments for their golden years. Not being investment experts, many employees turned to the growing array of mutual funds to populate their portfolios. For these newly-minted DIY investors, plug-and-play mutual funds made it relatively easier to construct a viable portfolio than more research-intensive individual stocks.

Yet, individual stocks have distinct advantages wherein they:

- Allow a degree of customization that mutual funds or their more recent offspring, exchange traded funds, often do not allow.

- Offer transparency by immediately permitting investors to know exactly what they own. There is no duplication of holdings as there might be when multiple mutual funds or ETFs hold some of the same underlying stocks.

- Reduce risk by allowing investors to pick the best companies for their needs and risk levels - by contrast a mutual fund that is based on the S&P 500, for example, will own *all* the underlying stocks in the S&P 500 Index, *including* those that are poor performers. This naturally increases the risk level of the mutual fund and potentially places a drag on performance.

- Allow investors to avoid a company that may not fit their ethical or religious views, and

- Have no underlying management fees as mutual funds and ETFs have – this allows investors to keep more of their gains over time and avoids a drag on the performance of their portfolios.

"Right-sizing" Investor Expectations

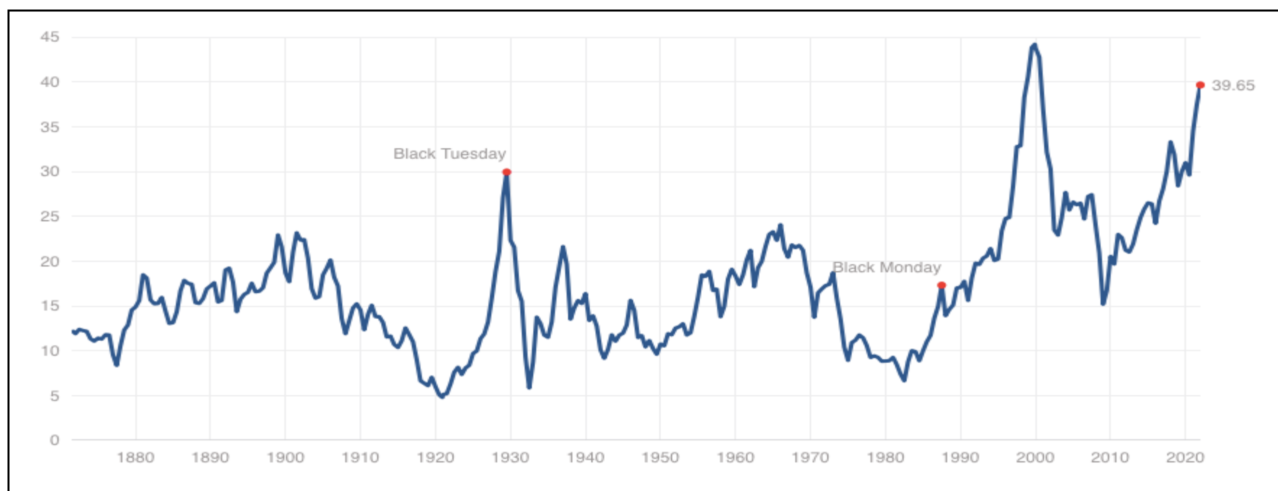
Jeremy Siegel notes that since 1802 the U.S. stock market has produced a 7% after-inflation return per year. In effect, that is the stock market's "natural" rate of return over a very long time.

The implication of that for investors is noteworthy. It means that with a conservative long term buy and hold strategy, at a steady after-inflation 7% annualized return, an all-stock portfolio can double in value in roughly 10 years. More ambitious and more aggressive portfolios that earn 9% per year, for example, can double in approximately 8 years. And at a much more robust 12% return per year, it would take an investor only about 6 years to double a portfolio. Similar results are possible with the skillful management of more diversified portfolios consisting of stocks, bonds, and other assets - those too can stay ahead of inflation with proper tending.

Keeping perspective on what is normal and possible even during times of inflation can be challenging especially bearing in mind that over the past 21 months, since the stock market hit its Covid pandemic low in March 2020, the S&P 500 has leapt by almost 114%. That translates to roughly 65% per year on an annualized basis. While few have complained about these returns, recent history has now skewed investor expectations to expect outsized returns as normal.

A recent survey by investment firm Natixis revealed that wealthy investors, which Natixis defines as anyone with $100,000 or more in investable assets, now expect to earn 17.5% *above* the rate of inflation well into the future. At the current 7% annualized rate of inflation, that translates into a 24.5% expected return, or several multiples of the historical averages. In other words, at least for now, investors have formed unreasonably high expectations which are detached from historical stock market realities, and which appear to ignore risk as an investment factor.

This mindset continues to be reflected to a great extent in the Shiller P/E ratio (chart below), a long-term valuation metric for the stock market, which continues to climb to multi-decade highs. As it does so, it increasingly warns of lower share prices ahead and of lower than normal returns in the future. If that in fact turns out to be the case, then our ability to stay ahead of inflation is at risk and must be watched with vigilance.



Good Investment Returns Rely on a Good Investment Recipe

Over my 30+ years analyzing securities and financial markets, building portfolios for both institutional and private clients, one thing has always struck me as being true, namely that there are as many ways to effectively manage a portfolio as there are good and effective portfolio managers. Each successful manager has a recipe that works.

As a light aside, I am reminded of my family's holiday in Greece a few years ago during which I resolved to try the local moussaka in every town we visited, from Athens to Corfu. I wanted to see and taste the differences and to determine which one was best. To my surprise, no two plates of moussaka were the same, yet each was delicious, and each was a testament to the skills and creativity of the professional cooks who made them.

My recipe for good portfolio returns involves a few key ingredients, some of which are behavioral. Patience is vital - without it we behave erratically and illogically. Perspective is also key - a photo of three grey dots may actually be a close-up of a much larger elephant. Mindfulness helps us to stay the course and to navigate the markets. Curiosity asks the all-important who/what/where/when/why/and how questions that lead to a deeper understanding of the catalysts that move stocks. Selectivity says "this stock fits my investment criteria and is therefore likely to do well in my portfolio." And strategy ties all of these together into actionable decisions.

Outpacing Inflation

At a time when rising inflation casts new challenges into our investment decisions, understanding that sustained inflation reduces purchasing power over time helps us to make more informed investment choices. Not all investments are well suited to tackle rising consumer prices and declining purchasing power. Stocks as an asset class, however, can be up to the task when selected carefully.

And while keeping up with inflation is a worthy and necessary goal that should be a part of every good investment plan, a simple lesson learned from a 1950s pop film serves as an enduring reminder that investing to outpace inflation is a better goal. Ultimately, exceeding inflation allows us to better afford the things we value most in our future, perhaps a comfortable retirement, a new home, education for our children, charitable giving, cultural projects, and even that timeless goal of a grand trip to France across the seas!

V. Henry Astarjian

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