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A Guide That May Help You Hedge Against Inflation

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The Value of a Dollar

On the surface, a dollar bill is still worth $1. But during high-inflationary periods like we're in right now, the true value of money takes on new meaning. According to the U.S. Bureau of Labor Statistics, the Consumer Pricing Index jumped 9.1% from June 2021 to June 2022, which represents a significant drop in the purchasing power of that dollar bill.

Thanks to inflation, food, gas, and other essentials haven't been rising this quickly in price in 40 years. Add in an expanding monetary supply and a fiscal deficit — not to mention factors related to seasonality, deglobalization, labor shortages, and supply and demand — and the dent inflation has left on peoples' wallets and portfolios come into greater focus.

The question, then, is how to best protect yourself and your assets.

What Is Inflation?

Economists define inflation as the progressive rate increase in the price of goods and services over a given period of time. It can often be seen as a broad measure of the cost of living, but it can also refer to increases in the price of specific products or services. Perhaps food prices are going up at a faster rate than other goods, or construction costs aren't in line with rate increases seen in other service areas.

In general, inflation can signify that the buying power of the dollar is on the decline. For example, let's say an electronic toothbrush currently costs $100. At an inflation rate of 2%, that same product will cost $102 the following year, assuming the price increase and inflation rate stay aligned.

In fact, the current U.S. housing market and its skyrocketing prices aren't caused by inflation alone. While purchasing a home would've cost around $235,000 in 2017, a combination of lower interest rates, higher building costs, decreased building activity, and inventory shortages drove the price up to a median of $428,700 in the first quarter of 2022.

With homes being the most significant single investment most people make in their lives, it wouldn't be out of the question to wonder how inflation will impact other investments.

How Will Inflation Impact Investments?

By and large, inflation is generally harmful to investors in a different way than it is to consumers. However, its effect varies from one asset class to the next. If high and persistent, inflation can significantly impact many investment classes. Investing in a high-inflation environment, as experienced investors will tell you, can be difficult. It's actually one of the worst environments for investors. Inflation can result in sub-par returns for stocks and especially bonds.

For evidence, look back to the 1970s when Middle Eastern gas hubs tripled fuel prices for U.S. customers. As a result, inflation rates that began the decade at 6% doubled by 1974 and increased to 14% by 1980. Out of those historic highs came an S&P 500 that almost 40% between 1973 and 1974, and large-cap U.S. stocks generated a -1.4% inflation-adjusted annual return over the course of the 1970s. Even T-bills and Treasury bonds took a hit.

Those who diversified their portfolios in the 1970s with tangible assets like gold fared better than others. If you believe that this period will be similar to the 1970s, the timing is good for owning hard assets such as commodities, buildings, land, and the like. With paper assets (i.e., cash, bonds) and companies like banks that deal with them, investors should be much more discerning.

Why? Because inflation has a way of sticking around longer than consumers would like for many reasons, but these in particular:

1. Federal Reserve Policies: An increasing money supply can lead to a situation where too much money is chasing too few goods and services, resulting in persistent increases in the prices of those goods and services.

2. Energy Prices: Everything depends on energy. When oil prices rise, it causes the price of goods and services across the economy to rise with it. We are expecting energy prices to continue rising due to inadequate investment in production over the last 10 years.

3. Deglobalization: Just as globalization is deflationary as the production of goods moves to lower-cost countries, deglobalization is similarly inflationary. The cost of goods tends to increase as production is moved back to U.S. factories.

4. High Debt Levels: Consumer, government, and corporate debt remain at historically high levels. This situation encourages policymakers to pursue financially repressive, reflationary economic policies, which include allowing inflation to accelerate.

5. Deficit Spending and Stimulus Capital: The Federal deficit continues to rise as 10,000 Baby Boomers retire each day and begin collecting their Medicare and Social Security benefits. Also, deficits expand further when Congress passes economic stimulus programs that they hope will spur growth in the economy.

6. Rising Wages: Boomers are retiring in droves and their replacements, which are fewer in number, are asking for more to slide into those spots.

