Quarterly Point of View
Inflation & Valuation

October 11, 2022

September was an awful month for stocks, ending a third straight down quarter for the S&P500, the first such stretch since the Global Financial Crisis in 2008-2009. The primary culprit for this disconcerting performance was the market's realization that the Federal Reserve waited too long to address inflation. Not helping the unsettled nature of things were inflamed geo-political tensions - most notably veiled nuclear threats by Russia's Vladimir Putin. Piling on to these worries was intense volatility in sovereign debt markets, particularly in the United Kingdom where the Bank of England has been forced to intervene multiple times in the last few months. On a year-to-date basis through the end of the third quarter, the S&P500 has lost nearly 24% and long-dated US Treasury bonds are down an astounding 29.9%[1].

Last quarter we discussed the Federal Reserve Bank's failure to normalize interest rates throughout the past decade, and when that ultra-easy monetary policy met up with the unprecedented fiscal action in response to the Coronavirus Pandemic, it was gasoline poured on an already lit fire, resulting in inflation rates not seen in four decades. Though not acknowledging past mistakes, it appears the Fed is now fully aware of the corner it has painted itself into. Chairman Jerome Powell stated at the Jackson Hole central bankers' symposium in August regarding aggressive rate hikes, "It is very much our view, and my view, that we need to act now forthrightly, strongly, as we have been doing, and we need to keep at it until the job is done."

Though the latest CPI reading showed a slight improvement, coming in at 8.3%, down from just over 9% in June, it appears we are not seeing a temporary phenomenon, but a paradigm shift with respect to inflation and interest rates. Even if inflation were to drop materially from current levels, it is our view it won't retreat any time soon to the extremely market friendly rates of 2-3% that were enjoyed for the previous quarter-century. If we are correct that inflation will remain above those "Goldilocks" levels of the past 25 years, we need to digest the potential impact that will have on future returns, and determine what will power those returns.

It is obvious by the chart above that inflation has broken out well above levels not seen at any point since the early 1980s. The good news is that we can at least make a tepid case that some of the factors feeding rapidly rising inflation are temporary. Issues such as Russia's war in Ukraine impacting energy and food prices globally, as well as supply chain bottlenecks affected greatly by measures put in place all over the world to combat the pandemic, are a few pressure points that could potentially see some relief over the next few years.

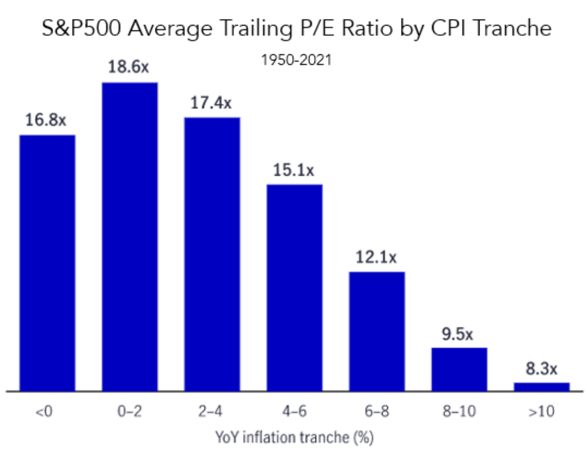
There will remain structural factors, however, that will make inflation tougher to tame than we all might hope.

The first is what might be called de-globalization or even anti-globalization. In the previous several decades globalization appeared almost unstoppable, as the volume of global trade increased at twice the rate of global GDP, and liberalization of trade and investment in Asia, Eastern Europe and Latin America, where labor costs were lower, fueled cross-border realignment of intermediate and final goods production. The globalization trend had a direct dis-inflationary impact on advanced economies, particularly the United States.

In 2018 and 2019, President Donald Trump launched a series of trade wars, amongst other actions substantially raising tariffs on imports from China, and the de-globalization trend had begun. In the past couple of years, these pressures have only intensified amid rising national security concerns and geo-political tensions. When added to the pressures companies were facing during the pandemic to build "just in case" inventories versus the previous goal of "just in time" inventories, a drum beat developed regarding "re-shoring" production domestically, or at the least "friend-shoring" to allies. Most any way we slice it, the de-globalization trend, which we believe is real, is inherently inflationary.

