INVESTMENTS & WEALTH MONITOR

A reprinted article from March/April 2022

Inflation's Corrosive Effect On Financial Asset Returns: Building Portfolios with Rising Rate and Inflation Contingencies

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Inflation's Corrosive Effect On Financial Asset Returns

BUILDING PORTFOLIOS WITH RISING RATE AND INFLATION CONTINGENCIES

By Phillip "Felipe" Toews

Inflation has dominated much of the financial news recently because it has moved above 7 percent for the first time in decades. Some economists argue that inflation will be transient due to low long-range projected gross domestic product growth and demographic trends. Yet, current inflation is accompanied by many typical attributes of past inflationary periods such as supply shortages, surging commodity prices, and a tight labor market. It's been so long since we've had meaningfully high inflation that investors may have little understanding about what the effects on portfolios might be, and even fewer ideas about how to navigate high-inflation environments.

EXECUTIVE SUMMARY

- Relative to the global experience, U.S. inflation has been relatively benign, yet the past three episodes of high inflation in the United States produced cumulative price increases averaging more than 100 percent.
- Advisors may be underestimating how bad bond performance can be during rising rate and inflation environments.
- Stocks may help avoid real losses but may not produce real gains during periods of high inflation.
- Strategies are presented for addressing high inflation in portfolio construction.

We last saw high inflation, which we're defining as periods when inflation reached double digits in a single year, in the 1970s and 80s. Those of us who are age 50 or older recall certificates of deposit paying 13 percent and oil prices surging. But looking further back reveals three incidents of high inflation worth noting. In this article, we'll examine the last three periods of inflation in the United States and their effect on stocks and bonds. We'll then expand the conversation to look at stocks and bonds during extended periods of rising interest rates and inflation. Finally, we'll use this information to provide some commonsense strategies for navigating periods of high inflation and rising rates.

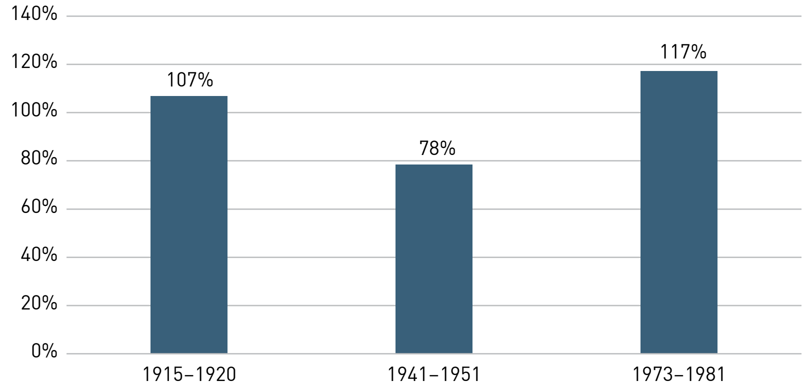
Instead of looking at individual years, it's helpful to look at the cumulative effect of inflation during high inflation periods; in other words, those times when inflation was decidedly not transient.

As shown in figure 1, between October 1915 and June 1920 inflation rose by 107 percent. This period includes the highest level of any single year of inflation with 12-month inflation peaking at 23.7 percent in June 1920. Between May 1941 and February 1951, inflation increased by 78 percent. And from February 1973 to September 1981 inflation surged by 117 percent. On average these three episodes saw inflation rise by 101 percent cumulatively, doubling prices over periods ranging from 4.5 to 9.75 years.

