Inflation May Hurt Your Pocketbook. Don't Let It Hurt Your Portfolio

February 2022

Featuring:

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VO [00:00:01] Is your wealth strategy supporting your long-term goals? Welcome to *Your Active Wealth* with BNY Mellon Wealth Management, where we offer insights that can help you move closer to your goals. We'll tackle timely topics through the lens of the five pillars that comprise our Active Wealth framework, Invest, Spend, Manage, Borrow and Protect, and provide guidance on navigating the unpredictable, to help you build and sustain wealth.

Alicia [00:00:34] Hi, everyone, welcome to *Your Active Wealth*. I'm your host, Alicia Levine, head of equities and capital markets advisory for BNY Mellon Wealth Management. And I'm thrilled to have with us today, Leo Grohowski, chief investment officer of BNY Mellon Wealth Management. We're going to talk about inflation today. Now, Leo, you and I have worked in markets longer than either of us care to acknowledge. But I think the fact that inflation is the highest it's been in 40 years means that neither you nor I have invested money during an inflationary environment. But I want to talk about this with you. And we want to talk about how wealth management is thinking about investing in this environment. So, Leo, thank you so much for joining and welcome to the podcast. So, we haven't seen such inflation in 40 years, and that's several Federal Reserves and several market cycles. So, can you help us understand what's triggered the current inflation spike?

Leo [00:01:32] Yeah, thanks very much, Alicia, and it's a pleasure to be with you today. Discussion is certainly well-timed, with January's consumer inflation being released late last week and coming in much stronger than expected. January's CPI climbed six tenths of a percent. Expectations were for a four tenths increase, and I always look at the 12-month numbers and on a year-over-year basis, prices running very hot, 7.5% year-over-year increase in inflation. And that compares to December, which was running at 7% increase year-over-year. And I think, as you said at the outset, Alicia, you have to go back to the early 1980s, actually 1982, when Ronald Reagan was president to find inflation at that level. As we all know, inflation was very harmful economic problem back in the 70s and 1980s, even hitting double digits. Many say that rising costs even brought down two presidents. Right? President Ford, President Carter. And inflation's generally been in check for 30 plus years now. So Alicia, as you mentioned at the outset, a lot of investors and a lot of colleagues and a lot of people in the asset and wealth management business haven't been around for anything but the multi-decade decline in bond yields that we've experienced really since the 1980s. And inflation sometimes comes about during periods of strength in the economy. We've certainly seen that happen in this post-COVID recovery. GDP was recently announced at 6.9% in the fourth quarter of 2021, and that brought the full year number to 5.7% for 2021. U.S. GDP, a very, very strong number. I also remember that back in college as an economics major, I remember that inflation was caused by too many dollars chasing too few goods. That certainly played out in the recent months when COVID hit and the economy cratered. The government really sprang into action and helped mitigate the harm. I remember you and I talking about the speed and the magnitude of both monetary and fiscal policy response. Very, very impressive. Very impressive. Now that did lead to a huge increase in the money supply. And in fact, a very famous economics professor, Milton Friedman is quoted as saying, inflation is always and everywhere a monetary phenomenon. And so the broadest measure of money supply in the U.S., M2, currently stands at $21.6 trillion, and in February of 2020, we were at fifteen and a half trillion. So once again, the impressive monetary and fiscal response, which really helped mitigate the damage caused by COVID and certainly helped the financial markets also created a big uptick in the money supply. And at the same time, supply chain bottlenecks, which were a global phenomenon, not just a U.S. phenomenon, combined with a shortage of labor, all of that has really gone into this Cuisinart of factors that's helped create really inflation that remarkably, a few months ago, many were using the word, including the central bank, "transitory." But clearly, we have a problem now in that word, transitory, has been retired.

Alicia [00:05:03] That's right. That was one of the great central bank communication's moments when Fed Chair Jay Powell said that transitory was going to be retired. And as you know, I like to tell clients like, let's not forget, prices are given by the crossing of the supply and the demand curve. And so, when you speak about how inflation started here, it's not just that demand was rising, but also that supply was decreasing. And so that's something to really keep in mind here. So now we have this rampant inflation. We see it in wages, we see it in rents, we see it in goods prices. We're starting to see it in services prices as well. What can be done here to bring inflation down?

Leo [00:05:46] You know, since we were talking about history earlier, when we look back at the last serious inflation we had in the 70s and into the early 80s, the Federal Reserve, led by then chairman Paul Volcker, raised the federal funds rate to a peak of 20% in June of 1981. And I was actually entering into the business back then and remember, right, short rates at 20% and how happy people were to get mortgages in the mid-teens. It seems like a lifetime ago.

