Second Quarter 2018 Knowledge College

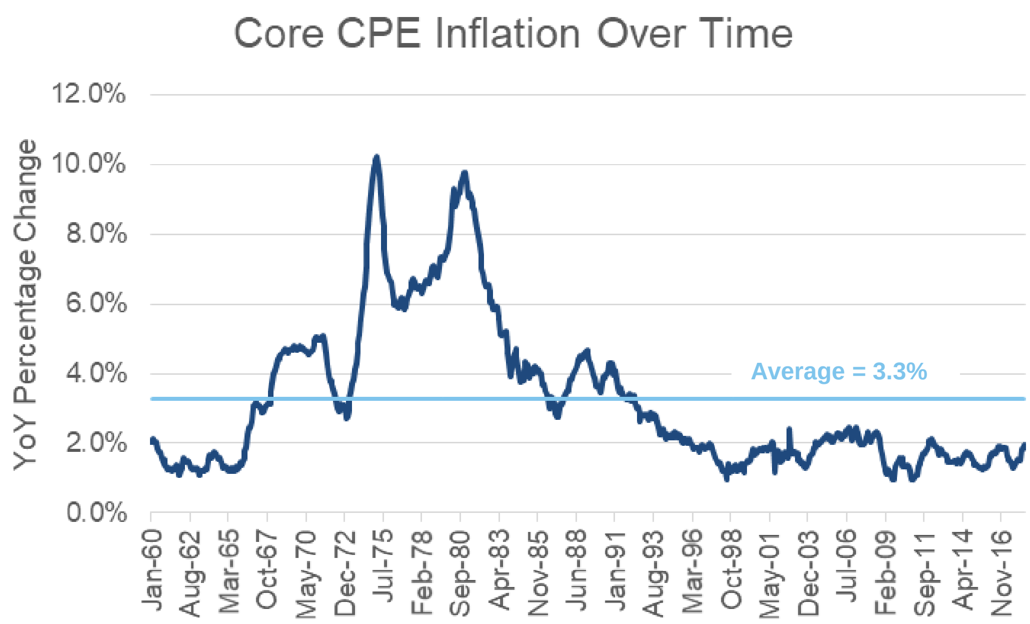
Inflation Returns to the Conversation

During the month of May, core inflation did something it hadn't done in six years. It reached two percent. Two percent has become an important barometer for the market because the Federal Reserve (the Fed) has targeted two percent as an optimal level of inflation for the U.S. economy.

As inflation meets and has the potential to exceed this important level, investors should take note. It has been said, "one cannot spend investment returns, only dollars." Given benign inflation over the last two decades this is a phrase likely lost on many investors. However, investors that experienced the 1970s and early 1980s recall inflation's impact all too well. The performance of your portfolio only matters in the context of how prices in the world changed during that time. If a portfolio grows by three percent, but inflation also increases by three percent, an investor has made zero real returns and is in the same position as they started from a spending standpoint.

The chart to the right shows the Fed's preferred inflation gauge (Core PCE) dating back to 1960. Recent experience with inflation has left investors believing it is not a threat or, if it is, that they will address it when it finally comes to pass. Investors' attempts to "time" inflation has historically produced disappointing results. One of the biggest hurdles with inflation is that it is seemingly impossible to predict when it will occur. Plenty of professional forecasters have tried, with a track record worse than flipping a coin. Since 1981, these professionals have only been able to correctly predict the direction of inflation 44% of the time, based on data we collected from the Federal Reserve Bank of Philadelphia. Given this track record, investors attempting to time inflation will more likely than not produce unwelcome results.

The inflation phenomenon is not only hard to predict but also plays a material role in asset class returns. Portfolio staples such as stocks and bonds tend to underperform during inflationary periods. So, not only are real returns harder to come by, these traditional asset classes have historically underperformed when inflation materializes.



