Investment Insights

Inflation is at 30-Year Highs…
Views from an Investor, Not an Economist

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Key Takeaways

- It is no secret—inflation is upon us. It is now considered the biggest tail risk among investors, with a barrage of predictions making their way into your inbox.
- We look at inflation as investors, not economists. This has four big differences: 1) we use probabilities instead of predictions, 2) we care more about the long term than the short term, 3) we value inflation-hedging assets relative to the investment universe, and 4) we focus on robustness over relationships.
- We approach this not with fear, but with well-protected portfolios. Understanding the full array of potential inflation pathways is key. When assessing risk, the range of potential outcomes is arguably wider than usual, so portfolio robustness is the tool of choice.

Why Inflation is Worthy of Discussion

Inflation can strike fear into the heart of the average household. Rising prices at the gas pump or in the grocery store are disconcerting, particularly when wages don't seem to be keeping pace. With the most recent headlines trumpeting a level of inflation not seen for the past three decades, it's no surprise this concern is especially high now.

As investors, the concern is magnified, especially if it feels like the ability to reach important financial goals could be in jeopardy. We find client conversations usually stem from three layered questions:

- **Why does inflation even matter?** In financial circles this is sometimes assumed, but it is always worth revisiting. For example, higher inflation tends to lead to higher interest rates, which hurt corporate profits and cause losses for bond holders. It also means higher input costs and a loss of purchasing power, hurting companies that rely on future profit growth unless they can pass on those higher costs.
- **How can I tell what inflation is going to do?** This is a danger zone, as even the most seasoned professionals have a terrible track record. We try to steer people toward assigning probabilities instead of making predictions. Putting all your chips on one outcome is a high-risk strategy, and it goes against the principles of good investing.
- **What can I do to protect against inflation?** During inflationary spikes, people tend to gravitate toward inflation-protected assets. However, that increased demand often means the cost of such "insurance" is high. That leaves investors facing one of two risks, depending upon what happens to inflation and how portfolios are positioned.

> The first risk is that investors fail to prepare for high inflation and find that their wealth falls in real terms. The second is that investors mistakenly prepare for higher inflation only to find inflation stays low and they suffer unusually large losses because they overpaid for the protection.

Inflation Views as Investors, Not Economists

The real victim of high inflation tends to be investors, who see a loss of purchasing power and must generate a higher return simply to maintain the value of their capital. It is therefore unsurprising that inflation periodically becomes the dominant topic of conversation.

It is worth reminding ourselves of the key features of inflation that are often missed when investors discuss the topic. The most important point to remember is that inflation does not measure a change in prices, but rather the rate of change of prices, typically over a 12-month period. Consequently, the impact of inflation to an investor is less intuitive than other price measures. Consider a basket of goods and services that doubles in price over the next month and then maintains those prices for the next 12 months. At the end of that 13-month period, the inflation of that basket would be recorded as zero, even though we would be considerably poorer than we were at the start of the period. Inflation therefore requires momentum to maintain its current rate.

Also, persistent inflation has a compounding effect that can significantly erode the value of your capital, even when the headline number appears to be low. The persistence of inflation is therefore even more important than the current rate. So it is unsurprising that economic commentators are more focused on the inflation trend than they are on its current level, and it explains why forecasting inflation appears to be an important activity for investors.

High Inflation is Probable, But Not a Prediction

At Morningstar, we avoid forecasting the rate of inflation and instead consider the impact of a range of inflation scenarios on our portfolios. While this may appear to be a subtle distinction, it has a significant impact on the way we think about portfolios.

For example, as economies continue to recover from the pandemic, there is a decent probability we'll see higher inflation over the next year or so. A part of this will be due to the fact that we're coming off from a low base last year. But that doesn't mean we carry a 100% confidence rate. Another pathway is that central banks feel compelled to react quickly, stifling consumer demand and causing inflation to fall.

Adding to the uncertainty, central banks have tweaked their mandates to be more tolerant of inflation overshooting targets and have kept in place extreme levels of stimulus, even in the face of surging inflation pressures and economic rebounds. The ingredients are present for a policy mistake, with high levels of debt incentivizing governments to keep interest rates as low as possible for as long as possible in order to prevent a blow-out in interest payments.