In the United States we've been lucky to have experienced hyperinflation, defined as inflation of 20 percent per year or higher, only once, in 1920. But other countries, even developed countries, have experienced inflation that dwarfs our experience in the United States. Some specific examples include France in 1795, when inflation rose as high as

Figure 1

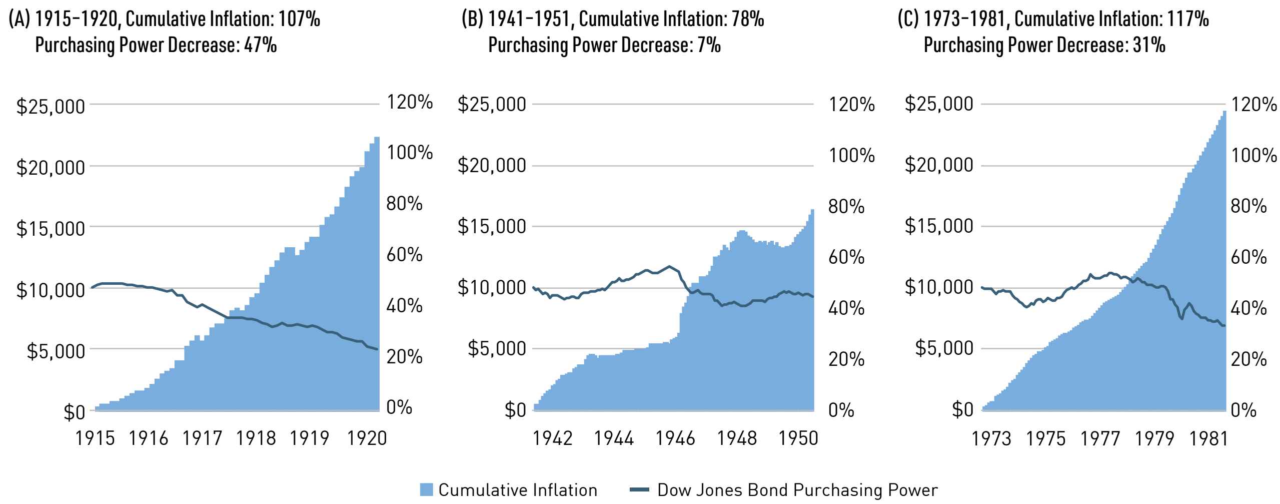
CUMULATIVE EFFECT OF HIGH INFLATION IN THE UNITED STATES



Source: Shiller

Figure 2

DOW JONES BOND LOSS OF PURCHASING POWER AND CUMULATIVE INFLATION



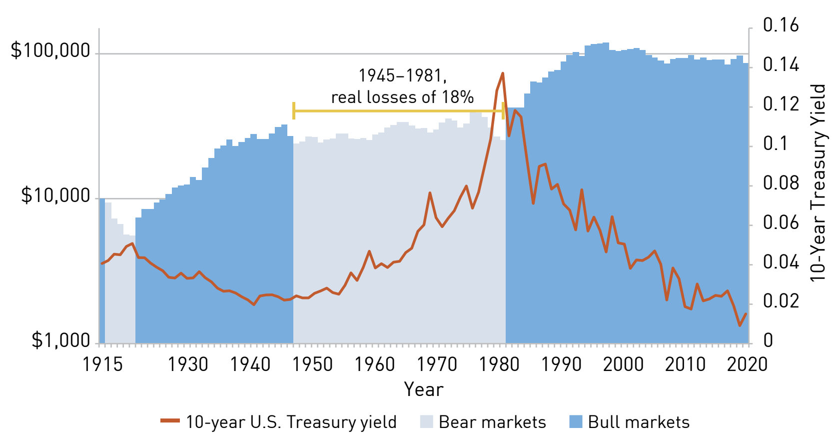
Average cumulative inflation last three instances in the United States: 101 percent average loss in purchasing power—bonds: 29 percent

Source: DJ Corporate bond index from Global Financial Data

Figure 3

REAL RETURN—DOW JONES BOND INDEX SHOWN WITH 10-YEAR TREASURY YIELD

Secular Bull and Bear Markets, 1915–2020



Source: DJ Corporate bond index from Global Financial Data

304 percent in one month. In 1923, Germany experienced inflation of 29,500 percent in one month (or 20.9 percent in one day). More recently, during one month in 1990 Argentina experienced inflation of 197 percent and in 1992 Russia's currency collapse led to a 245-percent inflation increase. An historical examination of global inflation by Hanke-Krus found more than 50 instances of country-specific hyperinflation exceeding 50 percent per month in the past 100 years.[1] The driving force behind many hyperinflation events was not capacity or labor shortages, but currency devaluations associated with high sovereign debt (nothing to worry about here, of course).