Data compiled from the St. Louis Fed

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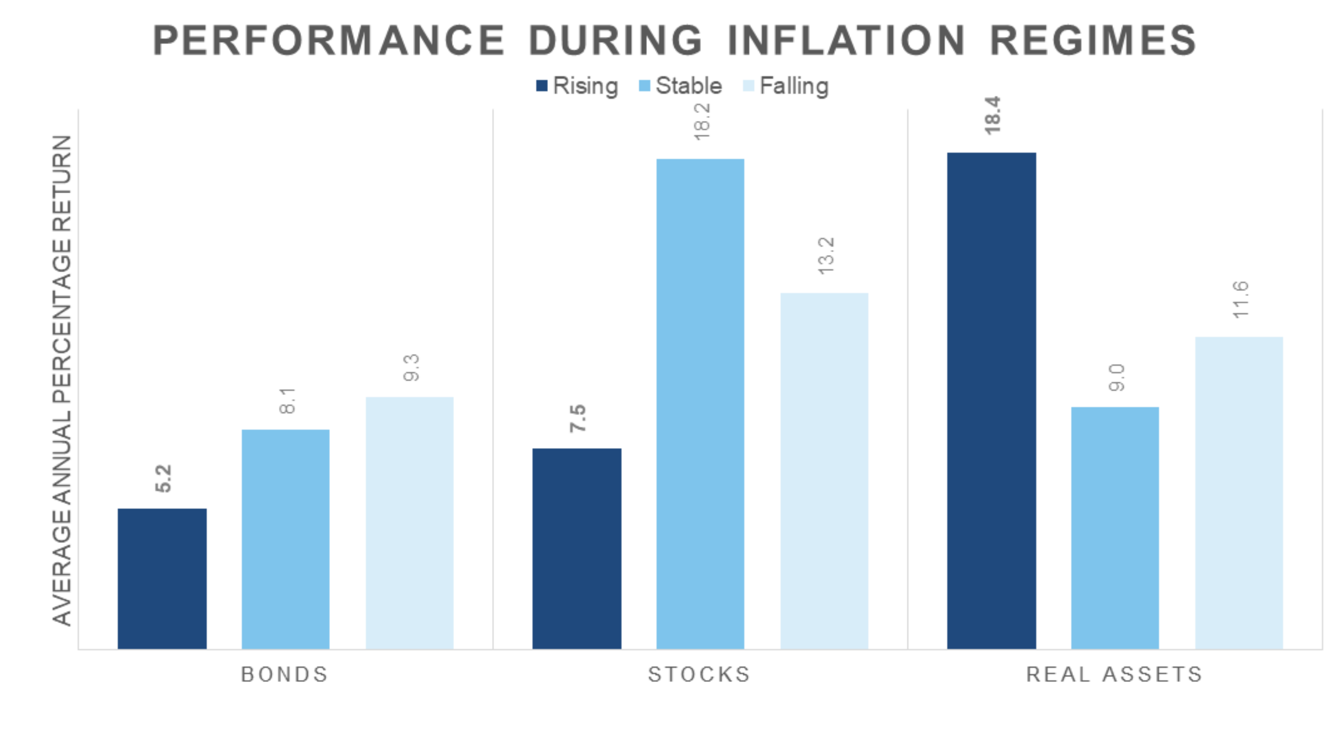
The chart at the bottom of this page illustrates this with the returns of stocks, bonds and real assets during three distinct periods of inflation – rising, stable, or falling. Real assets tend to perform better during inflationary periods rather than when inflation is stable or falling. The tangible nature of real assets is one of the characteristics that allow them to act as an inflation pass-through for investors. Rather than deriving their value from a stream of cash flows and a residual claim on a balance sheet, real assets can act as a physical store of value. For example, a lease in real estate is able to adjust to inflationary pressures through rent increases or through the ability to lease at market rates to new tenants. Additionally, if the materials used to build a structure cost more, the building inherently costs more to replace and can thus achieve a higher valuation. In similar fashion pipelines that carry oil or natural gas have contracts that often increase as inflation increases. These qualities create the foundation of an asset class that often performs better during periods of rising inflation and which can help portfolios weather these environments.



As inflation begins to make its presence known for the first time in many years, we believe it is important to consider real assets as an integral part of a prudently diversified portfolio. While we have no anticipation that inflation will run rampant, we have also noted it is a difficult phenomenon to predict. Reacting to inflation's arrival *after* the fact does very little to protect portfolios. Strategic utilization of real assets may help reduce the impact of rising inflation, while also increasing the probability of successful long-term outcomes through thoughtful diversification relative to portfolios otherwise reliant on a mix of only stocks and bonds.

Annual return data since 1978. Bonds are represented by The Bloomberg Barclays Aggregate Bond Index, Stocks by the S&P 500 and Real Assets by a 50/50 blend of the Bloomberg Commodity Index and FTSE NAREIT Equity REITs index, rebalanced annually until 1996. From 1996 to 2017 this is represented by equivalent allocations to the Bloomberg Commodity Index, the FTSE NAREIT Equity REITs index, and the Alerian MLP Index, rebalanced annually.