You'll find economists that sit on all sides of the debate, but we don't see much value in their expert views. The temptation to forecast lies in the fact that in hindsight, the path of history appears deterministic and predictable. Investors therefore fall into the trap of believing that prediction is a worthwhile exercise. In reality, the future is uncertain and, consequently, should be viewed as a range of possible outcomes rather than a single event. As some of these outcomes are more likely than others, a useful forecast will always have a probability attached to it.

Long-Term Inflation is Less Known (And Potentially Unknowable)

Most of the inflation chatter is currently about short-term challenges. This includes supply-chain issues, the "Great Resignation" (employee demand) and pent-up savings from the pandemic. These are all important parts of inflation, but they are all quite short-term in nature.

What matters more is the long-term dynamic. High inflation outbreaks are uncommon, and your chances of correctly forecasting such big structural shifts are not good. What makes it challenging is the complexity of our highly integrated, multi-polar global economy and the slow-moving nature of structural changes. There is scant evidence of forecasters getting these big calls right and far more evidence of them getting it wrong.

There are also some big questions around the conventional understanding of the relationship between inflation and monetary policy. So we approach the topic very humbly. For example, the impact of unprecedented stimulus from governments and central banks needs to be balanced against the falling velocity of money from people and businesses limiting their spending.

We'd simply say that the range of potential outcomes is wide. As part of this assessment, we can't disregard the threat of higher long-term inflation hurting both equity and bond investors—which needs to be protected against.

The Value of Inflation-Hedging Assets

The role of the investor is to estimate the impact of various scenarios, considering which of those scenarios are worth 'insuring' against and which are not. The price of the 'insurance' will usually reflect the consensus view of the most likely outcome but occasionally will reflect the most 'vivid' outcome instead. This latter situation tends to occur during periods of high emotion among investors. When the dominant emotion is greed, it is likely that investors will underprice negative outcomes, and the reverse is true when the dominant emotion if fear. Investors able to think independently and adopt a long-term perspective can use these periods to purchase insurance that is unusually attractively priced or avoid insurance that is overpriced but popular among other investors.

We used this approach to the benefit of clients in the second quarter of 2020, when investors became unusually complacent about future inflation in the face of the pandemic. It seemed clear to us that this was leading to the underpricing of assets that provide protection against inflation (such as inflationlinked government bonds). We therefore added these holdings to our portfolios and witnessed the price rise sharply (compared to conventional government bonds) over the subsequent six months.

Positioning for Portfolio Robustness

Instead of trying to guess what inflation will do next, investors are better served by building portfolios composed of the most attractively valued investments they can find and the least expensive diversifiers. In this sense, our investment expertise lies in our understanding of potential inflation pathways and how it may impact our portfolios. So instead of basing an investment strategy on an inflation view, we'd highlight two strategies that can tilt the odds in your favor:

- The first is that we are biasing portfolios to better value opportunities that have a bigger margin of safety priced in. These investments are more likely to provide higher returns and offset any higher inflation. Energy equities, U.K. equities, and emerging-markets bonds stand out in our research, and they are featured in our Morningstar managed portfolios and funds.
- The second is to test portfolios for a wide range of different economic and market scenarios, not just high inflation. This can reveal which scenarios are best and worst for performance as well as less obvious sources of diversification. From this type of analysis, we can still see a role for high-quality government bonds in specific deflationary surprises. Foreign currency can also be effective as a diversifier against specific inflation risks and is an underrated part of portfolio construction.

Final Thoughts

Inflation is simple conceptually but complex as an investor. The challenge is that most investors are naturally drawn to the most vivid outcome and consequently find it challenging to adopt a contrarian position when it makes the most sense to do so. It is for this reason that describing the future probabilistically is not only essential for investment decision making but also for communication. Encouraging clients to consider alternative outcomes from the dominant narrative while also placing a probability on those outcomes can help them stay on track through any environment.

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Based on a proprietary valuation-driven asset allocation process, our strategies offer investors a range of multi-asset risk- and outcome-based strategies designed to help meet a variety of goals. Also, our separately managed accounts offer concentrated portfolios of our portfolio managers' best ideas. We put more than 35 years of investment experience to work in every portfolio we manage to offer you a better investing experience, because your journey also matters.

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