Advisors that we work with have a sense of dread about the impact of inflation on financial assets. Although economic challenges are associated with high inflation, looking at how these episodes of inflation play out provides insights and potential strategies for navigating longer periods of inflation.

THE TRIFECTA: RISING RATES, HIGH INFLATION, AND DEFAULTS

BONDS AND HIGH INFLATION IN THE UNITED STATES

Bonds fared the worst among the two core asset classes during episodes of high inflation. The reasons are multifaceted. Bonds face three primary risks: default risk, interest-rate risk, and inflation risk. Inflation directly reduces the purchasing power of bonds, and when inflation exceeds bond coupons, bonds can experience real losses.

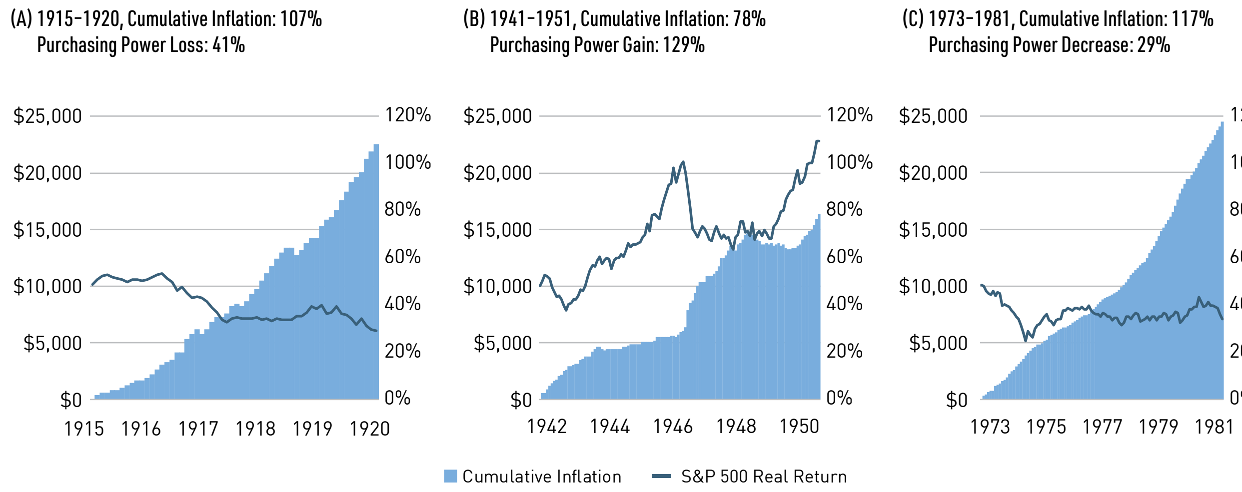
Because the primary means that central banks use to lower inflation is increasing interest rates, and because rising rates potentially cause principal losses in bond funds, this can amplify real losses in bond portfolios. Finally, if stagflation is present, bond defaults also can increase, causing all three risk factors to diminish real bond returns.

We break down the three inflation periods to examine these effects on bond real returns in figure 2.

High inflation from 1915 to June 1920 caused a rapid decrease in bond purchasing power by nearly half (47 percent), the worst of the three instances that we looked at. Between 1941 and 1951, bonds lost 7 percent real. Finally, the longest period of high inflation, between 1973

Figure 4

S&P 500 LOSS OF PURCHASING POWER AND CUMULATIVE INFLATION



Source: Global Financial Data

Average cumulative inflation last three instances in the United States: 101 percent average purchasing power gain in stocks: 20 percent

and 1981, caused real bond losses of 29 percent. On average, bonds lost 29 percent real during these periods. These index returns would need to be decreased by the costs of ownership of funds or advisor fees during that time, exacerbating the real losses realized by investors.