Alicia [00:06:19] I remember it well. I remember the conversations at home about the mortgage rates. It was crazy.

Leo [00:06:24] Yeah. And as you would remember, the strategy worked, right. So really bringing those short rates to very lofty levels did slow the economy, and inflation was eventually brought under control. As we fast forward to today, the January policy meeting, the Fed did confirm that interest rate hikes will commence the next meeting being on March the 16th, and obviously that was at the time a big reversal from late last year. It also confirmed that the asset purchase program, known as quantitative easing, will begin to end in March, and so that gave the meeting a much more sort of hawkish stance than what many market participants had become accustomed to and frankly caused a lot of the volatility in equity market drawdown that we saw in the month of January. So shrinking the size of the Fed's balance sheet, I think that's going to be an important part of monetary policy sort of helping to get us out of this inflation problem along with increasing interest rates. The markets are obviously concerned about just how aggressive the Fed will be following that January CPI report last week. The market was pricing in just under a 70% chance of not only a March rate hike, but of a 50-basis point hike in rates in March. Also, the markets now pricing in somewhere between six and seven rate hikes over the course of the next year. So we tend to think that the Fed is likely to raise rates by 25 basis points in March. So again, that's become sort of an out of consensus view. And we do think, Alicia, that the Fed will likely raise rates five times. That looks to be on the conservative side now, right? But clearly, the Fed has a balancing act in here, right? Hiking rates into an economy that's probably naturally going to slow is always a challenge and trying to engineer this sort of softer landing. I think we're all going to hear words like policy error, phrases like policy error, a lot more because of this, right? The Fed was obviously now with the benefit of hindsight behind the curve. Now is the Fed going to do too much to slow an economy that is probably going to already be slowing due to just a natural tendency after such a strong run up? So I do think as you know one of our key themes this year is volatility, and we certainly are seeing that play out here in the early going and we think it's going to be that kind of year, just a very, very choppy year for many asset classes, including U.S. stocks and bonds.

Alicia [00:08:56] That's right. I mean, this is the buckle your seatbelt year. But you know, Leo, I just want to ask you, how do you think the Fed got this wrong? In the sense that this is an institution dedicated to preventing inflationary spirals. What do you think happened here?

Leo [00:09:11] I think it was really an underestimation of the strength of the underlying economy. And when you combine that with just the massive doses of stimulus and I think the supply chain disruptions, Alicia, were more significant and longer lasting than not only the Fed, but many of us have thought. We never expected to see as many ships as we still have waiting to get into the ports of Los Angeles and in Long Beach. So really a combination of factors. The last one, I would add, would be the labor market. I don't think the Fed or many economists anticipated how tight the labor market would be, in part by a quit rate and a labor force participation rate that has remained challenged. And so I think that's a big part of sort of the potential outlook going forward, right? Will there be an uptick in labor force participation and remove some of that tightness in the labor market, which the Fed did not foresee?

Alicia [00:10:18] That's right. I mean, I think when the textbooks are written about this period, I think there's going to be a lot of attention paid on perhaps some of the disincentives that the stimulus created, in part because the virus wasn't linear. So there was an attempt to keep households whole, but it had effects in other parts of economic activity, making the labor market look like it had more slack than maybe it did. But having said all that, that's in the rear-view mirror. What is your outlook for inflation going forward?

Leo [00:10:46] Yeah, I think that's really the critical variable. I've never seen such a variability in an inflation outlook for one year, as I'm seeing currently. So I think, look, inflation has persisted, certainly for longer than the Fed and most economists have expected. As we've mentioned, it's mostly been driven by goods inflation as well as these wage pressures. And in fact, last week's CPI report did show a broadening out in inflation, areas like apparel, medical services, housing, particularly the rent component. And I don't think, Alicia, that these turn on a dime, number one. And number two, I don't think inflation gets back to pre-pandemic levels. So I do think that inflation remains at a more elevated pace than what many of us have been accustomed to for a number of decades now. But I do think that while higher inflation is likely, we are seeing some very early signs of supply chains disruptions easing. We are seeing a shift, a gradual from goods to services as a lot of the states are now ending their COVID restrictions, and we also could see wage pressures moderate as the participation rate increases. We did see in January's employment report a modest uptick in labor force participation. And so that's going to be critical. And finally, I would say, Alicia, that simply the base effect comparing the prices in 2022 to 2021 will show some moderation, right? Simply because the rates were moving so much higher in 2021. So I think all of those factors should lead to some relief in the inflation picture. And also, we shouldn't underestimate two very powerful forces that are still in place. Aging demographics, right? Not just here in the U.S., but across the world's largest economies and also technological disruptions. I think too, as you well know, Alicia, the pandemic certainly put a focus on a third inflation dampener, productivity growth, really prevalent in a lot of industries, retail, health care, manufacturing, certainly where you and I work in financial services. All this, I think, brings inflation into a range probably between 3 and 3.5% by the end of 2022. Again, higher than where we've been over the past decade. But we think still in a range that's overall supportive of growth.

