Inflation

With the pandemic has come a higher rate of inflation. Expectations and realities each have centered on an inflation rate of about 2%. Indeed, this has been the target for monetary policy. But inflation now is running above 5% and current policy is based on this higher rate being transitory, i.e., it will not last long. If higher inflation remains higher longer, both daily living and investment portfolios could be impacted unfavorably, especially if monetary policy were to shift to higher interest rates. Consumer and investors certainly can and will adapt but at what cost in either standards of living or portfolio returns? A review of some important inflation characteristics can provide perspective for investing yet ahead.

PERSPECTIVE

A long view of inflation, as shown in Chart I, provides some perspective on the transitory nature of inflation. Since the early 1980s, inflation generally has ranged between 0% and 5% with a slight downward trend. Outright deflation (less than 0%) has been rare in recent decades and the volatility of inflation rates has moderated as well. While rates of inflation above 5% appear to have been more transitory than not, they can persist. And such persistence has brought changes in monetary policy more than not. No time horizon has been set for which a turn in inflation perception from transitory to intolerable would induce a policy response, but few doubt that a policy response would materialize.

A general relationship has prevailed between rates of inflation and investment market returns as seen in Table I. With respect to inflation ranges, deflation and high inflation (more than 5%) have occurred with lower but meaningful frequencies. Corresponding market returns generally were less favorable in either of these frequencies as well. However, it is important to note wide return variances have occurred within each frequency. Money market returns have moved higher with inflation although perhaps not keeping pace. Bond market and stock market returns have dropped meaningfully when inflation has reached a higher range. Sustained higher inflation from current low levels of interest rates and high levels of stock market valuations could bring challenges for subsequent market and portfolio returns.

Recent rates of inflation have varied widely across the broad range of household goods and services. Table II provides context for the possible impact on consumer and household behaviors. Individual household inflation reflects actual spending patterns versus the index weights. Whether at home or away, a non-meat diet has become relatively less expensive. Purchasing a used vehicle has became more expensive in part due to the chip shortage for new vehicles and the higher demand for vehicle transportation. Higher inflation and rate disparities would change consumer behavior with consumption either deferred or accelerated and substitutions more likely.

INVESTMENT IMPLICATIONS

Many factors contributed to the low rates of inflation in recent years including wage constraint from a global labor force, productivity advances from technology, and expanded supplies of commodities. Pandemic-induced supply and demand imbalances have contributed to the recent rise in inflation. While perhaps too early to call the inflation trend ahead, assessing the impact on both consumption patterns and future market returns is timely and appropriate.

CHART I

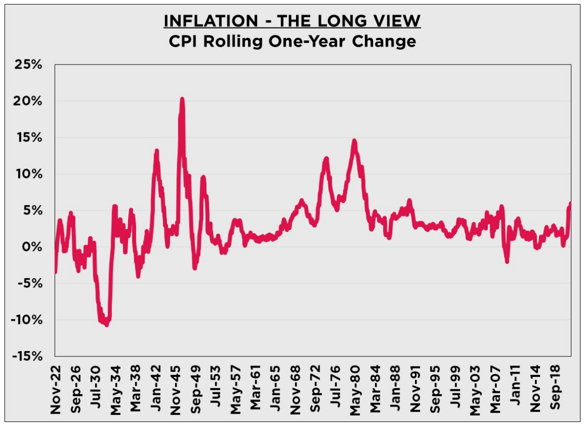

TABLE I

INFLATION & MARKET RETURNS*

INFLATION RANGE	INFLATION FREQUENCY (AVERAGE)	AVERAGE MONEY MARKET RETURN	AVERAGE BOND MARKET RETURN	AVERAGE STOCK MARKET RETURN
LESS THAN 0%	12% (-3.1%)	2.4%	4.6%	7.6%
0% TO 2%	28% (1.2%)	2.2%	5.0%	14.1%
2% TO 5%	40% (3.2%)	3.9%	6.8%	15.0%
MORE THAN 5%	20% (8.6%)	5.6%	4.8%	8.3%

*Rolling One-Year Periods 1922-2021

TABLE II

INFLATION & BEHAVIOR*

CATEGORY	INFLATION RATE	INDEX WEIGHT
TOTAL CONSUMER PRICE INDEX	5.4%	100%
FOOD - HOME	4.5%	8%
FOOD - AWAY	4.7%	2%
MEAT, POULTRY, FISH & EGGS	10.5%	2%
FRUITS & VEGETABLES	3.0%	1%
RESIDENCE - OWN	2.9%	24%
RESIDENCE - RENT	2.4%	8%
ENERGY	24.8%	7%
VEHICLES - NEW	8.7%	4%
VEHICLES - USED	24.4%	3%

*Twelve Months Ended September 2021