THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

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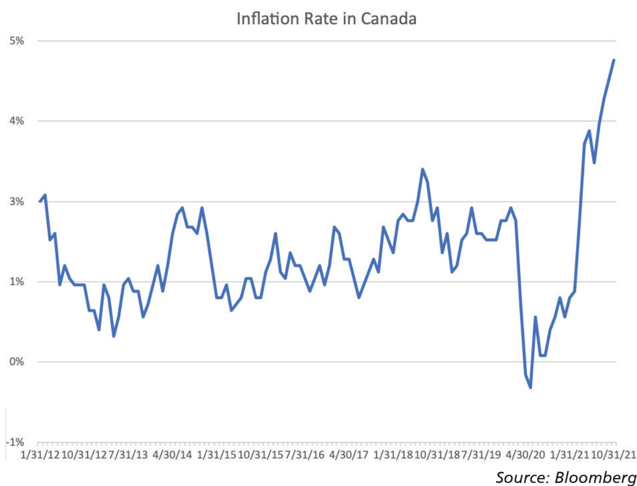
Asset Allocation

INFLATION AND STOCK MARKET RETURNS

By Michael Chu, Senior Wealth Advisor

Inflation is a big topic these days. Now, whether inflation is transitory or long-lasting – that's still up for debate. But it's hard to deny that prices have been rising across a wide range of goods and services.



Source: Bloomberg

The spike in the above graph might fall back to the 2% goal set by the Bank of Canada. But who knows the longer-term effects of the pandemic and unprecedented government spending? Even in normal times, predicting inflation is difficult, if not impossible.

Ben Carlson of Ritholtz Wealth Management talks about what we're seeing today – and suggests some reasons why this recent bout of inflation could be transitory:

1. Supply shortages, as companies did not see the economy coming back online this soon and will be adjusting
2. People spending money now that things are opening back up, so there is a burst from pent-up demand being satisfied
3. Demand should slow down once extra unemployment benefits and government cheques expire
4. Supply chain bottlenecks should resolve.

Carlson also suggests some reasons inflation could be more elevated going forward:

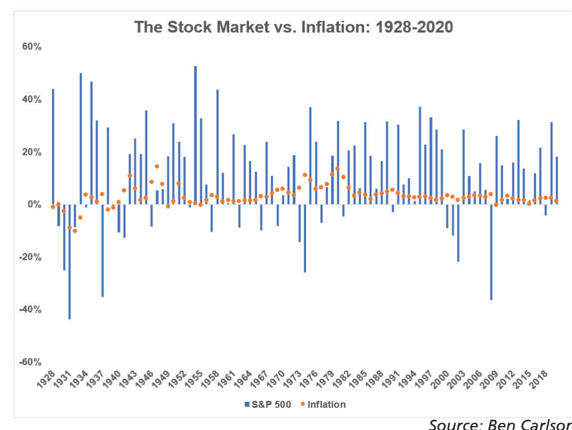
1. Homeowners buying more things with their paper gains
2. Wages are rising and may not revert
3. Lower interest rates might be here to stay, leading to higher borrowing/spending than normal
4. Psychology plays a role, too, driving more demand in anticipation of future higher prices.

At the Stan Clark Financial Team, we're leaning more towards the transitory camp. Price increases could be with us for a while longer, especially as new variants and vaccine hesitancy cause the pandemic to stretch out longer than expected. But we believe central banks have tools to fight inflation. And, we believe that technology and innovation will continue to contribute to lower prices over time.

However, as there's never been an economic experiment of this size before, it's helpful to be prepared for either scenario. No one knows how all these trillions of dollars will impact the trends that were underway before the pandemic in demographics, interest rates, prices, spending, and supply and demand.

Jeremy Siegel, finance professor at Wharton, who last year predicted an upward run in prices when few others did, expects 20-25% of cumulative inflation over the next two to three years in the U.S. before such inflation subsides – which would still be considered as transitory. But Siegel also thinks that inflation could grow worse if the Federal Reserve doesn't get a handle on money-supply growth – which might mean higher interest rates or more bond-tapering sooner than expected. He attributes most of the inflation to a stimulus-triggered surge in demand, rather than to supply issues.

If higher inflation were here to stay, it might seem to be a risk to the stock market – an inflation scare could spook investors. But let's look at some historical data. Here are the annual returns on the S&P 500, along with annual inflation, going back to 1928.



Source: Ben Carlson

As you can see, there's no clear pattern here. Even when past inflation has been high or higher than it is now, the stock market has held up pretty well.

The following table ranks the highest calendar-year inflation rates with the corresponding rates of return on the stock market.

The average return is 9.4%, in line with the long-term average over the last 100 years. In fact, eight of the 17 years shown above had double-digit returns. Note that these are nominal returns, so on a real or after-

inflation basis, returns are less – but it's not like things were a disaster, given higher inflation.

So, how *does* the stock market seem to hold up, given higher inflation? A good reason might be that company profits – the main factor in long-term stock market returns – actually provide a pretty good hedge against inflation. Think about it. Inflation occurs when companies raise their prices, and revenues rise as prices rise. If company revenues and costs both increase at the rate of inflation, then company profits, being the difference between them, will also increase at the rate of inflation. This won't be the case for every company, but across the broad range of companies represented by the stock market, profits tend to be hedged this way. This contrasts with fixed-income investments, most of which clearly lose more as inflation rises.

Inflation	S&P 500	Year
14.4%	5.2%	1947
13.6%	31.7%	1980
11.3%	18.5%	1979
11.1%	-25.9%	1974
10.9%	19.2%	1942
10.3%	-4.7%	1981
9.1%	37.0%	1975
8.5%	-8.4%	1946
7.9%	23.7%	1951
7.7%	5.7%	1948
7.6%	6.5%	1978
6.5%	-7.0%	1977
6.2%	-14.3%	1973
6.1%	20.4%	1982
6.0%	25.1%	1943
5.8%	3.6%	1970
5.7%	23.8%	1976

Source: Ben Carlson

Now, we're not saying the stock market is impervious to inflation. It's just that the two don't necessarily go hand in hand as one might expect. Nobody knows what inflation will be, nor what the stock market will do in the short term in response. Many factors affect prices. It is usually the surprises – the things no one is anticipating – that have a greater effect. In any event, the stock market does seem to be a good hedge for moderate inflation. Best strategy is, be prepared for a variety of situations (including deflation!) and have a good financial plan to help you navigate the future.

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