THE BIG BAD BOND BEAR–36 YEARS OF REAL LOSSES

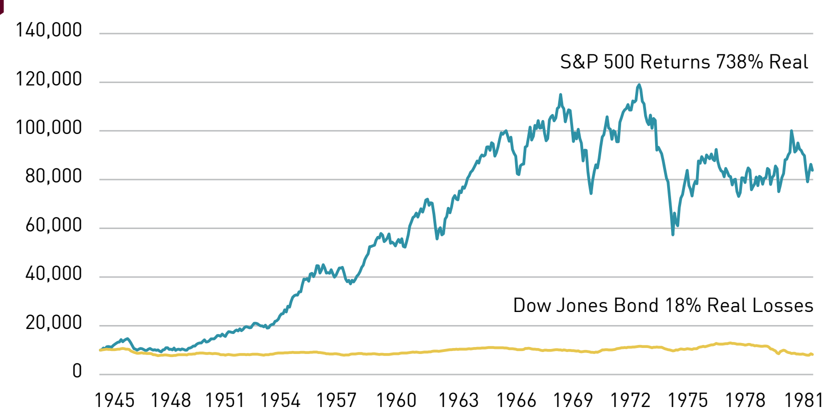
Examining the worst experience of rising interest rates and inflation on bond portfolios, however, requires zooming out. The most oppressive environment for bonds was made up of parts of the last two inflation episodes when yields also were rising dramatically (see figure 3). Between 1945 and 1981, bonds experienced real losses of 18 percent. That's less than the losses realized during two of the individual inflation episodes discussed here, but the massive duration of that loss, 36 years, means that some investors potentially realized real losses in bonds over their entire investing lifetimes. Once costs of bond ownership (funds, advisor fees) are taken into account, total real losses over that time may have exceeded 50 percent.

STOCKS DURING HIGH INFLATION

Stocks fared better on average during the last three periods of inflation, but they still struggled to produce real gains or experienced significant real losses depending on the time period chosen (see figure 4).

Figure 5

STOCK RETURNS DURING BOND BEAR MARKET (1945–1981)



Source: DJ Corporate bond index from Global Financial Data, S&P 500 Index Data from Bloomberg. Inflation data form Shiller

Between 1915 and June 1920, stocks lost 41 percent of their purchasing power. However, from 1941 to 1951 they gained 129 percent in real terms, and between 1973 and 1982 stocks realized losses of 29 percent real. On average, stocks gained 20 percent cumulatively during times of inflation. However, the fact that there were losses in two out of three episodes of inflation is far from encouraging.

To gain insights about stock market performance during times of inflation, it's worth looking at the anatomy of stock market declines. In each inflationary period, stocks fell leading into or during the initial years of high inflation, only to later rally, sometimes strongly, as inflation reached new highs. In other words, as inflation moved from benign to rampant, stock investors reacted negatively, only to ultimately drive prices higher as investors came to realize that stocks were real assets with innate inflation-buffering characteristics. Chiefly, as prices rise, companies pass through some or all of those increases in the form of higher prices, which translates to higher revenue and potentially higher profits.

STOCK MARKET PERFORMANCE DURING THE BIG BAD BOND BEAR

Looking at the long period of financial repression between 1945 and 1981 revealed bonds' vulnerability to generational declines (see figure 5). Looking at that same period for stock returns, however, reveals the ability of stocks to provide strong real returns even in the face of rising rates and rampant inflation. Even as yields on the 10-year Treasury bond rose from just over 2 percent to 14 percent, stocks during that period grew by 738 percent real or 5.9 percent per year.

