Equity Investing For Higher Inflation

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In the previous market outlook, I suggested that now is a time to be timid while others are getting greedier by the day. Broadly speaking, I am beginning to lower the overall equity allocation to raise cash level for better buy opportunities down the road. I am steering the portfolio towards dividend paying, value sectors which should be more resilient to a correction, while simultaneously positioning it for long term themes. In this article, I will further elaborate how I have constructed my portfolio for the greatest worry on my mind.

Stealthy Destroyer of Wealth

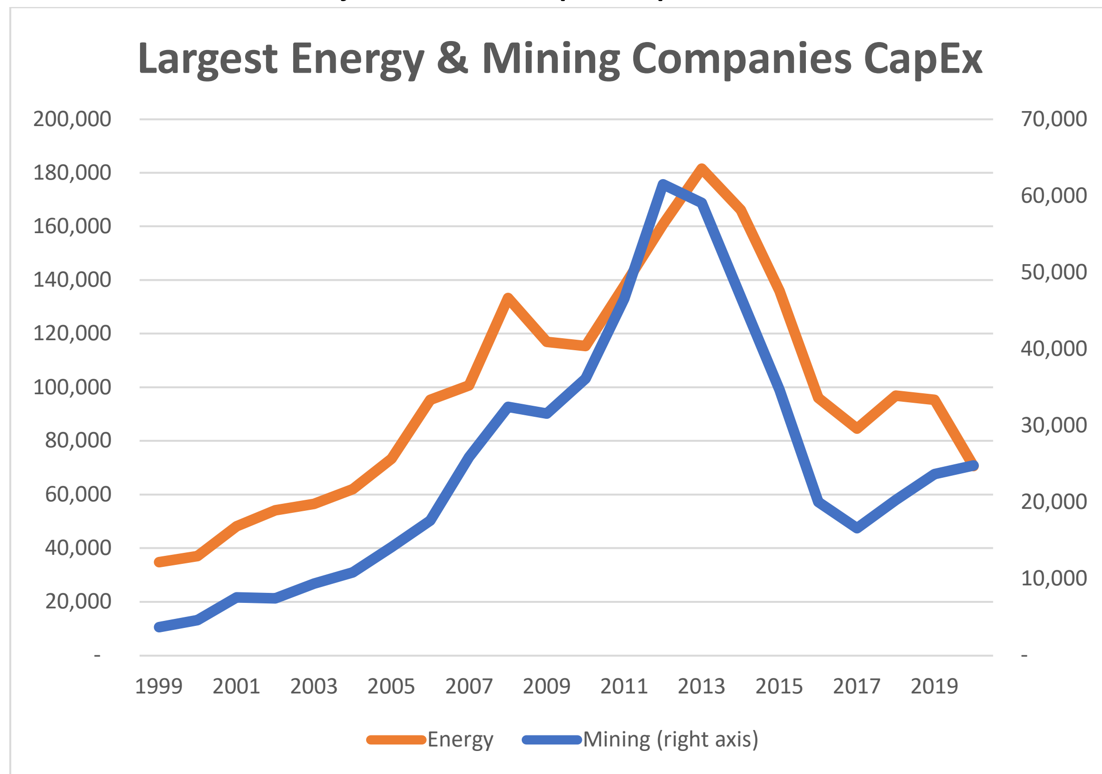
Inflation works like termite, chipping away at the foundation little by little. The last four decades have been a great time for investors of financial assets, as actual inflation has descended on a steady downward slope. As a result, worries of unexpected inflation have been largely absent from investor's mind. However, I see sufficient amount of evidence which points to inflationary resurgence as the greatest threat over the next few years. Here are my reasons:

<u>Commodities Boom</u>

Many commodities have already staged rally of 50% or more from the pandemic trough, with the most economically sensitive raw materials continuing to make new highs. Inputs from semiconductor to lumber have reported a widening shortage problem; similar inventory deficit may begin to show up in copper, aluminum, etc. Shortage of key materials may boost further round of price hikes, instilling a slow but definite change in mass inflation psychology to expect higher prices to come. Nevertheless, the Fed has argued that this phenomenon of supply chain disruption is of transitory nature.