Investing in Common Asset Classes

Let's take a look at the investment landscape using a broad view that includes more than the "traditional" asset classes of equities, bonds, and money market instruments. Understanding the types of asset classes will be critical to selecting a mix of investment assets to reach your financial goals during a period when inflation is likely to remain high:

- **Gold:** History tells us that the price of gold increases when inflation is high and when inflation-adjusted interest rates are negative. During such periods, capital tends to flow into hard currencies which are likely to serve as a store of value, and gold is the hardest currency there is. During the inflationary 1970s, gold was the best-performing asset class.

- **Commodities:** Commodity prices tend to rise during inflationary periods when there is too much money chasing too few commodities. This is true for all commodities, but especially for energy and food-related ones. Commodities are currently quite inexpensive relative to the price of stocks. During an inflationary period, that relationship should reverse over time.

- **Real Estate:** Real estate can be a good hedge against inflation for many reasons. First, real estate is effectively a bundle of commodities — land, labor, lumber, steel, glass, etc. As prices rise for these inputs, so does the replacement cost of an existing building, providing a gradually rising price floor. Second, landlords can raise rents. Third, if a mortgage can be obtained at a fixed interest rate lower than the inflation rate, profits can be earned as revenues rise while debt-servicing costs remain fixed.

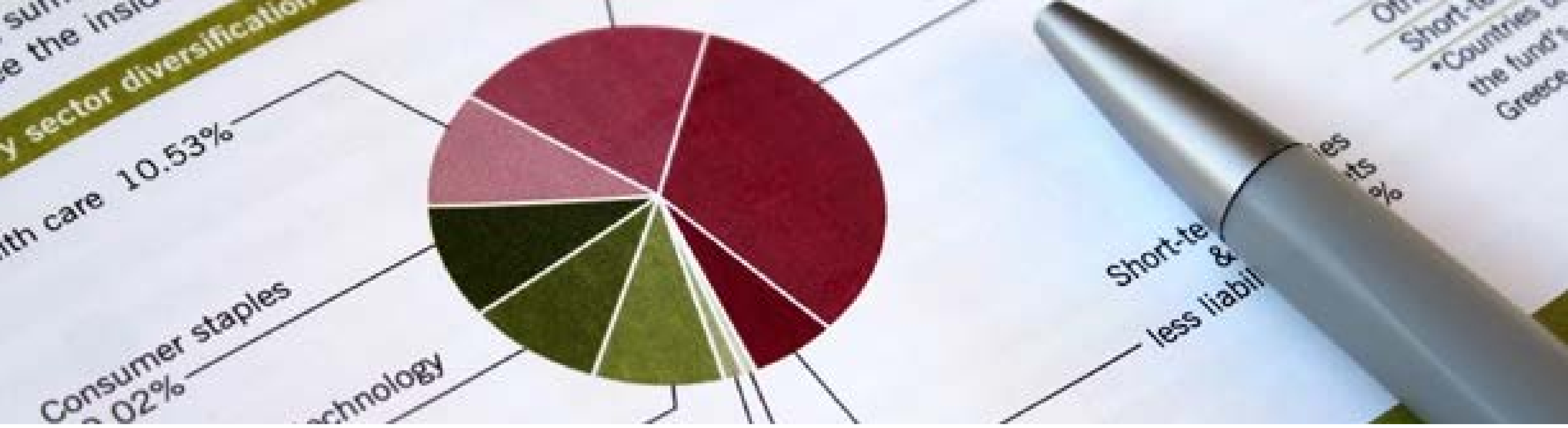
- **Stocks With Low Price-to-Earnings Ratios:** Price-to-earnings (P/E) ratios measure share price in relation to earnings per share. A high P/E ratio can mean investors must pay more for each dollar of earnings. The reverse would be true for low P/E ratios. The lower the P/E, the higher the possibility that your returns will increase from earnings growth and from an expansion in the P/E ratio. These "value" stocks are more likely to perform well when P/E ratios generally compress because inflation is high.