Alicia [00:13:19] Look, I mean, that makes sense because after all, households over ordered on goods and therefore, you know, we had extreme demand in the goods sector, which is why we have such big inflation in those areas, as you pointed out, Leo. But the big question, I think that, you know, investors really want to know is this is all fine and good, but what should we do about it in our portfolios? So there's an understanding that inflation can be very difficult for the bond investor. But how does inflation affect equities?

Leo [00:13:49] Well, back to where we started this discussion in the early 1980s. I remember growing up in an equity market that was looking at P/E multiples in the mid to high single digits. Today we have P/E multiples in and around the range of 20 times earnings. So I think first of all, all investors should recognize the inverse relationship that exists between price to earnings ratios and inflation, right? And that's why we spend so much time on it, because it's a critical component to the valuation of asset classes, including equities. And so consumers can certainly be hurt, as we all know by the destructive power of inflation. And historically, equity investors need to be cognizant of the decline in P/E ratios as a result. During past times of higher inflation, stocks can still provide solid returns. It's really during the extremes, right? Say, 6% or higher where we see a major degradation in P/E multiples. So really in the range of 2-4% markets can do exceedingly well. We think that even with inflation in the range of what we're expecting right, 3-4%, stocks can continue to perform well. But clearly it's something that we have to monitor. And look, let's all keep in mind, some inflation for companies can be good, right? It allows for pricing power that hasn't existed in a long period of time, and we're seeing that in some areas like commodity linked companies and banks, of course. So a little bit of inflation is certainly welcomed by some companies that have the ability to pass along these prices. And Alicia as you know, consumers are in very good shape. Consumer balance sheets and even income statements are in good shape. And so the ability to withstand some of these price increases is better than it's been in a while.

Alicia [00:15:40] You know, that's absolutely true, Leo. And as I like to tell our investors, earnings, which are really what propels the equity market, earnings are nominal, meaning earnings take into account inflation. And so I wouldn't be so worried about inflation simply because companies with pricing power, as you've said, can earn right through it. And what we have seen is that many companies are being able to put through price increases, which the consumer is accepting. So with earnings nominal, I think investors can worry less about it. But it's very clear, as you've pointed out, that there are some multiple compression going on in certain parts of the equity market as yields are going higher and as inflation expectations are moving higher. So if we're going to be in equities and we do think you should be in equities, what are the kinds of equities that investors should be involved in if they want to build an inflation resistant portfolio?

Leo [00:16:37] Yeah. First of all, I think this year, more than most, being sectorly diversified, I think is going to be important. There's going to be a lot of to-ing and fro-ing between value and growth. So first, I think being sectorly diversified is going to be important. But you know, as you point out, I think some sectors and industries are really going to be in a better position to benefit from an environment of higher inflation and rising interest rates as well. I mentioned banks and commodities earlier. So I think, generally, well-run businesses with really strong cash flow and pricing power, that's sort of a bigger picture what we're looking for. And those that can pass along some of the rising costs to consumers, right? We saw this in Amazon's recent report and the higher prices being passed along to, you know, Prime customers. And they in turn had to absorb higher prices from firms like UPS. So we do see that companies that will be able to maintain and even improve margin have that pricing power. Certainly in the shorter term, the energy sector, Alicia, I think, should continue to do well. Remarkably, the energy sector within the S&P is less than 10% of the overall market capitalization of the S&P. You and I both remember days when it was well over 20% of the S&P. So certainly the energy sector has been an under-loved sector for some time. In the short run, we do see a supply demand imbalance continuing. So I think shorter term the energy sector can hold up well. Also, the health care industry tends to have pricing power. Over the last two decades, costs have been increasing at about double the rate of inflation. Of course, we're going to have to watch the regulatory side of things when it comes to pharmaceutical companies specifically in health care in general. But health care tends to do well and has some pricing power. And then a sector that's certainly caused a lot of the shortages in the auto area where we still see used car prices having a significant impact on inflation, the semiconductor industry. Chips are in so many of the things, not just autos that we use today, smartphones, et cetera. Demand is very, very strong. And at the same time, we're seeing a consolidation in manufacturing, right? Some recent news about increasing capacity and production here in the United States. But generally, semiconductor industry, I think, is also one Alicia that would have pricing power. And finally, some consumer staples companies also with pricing power. Think of some food and beverage companies with strong brand names, right, that consumers are going to continue to buy even as prices go higher. So again, sectoral diversification, but energy, at least in the short term. I think some areas of health care, semiconductors and again have to be very stock specific here, but also some consumer staples companies.