Of longer-term concern to investors, the reason to expect higher input prices going forward is the lack of capital expenditure into exploring and mining industrial inputs over the past decade. As the commodities complex reached its new century high in 2008, the sector has steadily languished since 2010 with average prices losing more than half of its values. Driving the major cycles of commodity prices, the economy of supply and demand reinforces the axiom that the best cure for low prices is low prices. The seeds for commodities' recovery were planted as the major producers steadily curtailed capital expenditure back to pre-2005 levels. With reduced capacity for energy and metal production, while post-COVID demand recovery gets fuels from massive stimulus measures, the stage may already be set for a new commodities bull market. I will leave the global drive for de-carbonization as a separate yet as powerful reason to be explored in a separate article.

Chart 1: Major Producers Capital Expenditure since 1999



Note: Energy producers include Exxon Mobile, Chevron, Total, BP, Royal Dutch Shell, ConocoPhillips. Miners include: BHP, Rio Tinto, Vale, Freeport-McMoran, Anglo American. Data: Bloomberg

Too Much Debt

Savers have to worry about inflation eroding the future purchasing power of their assets. Borrowers would prefer higher inflation as higher prices reduce the present value of their future dated liability. Additionally, heavily indebted governments have another unspoken motivation to prefer higher inflation; i.e. higher prices boost their tax receipts from higher nominal GDP (income tax and sales tax) and capital asset prices (capital gains tax.) For borrowers, deflation would be the scariest scenario as the real value of liability rises which puts pressure on their ability to pay back.

With governments around the world bearing the highest debt load since WWII, it is not surprising that policy makers prefer to tolerate higher inflation in the future than risking an outright deflation. The US federal government debt as a percentage of GDP stood at 128% at the end of 2020, and is expected to exceed 140% in 2026. This translates to $226,000 per taxpayer according to USDebtClock.org, raising a real concern whether any policy maker still believes in fiscal responsibility. Given the clear choice between deflation and inflation, it is not surprising to see the Federal Reserve changing its policy to tolerate higher inflation in the future. In defense of the more relaxed attitude towards inflation, the Fed points out that they have many policy tools at their disposal to control inflation, if it were to get out of control. Should savers trust the government for protecting them vs the borrowers wishing for a higher inflation in the future? For me, the risks are asymmetric and this line of argument provides little

comfort. History of inflation repeatedly showed that *letting the cat out of the bag is a whole lot easier than putting it back in.*

