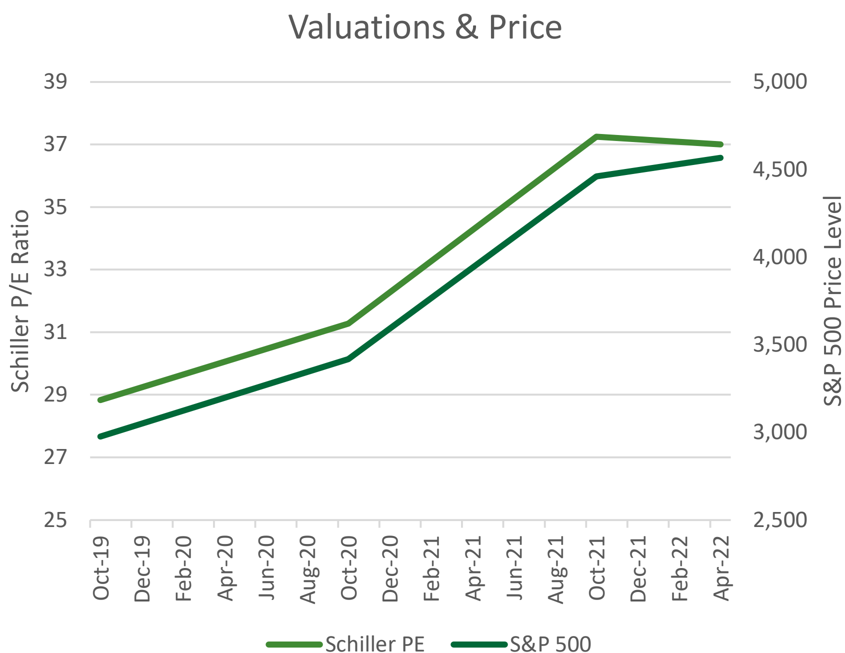
Inflation Here To Stay

As the world digests the humanitarian and geopolitical repercussions of Russia's invasion of Ukraine, financial markets are having difficulty absorbing inflation numbers they have not seen for decades. Russia's invasion certainly added to market turmoil (largely by amplifying near-term inflation expectations), but it is not the root cause.

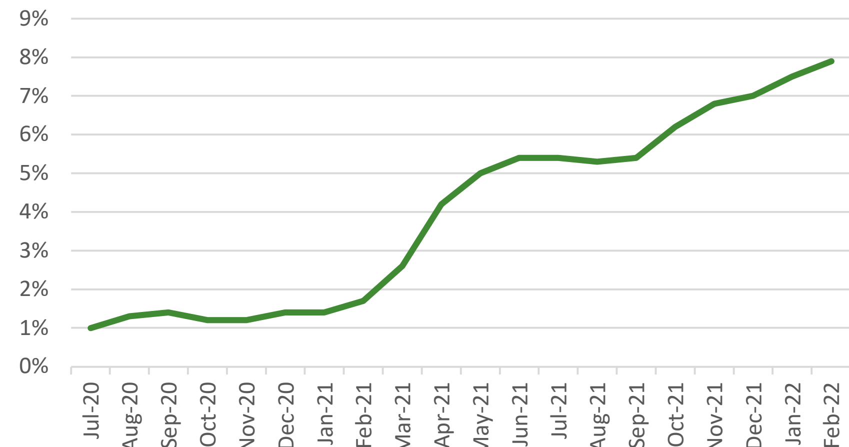
It is important to remember that inflation becoming a problem for financial markets is not exactly a surprise. To recap some of our recent Quarterly Insights:

October 2019 - we wrote that the Fed was re-lowering interest rates which would likely boost stocks in the short-term by inflating valuations. Since that time US stock valuations increased 28%, driving stock prices up 53%.



Source: www.multpl.com

July 2020 - we wrote that the consequence of keeping interest rates too low for too long would result in higher future inflation. The annual inflation rate has since increased from 1% to 8%.

