What's Left

Investor goals include preserving capital, current income, growth and, for many investors, some combination of each. For all, outcomes are determined after taxes, after expenses and after inflation. Recent high inflation has challenged markets and investors. Higher inflation has combined with market losses across a broad range of asset classes and sector. As a result, losses in real terms, i.e., after inflation, have been exacerbated. Some relationships between nominal and real returns for important asset classes can provide perspective for investing ahead and what's left for investors after inflation.

PERSPECTIVE

Low inflation through much of the 2000s has been a benefit to most but not all investors. Those pursuing a primary goal of preserving capital were disadvantaged materially. Chart I shows decades-long trends in inflation and real returns for a one-year maturity, U.S. Treasury investment. The analysis is simplified by measuring one-year holding periods, i.e., the starting interest rate less the subsequent inflation yields the real return. The average such real return over the whole period was +1.2%. For much of the past twenty years, this "safe" investment resulted in a negative real return. Recent high inflation has pushed real returns to record negative levels. Even with a decline in inflation, preserving the real value of capital will remain a challenge without higher short-term interest rates.

Whether gold, oil or corn, commodities have been viewed as an alternative to traditional bond and stock investments, especially when inflation is high. Chart II shows real returns from a basket of commodities relative to inflation. The average real commodity return over the whole period was +1.6%. This average real return was marginally higher than that of one-year U.S. Treasuries but came with a significantly higher level of return volatility. While inflation has displayed more moderation in its movements, commodity trends have varied between longer periods of relatively favorable and unfavorable nominal and real return outcomes.

The impact of inflation on individual stock returns can vary widely depending on the company's ability to maintain profit margins through controlling input costs while advancing product prices. Chart III shows real returns for the total U.S. stock market relative to inflation. As with commodities, real stock returns vary widely but with many more periods of gain than loss. Over time, investing in the stock market has more than compensated for inflation with an average real return over the whole period of +8.9%. Periods of real losses tended to coincide not just with higher inflation but also with economic slowdowns or outright contractions that challenged corporate earnings growth.

CHART I

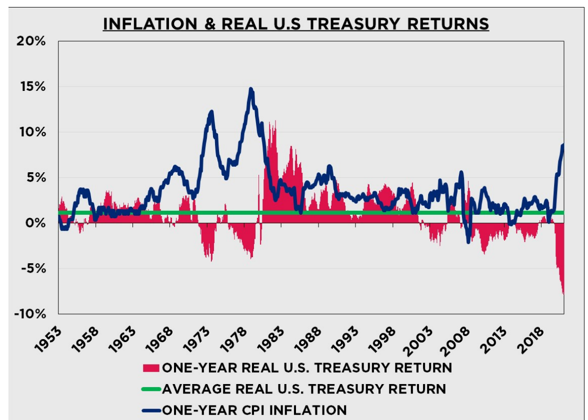


CHART II

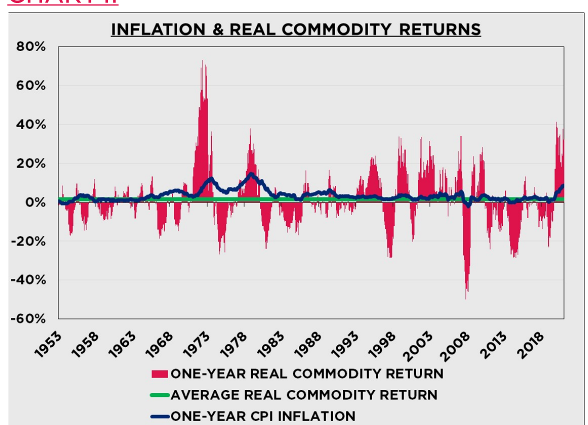
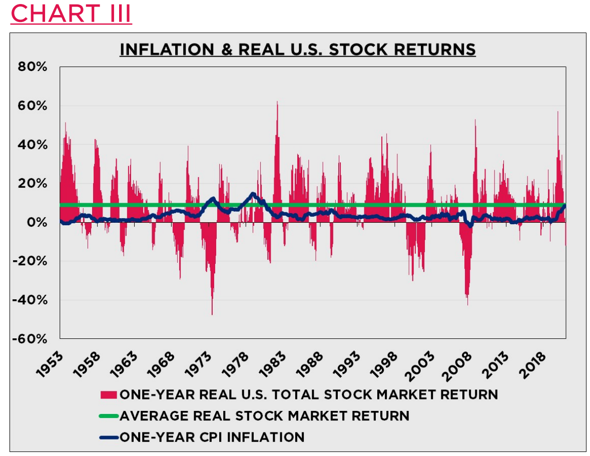


CHART III



INVESTMENT IMPLICATIONS

Achieving real returns amidst high inflation is challenging for many traditional and alternative investments. While some investments may have specific inflation-protection features, their own attractiveness and return potential turn on available prices at purchase. Recognition that lower inflation is a public policy priority is important although market supply/demand forces likely will govern outcomes. Over time, return and risk patterns from various assets will determine their proper portfolio allocation and what return is left for investors after inflation.