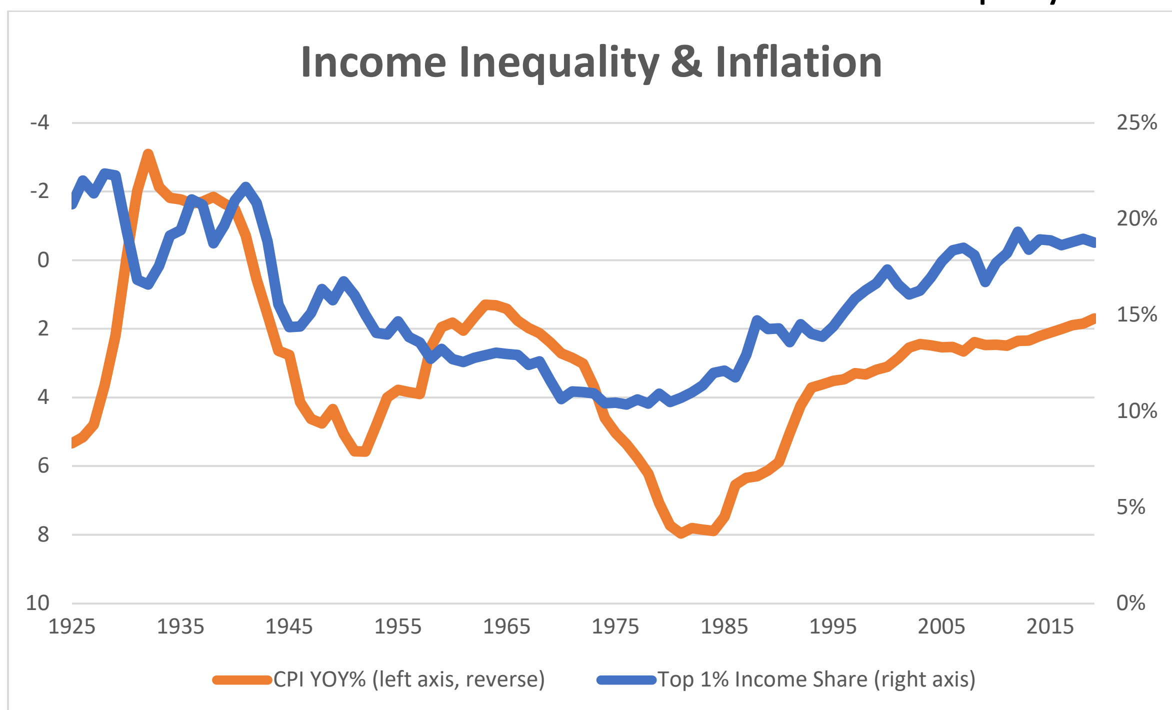
Income Inequality

One of the socioeconomic topics that has received most public attention is the widening gap between the top 1% and everyone else. The income and wealth gap has been expanding in the last few decades. Chart 2 shows that potentially there may be a negative correlation between income inequality and inflation; i.e. higher inequality occurs when inflation is low, and vice versa.

This statistical relationship may be spurious or may hint at a causality between the widening wealth gap and lower inflation. I can offer a few likely theories to explain this observation. One, it is well known that lower income households have much higher propensity to consume as compared to higher income households saving more of their income. The stimulative fiscal and redistributive policies of the 1960-70s may have contributed to the higher intensity of goods consumption which indirectly pushed up the commodities prices of that era. Conversely, higher inflation rate of the 1970s led to lower valuation of financial assets which flattened the wealth gap.

We do not know the exact causality between inflation and wealth gap, if there is any at all. Despite the absence of economic theory, I worry that the muscular fiscal and redistributive policies coming from the current administration will likely lead to higher consumption of all commodities.

Chart 2: Potential Correlation Between Inflation and Income Inequality



Data: CPI data from the BLS; income share data from the World Inequality Database

Investing to Hedge Inflationary Uncertainty

With these reasons for raising alarm about higher inflation going forward, I will suggest a number of broad strategies to protect one's portfolio in such uncertainty.

Emphasis on Dividend Paying Stocks

Higher inflation will threaten the purchasing power of longer dated earnings cashflow much more than shorter dated ones. The reason is the same as how longer dated bonds will lose out more than shorter maturity ones in an inflationary environment. The measure of bond price sensitivity to rate rises is called duration. In fact, we can apply the same duration concept to equity investing, using it as a measure of a particular stock's sensitivity to future inflation.