The second structural factor is labor. The US Unemployment rate in August hit 3.5%, the lowest in 53 years. Wages are rising and employers across a broad swath of industries are acquiescing to employee demands in order to obtain and retain labor, as worker shortages are evident seemingly everywhere. The price of labor, one of the main cost inputs in the production process for most goods or services, is rising, resulting in cost-push inflation to consumers. Additionally, the increased wages may leave workers with higher disposable income, potentially leading to a rise in aggregate demand, which, depending on other factors, may result in a wage-price push. Just like de-globalization, the labor situation is inflationary and may not be solved any time soon.

Given these factors it's our contention we need to prepare for what this means for market valuations over the coming years. The chart below[2], which dates to 1950, shows the average trailing price to earnings ratio (P/E) of the S&P 500 during differing inflation tranches. The far-left tranche, for instance, displays any periods in that time where we've seen negative inflation, or deflation, and then everything from 0 to 2% inflation as a tranche, all the way to periods where inflation was above 10%, along with its corresponding average P/E.



The implications are clear, the higher the inflation rate, the lower the average P/E ratio. As discussed above, the inflation rate is running at 8.3%, yet the S&P500 currently trades with a P/E of roughly 17.5x trailing, implying it thinks inflation will retreat to a range of 2-4%. Unfortunately, that may be wishful thinking.

There are three components to total return: dividends, earnings growth and valuation adjustments. If the inflation rate ultimately is unable to get back down under 4%, investors are going to be entering a period of valuation contraction, not valuation expansion that has been enjoyed for so long. If we are entering a valuation contraction phase, that leaves the other two components, dividends and earnings growth, to do the heavy lifting. In that scenario it's still possible to produce productive returns, but investors – particularly those linked to market indexes - should not expect the same types of returns enjoyed the past decade.

We've looked at this a fair amount in past letters, but the 1970's were a period worthy of review because it was the last full decade that saw significant inflation. As inflation rose, valuations dropped, proving to be a headwind to total return. The S&P500 produced an average annual return of 5.9% for those 10 years, and 73% of that return was attributable to dividends. In other words, stripping out dividends, the market produced an anemic average yearly return that decade of roughly 1.6%.

There are several main lessons we attempt to draw from this. The first would be to set reasonable expectations for returns as we move ahead in a different inflation environment. By being clear headed about what's different now, we can set proper expectations, and by doing so raise the probability we avoid what's called the "behavior gap penalty." DALBAR, Inc. produces investor studies, and one such analysis looked at the average "stock fund" return for the 20 years ending 2011, and the average "stock fund investor" return. The average stock fund provided a return of 8.2% annually over that time frame, yet the average "investor" in those funds actually produced just a 3.5% average annual return. Why? Those who approach investing with unrealistic expectations are likely to get frustrated by the fund or the market in general, and will sell, swap funds, or buy them back - at all the wrong points. The massive 4.7% "behavior gap penalty" is incredibly penalizing to long term outcomes. Therefore, approaching the environment realistically will help investor behavior.

Second, starting valuations of investments will be much more important in the next decade than the past decade. Most market participants paid very little attention to the valuation of the stocks they purchased in the trailing 10 years, as it was all about "growth potential" and the narrative surrounding disruptors and innovation. Owning stocks sporting valuations that don't reflect much expectation of an inflationary environment will be much trickier, and could be much more costly, in the years ahead.

Finally, dividends matter. We call them the "engine" of total return, and that's why we focus so intently on them. If we are entering an era where producing attractive returns gets harder, then capitalizing on those companies that can give us an attractive upfront cash yield and grow those payments to us annually, will be all the more important.

We'd like to be wrong about inflation. That would be good for many reasons, one of which may be sustainably higher stock market valuations. But if we're right that the years ahead will look different from the recent past, then we're likely to be more prepared than most market participants.

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Chief Investment Officer
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