- **Foreign Stocks:** Though it should go without saying, it's a good reminder that the U.S. economy isn't the only economy. Not all will experience the same rise and fall as our market. If the dollar depreciates significantly against foreign currencies, international stocks, and especially emerging market stocks, foreign stocks are likely to outperform U.S. stocks. Countries that export commodities (such as Brazil and Australia) should perform especially well.

- **Growth Stocks:** Growth stocks enjoyed fantastic outperformance against a backdrop of declining commodity prices, globalization, low-interest rates, and disinflation. In an environment where commodity prices are rising, deglobalization is occurring, interest rates are rising, and inflation is accelerating, growth stocks are likely to underperform over the next decade as their P/E ratios compress to more reasonable levels.

- **Bonds:** When inflation rises, bond investors typically demand to be paid with higher interest rates. This doesn't bode well for bond returns, as bond prices must decline for interest rates to rise. Even without interest rates rising, the three-year Treasury bond currently is set to generate an annualized return of 3%. If inflation runs at 5% over the next three years, the real — or inflation-adjust — yield will be -2% annualized. That's a way to lose purchasing power. This is our least favorite asset class and will remain so as long as bond yields are lower than our expected inflation rate.

With additional inflationary periods likely, preparation could be key in determining the amount of risk you're willing to take with investments. Whether investing in more traditional asset classes or alternatives, a proactive approach can help balance a portfolio to fit your risk level and avoid costly mistakes.



Shielding Your Portfolio From Inflationary Periods

While the United States may already be in the midst of an inflationary period, certain strategies can better position your portfolio for such an environment. Certain asset classes offer better hedges against inflation, thereby protecting the purchasing power of your money. Before making any moves, however, do your research into the different asset classes. It's always wise to strategically determine the portion of your portfolio you're willing to allocate to each.

Advisors typically see diversification as a portfolio with 60/40 stocks/bonds breakdown. The theory is that when one does poorly, the other does well (and vice versa). Unfortunately, in an inflationary period, this strategy provides no shelter for investors. In 2022, for example, both stocks and bonds are declining in price.

In our view, diversification still has value, but the definition of diversification needs to be far broader. Owning alternative asset classes doesn't completely shield your portfolio from high inflation — but it should help.

Any one or combination of the following could prove beneficial in protecting your portfolio against inflation:

1. Own a meaningful position in gold and commodity producers.
By and large, both asset classes are likely to perform well in inflationary environments, with gold often seen as a reliable store of value for investors. Historically, this asset class has been known to outperform stocks when inflation is accelerating. As mentioned earlier, commodity prices usually rise with the rate of inflation. However, selecting the right commodity producers takes some skill, and the asset class itself is more volatile than other sectors of the stock market.

2. Increase allocation to international stocks.
While the dollar is still the world's reserve currency, it appears that Treasury bonds are no longer seen as a store of value by foreign central banks. We think the dollar is likely to depreciate vs. foreign currencies over the next decade. If we are correct, it will make sense to have a decent allocation to foreign stocks.

3. Own real estate with reasonable levels of leverage.
We would recommend a decent allocation to private real estate funds with reasonable levels of leverage. As an asset class, real estate tends to rise in price with inflation, and investing in real estate is especially attractive if it can be financed at rates of interest that are lower than the inflation rate.

4. Buy value stocks.
Unlike growth stocks, which tend to have elevated valuation ratios, value stocks generally have reasonable or even below-average valuation ratios. When inflation is high, valuation ratios tend to compress because the value of the future cash flows that a company generates declines. This risk is much greater for shares of a company with a 70x P/E for shares of than a company with a 5x P/E ratio. In addition to looking closely at valuation ratios, we try to identify companies with high fixed costs and low variable costs and we try to invest in companies that have pricing power when inflation is high.

Gearing Up to Go Forward

Investing in an inflationary environment is never easy. It requires unconventional strategies and an approach toward investing which assumes that it is no longer business as usual. It is a time where maintaining the real (inflation-adjusted) value of your net worth becomes the goal rather than growing it. It's possible to do, but only by approaching investments in an entirely new way.

If you're looking to build your investment portfolio, the best advice is to call somebody at Pekin Hardy Strauss. Our team can offer advice on this topic and many, many more. **Get in touch today.**

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