How "Sticky" Will Higher Inflation Be?

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THE US FEDERAL RESERVE (FED)'S MESSAGE ON INFLATION IS CLEAR: Higher domestic inflation is likely in the period ahead, but it should be "temporary" in nature. This begs several questions, among them: What exactly does "temporary" mean? Which price increases, if any, could be longer lasting? And if higher inflation proves to be "stickier" than anticipated, how might investors position their portfolios?

The Fed's latest forecast is for the Consumer Price Index (CPI)[1] to rise to 2.6% this year (which it already hit in March), before settling back down to just over 2% in 2022 and 2023. Likewise, market expectations (as observed in recent "breakeven" inflation rates) are for US inflation to pick up in the near term and then come down longer term. Yet I am hearing from some of my analyst colleagues that many areas of the economy are facing supply shortages and upward price pressures, including freight, semiconductors, housing, raw materials, and labor, which could take longer than a year to normalize.

Thus, in my view, the risk is that higher inflation may have a longer-than-expected "tail" before normalizing, or perhaps a more enduring structural component.

Key Points

- Higher inflation is likely in the period ahead, but it may have a longer-than-expected tail before normalizing, or perhaps a more enduring structural component.
- While the relationship among rents, home prices, and broader inflation is inexact at best, a turning point in rents is a potentially big deal for both the CPI and the PCE.
- Investors may want to consider seeking inflation protection for their portfolios. Potentially effective inflation hedges may include commodities, equities, real assets, and fixed income.

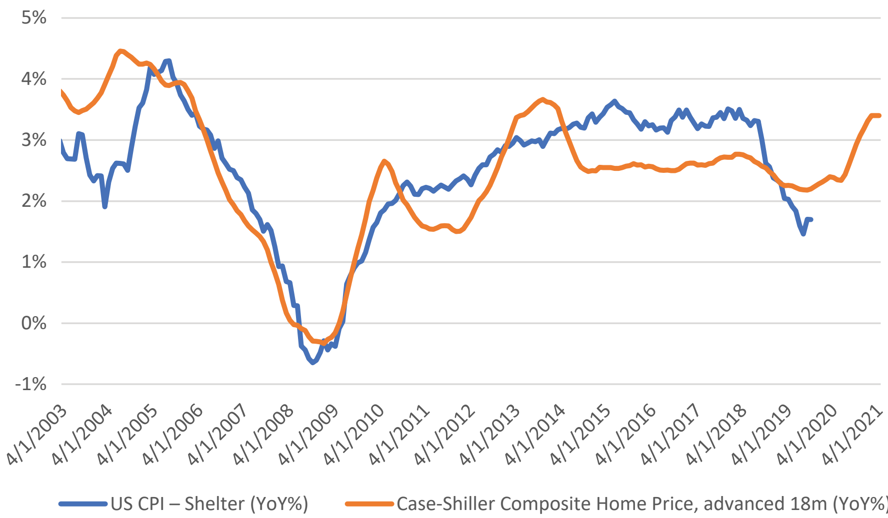
Inflation, Housing, and Rents

One area in which prices have certainly risen is in the housing market. Year-over-year, US existing home prices were up a record 17% as of March 2021. Equally important, but less discussed, is how higher home prices might feed through to "rents and shelter," the largest category in the CPI and one of the largest in the Personal Consumption Expenditures (PCE) Price Index[2] (the Fed's preferred inflation measure).

FIGURE 1 shows the surge in home prices and the accompanying collapse in rents when demand for space soared amid the pandemic, while inventories were tight and mortgage rates low. Notably, "shelter" costs, which have historically lagged home prices by around 18 months, have just recently inched up. If rents follow home prices as in the past, then rents could rise further and may also benefit from some shift back from working remotely as workplaces reopen.

While the relationship among rents, home prices, and broader inflation is inexact at best, a turning point in rents is a potentially big deal for both the CPI and the PCE. It's also likely to matter to markets and could stoke greater inflation volatility, if not a longer tail to higher inflation than the Fed and many investors currently think.

FIGURE 1
Rents Set to Rise?



Note: US CPI Urban Consumers Shelter SA, S&P CoreLogic Case-Shiller 10-City Composite Home Price NSA Index YoY% | Source: Haver, Bloomberg, 5/21.

Investment Implications

- **The length of the inflation tail is a wild card.** While near-term inflation looks poised to climb, there could be a longer tail to higher inflation than markets seem to expect—in the form of rising rents, for example (as noted above).
- **Investors may want to consider seeking inflation protection for their portfolios.** Potentially effective inflation hedges may include **commodities, equities, real assets, and fixed income**:
  - Commodities exposure in natural resources, agriculture, and industrial metals tend to be the most inflation sensitive.
  - Consider more value-oriented, cyclical equity sectors, such as energy, financials, materials, and some industrials.
  - Some companies will face profit-margin pressures. Thus, a key attribute to look for in any company these days (regardless of sector) is pricing power.
  - Real assets and some equity real estate investment trusts (REITS) could provide another source of inflation protection.
  - In fixed income, I believe short-duration[3] Treasury Inflation-Protected Securities (TIPS)[4] might outperform nominal US Treasuries.
- **Duration: Shorter is better.** While I still expect high-quality bonds to confer diversification benefits in the event of an equity sell-off, shortening fixed-income duration to guard against an inflation-induced spike in interest rates might be a prudent move.

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[1] The Consumer Price Index (CPI), a measure of change in consumer prices as determined by the US Bureau of Labor Statistics.

[2] The Personal Consumption Expenditures (PCE) Price Index is a monthly measure of imputed household expenditures defined for a period of time released by the Bureau of Economic Analysis.

[3] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[4] Treasury Inflation-Protected Securities (TIPS) are Treasury bonds that are adjusted to eliminate the effects of inflation on interest and principal payments, as measured by the Consumer Price Index (CPI).

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • US Treasury securities are backed by the full faith and credit of the US government as to the timely payment of principal and interest. • The value of inflation-protected securities (IPS) generally fluctuates with changes in real interest rates, and the market for IPS may be less developed or liquid, and more volatile, than other securities markets. • Investments in the commodities market and the natural-resource industry may increase liquidity risk, volatility and risk of loss if adverse developments occur. • Investments focused in specific sectors may be subject to increased volatility and risk of loss if adverse developments occur. • Different investment styles may go in and out of favor, which may cause an investment to underperform the broader stock market. • Diversification does not ensure a profit or protect against a loss in a declining market.

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