Alicia [00:19:36] Well, you know, that really makes a lot of sense, including, I think, some of the reopening ideas around travel. You know, for two years, much of the country has stayed put. It hasn't gone anywhere. And you know, we're seeing also that there's a high demand for travel. And so I think that area as well will benefit during this time, not specifically inflationary, but certainly on the top of the list of consumer demand of what they want to be spending their disposable income on. It makes sense that we can invest our way through an inflationary period on the equity side, but what happens in the bond market? How does inflation impact bonds?

Leo [00:20:16] Yeah, look, bonds definitely struggle during periods of higher inflation as interest rates rise. And we've seen that here in the early going with just last week, the 10-year Treasury hitting the 2% mark, which we hadn't seen since pre-pandemic days. So this aggressive tightening will certainly impact the shorter end of the curve. But as long as the economy stays strong, relatively strong we should see also an uptick, you know, the intermediate and longer parts of the fixed income curve, which again will be better for savers going forward, but not good, not as good for bond holders today. So we're all aware of that inverse relationship between interest rates and fixed income prices. And so prices of existing bonds are going to fall as interest rates rise. So I do think in general, investors have to look carefully at their average maturities or the duration positioning of the portfolio. And of course, always keep in mind sort of their credit positioning as well. And I think Treasury inflation protected securities or TIPS, were designed to help guard against inflation and the principle of a TIPS does increase with inflation as measured by the CPI. I think TIPS backed by the full faith and credit of the U.S. government, certainly an area that should be considered. As I mentioned earlier, shorter duration bonds still with better yields than cash, less sensitivity to interest rates. I think high yield bonds again, credits will have to be carefully evaluated. But taking advantage of that spread in corporate and particularly high yield bonds may still make sense, right? With an underlying economy that is strong. And then finally, floating rate securities, those can help cushion the impact because actually the interest rate will be floating with the likelihood of higher rates.

Alicia [00:22:06] That's right. So beyond the traditional stocks and bonds portfolio, are there any other asset classes that could benefit from mild inflation?

Leo [00:22:16] You know, as we move outside of that fixed income range of less traditional bonds, certainly real estate has tended to do well during inflationary periods. Real estate investment trusts do allow investors to participate in different sectors of the real estate market without having to actually buy and manage properties themselves. Here, I would say valuation is going to be very important though, right? I think investors rushing into an asset class like REITs just need to be very mindful that in a low-rate environment like we've had higher yielding asset classes like REITs have already done reasonably well. And so we do need to pay attention to valuation. Alicia, you've heard me say, I do think as painful as this volatility and higher rate environment can potentially be, I think there is going to be a shakeout, right? There are a lot of areas, including some segments of the real estate market where because of the easy access to capital, there has been what I like to call a buy first, ask questions later mentality, right? And I do think that investors are going to need to pay much more attention to valuation not only in the real estate markets, but in other markets as well. And again, as painful as that transition could be. I think it creates for a healthier potential investment portfolio.

Alicia [00:23:40] Look, Leo, I agree with you. You know, in the end, we've had extraordinarily low rates since the end of the global financial crisis, 13 years now of some version of quantitative easing, as well as very low rates, which has propelled certain asset classes much higher. It's healthy to take some of the heat out of that so that you can reset a little bit and it's better to have some of the heat taken out now than to keep on building up this kind of excess in some of the asset classes. So, Leo, I agree with you. I think it's always good to have a bit of a reset. It's just healthier for investing going on. So, Leo, I'd like to talk to you about wealth management at BNY Mellon. You know, we love speaking to our clients. Our clients really ask us the most interesting questions, have various concerns around this inflationary environment. So we have a personalized view and we build portfolios for each client. How do you put a portfolio together in a personalized way in the context of inflation?