BUILDING PORTFOLIOS WITH RISING RATE AND INFLATION CONTINGENCIES

Our examination of high inflation and rising interest-rate periods reveals that:

- Bonds consistently lost purchasing power during inflationary periods and are vulnerable to significant losses over very long periods.
- Stocks can rise during inflationary periods but are vulnerable to declines as the climate changes from benign to high inflation.
- Stocks over the very long range have produced significant gains even during periods of rising rates and inflation.

The first and obvious conclusion is that one attribute of conventional portfolios, maintaining an adequate allocation to stocks, may be one of the most effective ways to combat inflation. However, current high valuations and the potential for stocks to react negatively during the initial phase of rising rates or inflation suggests that hedging strategies for a portion of a stock portfolio may help lower vulnerability to real losses in stock portfolios. By maintaining adequate exposure to stocks, investors potentially can navigate periods of high inflation due to stocks' innate and potentially positive response to rising prices. By hedging portfolios against market declines, investors can attempt to address high valuations and the reality that each period of high inflation over the past century led to stocks falling during the initial years of rising prices.

STRATEGIES FOR NAVIGATING HIGH INFLATION

- Maintain exposure to the stock market to take advantage of its potential ability to increase along with inflation.
- Hedge stock portfolios in an attempt to address stock decreases during times of overvaluation.
- Move fixed income portfolios into fixed income alternatives or adaptive or unconstrained funds that attempt to mitigate the effect of rising rates or inflation.

Bond portfolios, especially for conservative investors that hold significant fixed income allocations, should consider migrating to fixed income alternatives or adaptive strategies that are tactically able to allocate to short duration, high yield, or inflation-protected securities, in order to help mitigate real losses in bond portfolios.

Our approach to inflation is illustrated in what we refer to as a behavioral portfolio (see figure 6). This portfolio holds common (i.e., 60/40) allocations to stocks but places half of those stocks into risk managed, hedged equity funds or strategies. It places fixed income portfolios into adaptive fixed income strategies that may move to short duration bonds or Treasury Inflation-Protected Securities if bonds turn lower.

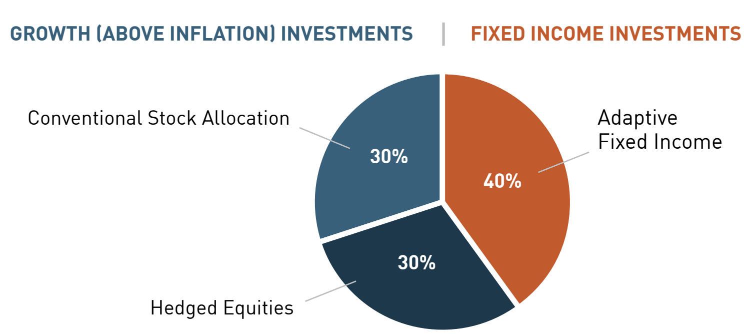
CONCLUSION

It's unknown whether inflation will remain high, move even higher, or be a transitory phenomenon. What we do know is that inflation has been declared dead many times in the past but has had a way of coming back to life. We also know that inflation has meaningfully risen and that economies are surging due to re-openings and easy money stimulus from the government's fiscal and monetary policies. Finally, interest rates remain near historic lows and threaten to move higher at the same time that stocks are valued in their top quintile of historic values. That means that both core asset classes are threatened.

We recommend against making an outright call that inflation will increase or that stocks will decrease. Instead, address the possibility that either will happen in the way that you position portfolios. By maintaining a conventional allocation between stocks and bonds, but choosing adaptive strategies, investors may be able to persevere regardless of inflation's path ahead.

Figure 6

BEHAVIORAL PORTFOLIO



Source: Behavioral Investing Institute

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ENDNOTE

1. Steve H. Hanke and Nicholas Krus, "World Hyperinflations" (August 15, 2012), https://ssrn.com/abstract=2130109.

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