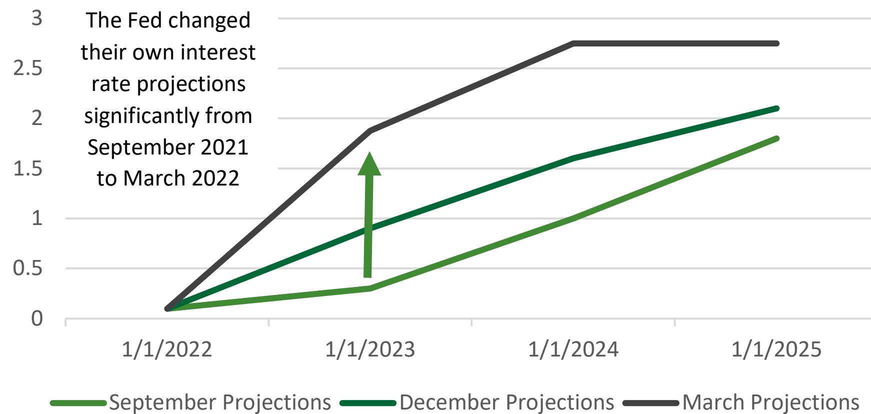


Source: www.usinflationcalculator.com

January 2021 - we wrote that extremely high US stock valuations were being supported by Fed Policy and were therefore at risk of declining if/when the Fed began raising interest rates.

July 2021 - we wrote that Fed Policy *should* be resulting in higher inflation, which we were not yet seeing. We hypothesized that for various reasons prices simply had not *yet* reacted to extreme Fed Policy, which may be creating an inflation "bomb" waiting for us at some point (we had no idea how timely that prediction would turn out to be).

January 2022 - we wrote of our concern that if the recent inflation data did not turn out to be "transitory" as the Fed believed, they may be forced to raise interest rates more aggressively than expected. This in turn could push stock prices down, perhaps by a lot.

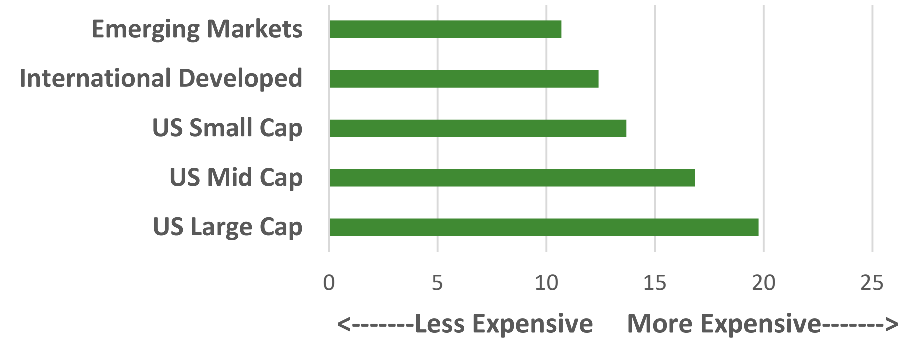


Source: The Federal Reserve

Today - inflation is higher than the Fed ever anticipated, is clearly not "transitory", and the Fed has responded with increasingly aggressive rate-hike projections. Just last week they stated they may hike faster than they had projected in mid-March and would consider double-hikes at their next several meetings. So what does this mean for investors, what can be done, and what should we expect?

For conservative or short-term investors the answer is actually rather simple. Because conservative investments are almost entirely based on interest rates, the years of paltry returns are hopefully coming to an end. As rates increase, short-term investors must endure some near term pain, but this pain will lead to noticeably higher future expected returns.

For long-term growth investors it's important to recognize that not all investments are equally impacted by Fed Policy. Not every asset class shot up to sky-high valuations over the last several years, and not all investments need to be worried about valuations deflating as interest rates rise. Additionally, not every central bank across the world mirrors the Fed, either in having easy policy over the past several years or the need for aggressive tightening now. Within a globally diversified portfolio, we have flexibility to change our allocations over time to manage ever-changing risk/return dynamics. As such, we began the process of shifting our allocations away from the most inflated asset classes well before the recent market turmoil.



Source: Morningstar