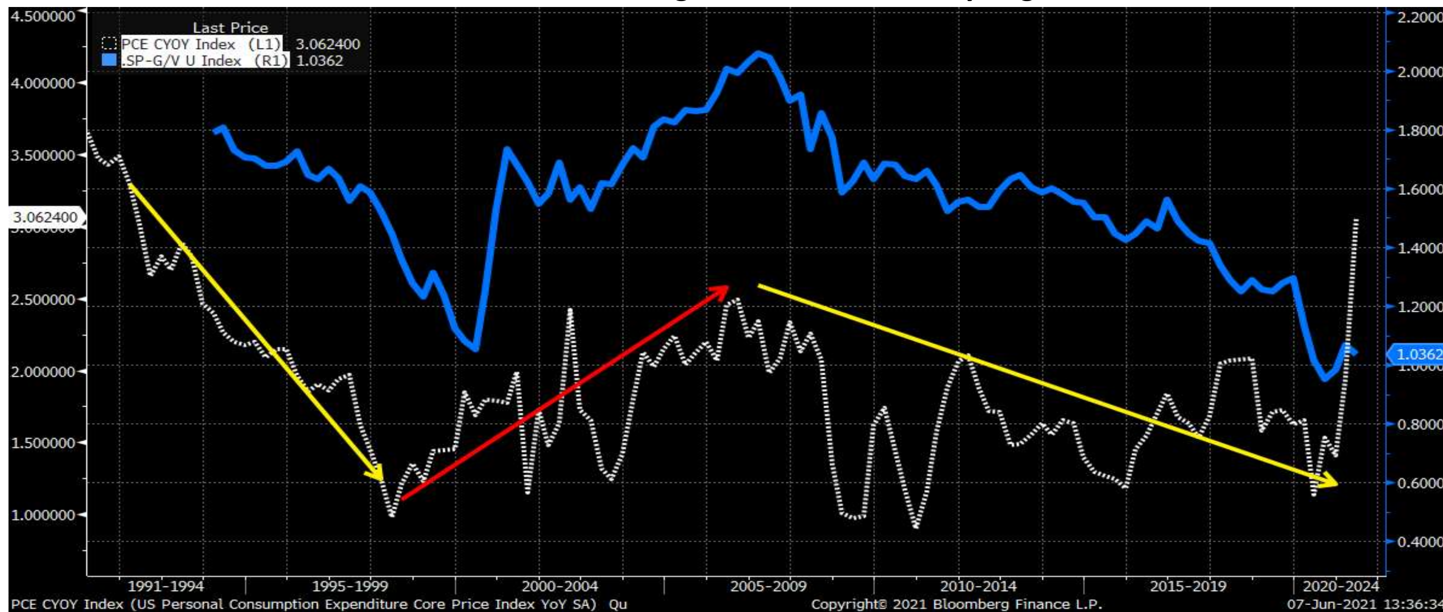
Think of equity duration as the time weighting of a stock's future dividend stream. Lower duration stocks tend to exhibit more stable earnings and able to pay out higher dividends, while higher duration stocks promise higher earnings growth into more distant future but presently pay little to no dividends. Higher dividend payout lowers duration and increases a stock's resilience to inflation. Another reason to emphasize dividend paying stock is quite basic: dividend returns have accounted for about half of the S&P 500 total returns since 1988. I would focus on stocks which pay out a sustainable dividend that is not threatened by inflation risk. Getting a steady dividend income beating the prevailing bond yield is perhaps the best reward to being a long-term investor of great companies.

Value over Growth

It is well documented that growth strategy has significantly outperformed value strategy during much of the last decade. However, that was not always the case. In fact, value strategy had done better in previous market regimes of rising inflation; e.g. between 1998 and 2008.

There are good reason to expect this to recur if inflation rises again. Value stocks tend to have higher current earnings, lower valuation, and pay dividends. These are all the characteristics of lower duration stocks which should be more resilient than a high PE growth stock which promises higher earnings in the distant future. Chart 3 shows that value vs growth relative performance depends on the market regime on inflation.

Chart 3: Value vs Growth During Different Inflationary Regimes



Note: Blue line is the ratio of S&P 500 value versus growth index. White dotted line is the PCE core index. Yellow trend lines denote disinflation regimes (1991-1998 and 2008-2020) and red trend line denotes inflationary regime (1998-2007). Data: Bloomberg

Inflationary Winners

There are other characteristics which may offer clues of a potential winning stock for an inflationary environment in addition to dividend paying and value factor. Different industries exhibit very different resiliency to inflation. Upstream input producers such as energy, mining, and materials producers should benefit from rising prices for their products. Companies with higher operating leverage should be able to increase earnings in a stronger growing economy. Pricing power is what we look for in companies which should thrive in a rising pricing environment.

Wrapping Up…

To be sure, I am not suggesting that 1970s-style inflationary spikes will be making a comeback. Investors have been so accustomed to subdued inflation over the years that markets have been long conditioned to ignore the threat of rising prices eroding future purchasing power. This article serves as a strong, hopefully timely reminder that the threat of higher inflation expectation may be more real than consensus thinking believes.

If the reader agrees with such an inflation thesis, I have provided some broad outline of a portfolio construction which should increase its resiliency to withstand inflationary forces: favoring dividend paying, value stocks in industries which should prevail if inflation were to resurge. I will go into more details of these ideas in the next article.

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