Leo [00:24:43] Customization is really critical, right? And so I think working with our wealth managers to craft an all-weather portfolio that can stay ahead of inflation. And I like to say, Alicia, we’ve talked today about sort of the inflation rate, right, as measured by the Consumer Price Index or the Federal Reserve's look at something called the PCE, Personal Consumption Expenditures Index. As investors, we all have our own personal inflation rate, right? It might be higher or lower than that, right, depending on our needs for goods and services and housing or tuition. It really needs to be a personal look at our liabilities and our spending. And so, fortunately, we've put in place some very powerful tools as part of our Active Wealth framework to look at things like spending and borrowing and stress test them, you know, higher rate, higher inflation environment. So before we even begin to think about portfolio construction, it's really doing a check or recheck on objectives and liabilities and spending. We've had a rising tide here of financial markets for more than a decade now, right with annualized returns in the low double digits for stocks and looking at our own capital market assumptions for the next three, five, seven, 10 years. You know, that's not likely to be the case. So I think taking advantage of the broad toolkit of Active Wealth to first understand objectives and then making sure that portfolio construction is in line with those objective is really going to be important. I would say if near term capital is not needed, if we have younger investors or pools of capital, certainly a larger allocation to stocks will prove to be helpful against higher inflation. I also think that taking advantage of liquidity premiums in asset classes like private equity will continue to help generate returns in a higher inflation environment. So on the other hand, I think retired those dependent on simply the income stream. I think diversification is going to be more important. I think inflation indexed securities like TIPS, like floaters I think are going to be more helpful to portfolio construction. So in a word, Alicia, I think now more than ever, I think customizing portfolios will be critical in making sure that objectives are revisited relative to this higher inflation, higher interest rate outlook that we have.

Alicia [00:27:22] So Leo, now that we've talked about inflation, can we just put the whole picture together and you are our CIO, can you give us a sense of the outlook this year?

Leo [00:27:31] Alicia, as we mentioned in our 2022 outlook piece, called a turning point. We think it's still going to be a positive year for equities, right? I think we're looking at a range of 4900 to 5100 for the S&P by year end. We're looking at an economy that's slowing, but generally still strong. Corporate earnings up nicely year-over-year. So I think when we step back, I'd still have to call it an equity friendly backdrop, albeit with higher interest rates and higher inflation. And I think the risk to our, you know, still generally optimistic view is clearly, you know what to the topic of today's podcast is about. Is the inflation outlook, right? We believe that inflation by the end of the year will temper back into a range of 3-4%. We don't believe inflation is getting back to pre-pandemic levels, but we do think there will be some tempering of inflation as a result of increased labor force participation, some solving of the supply chain issues. But that clearly remains a critical variable to our forecast and a key risk to our forecast. So I get asked the question a lot. What do you lose sleep about at night? And clearly it's the inflation outlook, right? And I think the longer inflation lingers at these high levels like that which we saw in last week's CPI report, the more the Federal Reserve may be forced to act to raise interest rates, and the more that could potentially set us up for a policy error and a potential recession in 2023. So that's not our forecast, but clearly, I think the risk lies with the inflation levels and our assumption that we do get a cooling in inflation from here.

Alicia [00:29:16] That's right. And you know, as I like to say, Leo, sometimes it's hard to know when you're in the middle of a regime change. And I think what's important for our investors is that they should not fear inflation. They should remain invested. They should ensure that their portfolios can withstand the potentially damaging impact of inflation. But that doesn't mean going to cash. That means working with your wealth manager and building portfolios to be levered to asset classes and to sectors that can benefit from inflation. And that really takes, you know, a long view. It takes a long view of history, what worked in the past and what can work going forward. Leo Grohowski, we'd love to thank you today for joining us. Chief Investment Officer at BNY Mellon Wealth Management. Your insights are invaluable. You know, you've seen many cycles, different periods of inflation, and I think our investors are very, very lucky to have you. And so am I.

Leo [00:30:15] Alicia, thank you very much. My pleasure.

Alicia [00:30:17] I'm Alicia Levine. Thanks for joining us today, and we'll see you next time on our next episode of *Your Active Wealth*.

VO [00:30:25] Thank you for listening to this episode of *Your Active Wealth*. Be sure to subscribe to this podcast on Apple Podcasts, Spotify, Google Podcasts or Stitcher and visit bnymellonwealth.com to view the latest insights on the subjects that matter most to you.