April 2021 – Inflation Concerns

“This is evolving science. You are seeing sausages being made – in front of the world’s eyes”.
- ***Saad Omer, Yale vaccine researcher***

At last, it seems, we are approaching what may be the beginning of the end of our modern-day plague. The vaccine development and rollout has shown that when working together, the world can endure and overcome many things – usually creating something incredible along the way. We are happy to hear from many of you that you have either received your vaccine already or anticipate doing so soon – most of us at Callahan Advisors have received ours and are looking forward to a return to normalcy at the office.

Inflation – Is it finally here?

The coronavirus had miserable effects on the U.S. and global economy in 2020, with millions losing their jobs and businesses forced to close their doors. Despite this, the pain in the stock market was felt for a relatively short amount of time. Between late February and March 23, the S&P 500 lost 34% of its value as investors reacted to the unfolding of the pandemic. The market then quickly recovered to within a few percentage points of its previous all-time high by June. The swift recovery can be attributed in large part to the combined effort of the Federal Reserve, Congress, and Treasury Department to provide expeditious and decisive action to support businesses and households who suddenly found themselves without customers and without jobs. Covid-19 relief packages were passed to prop up small businesses, local governments, and consumers – the most recent package being the $1.9 trillion American Rescue Plan and the likely impending Infrastructure Plan. Throw in the support from various central banks and the total stimulus is much higher. With all this spending, stimulus, and quantitative easing inflation might be a problem in the future. And if inflation does kick in, will it be transitory or more troublesome?

As the rollout of the vaccines continues and as the world re-opens for business, a possible scenario could be a ‘Roaring 20’s’ like economic boom. According to the International Monetary Fund, global growth could exceed 5.5% in 2021 – the highest growth rate in five decades as consumers emerge from lockdowns and resume normal activities outside of video conferencing. This has the possibility of upward pricing pressure – particularly on the price of energy, and food and services, such as transportation costs. Recent struggles in the global supply chain (chip shortages and rising lumber prices) also point to at least a temporary shift in upward pricing pressures.

However, in recent years, despite the unemployment rate at its lowest level in five decades accompanied by modest wage growth in 2019, there was no substantial increase in inflation. Increased globalization and gains in productivity through automation over the last few decades have had the effect of continued downward pressure on inflation. Further, the Federal Reserve has continued to impress upon investors and financial market observers that they do not anticipate longer term accelerated inflation as a result of the additional liquidity pumped into the economy. Fed Chairman Jay Powell stressed recently to the Senate committee: “Inflation dynamics do change over time, but they don’t change on a dime.”

However, inflation can become a self-fulfilling prophecy if there is enough public hand-wringing over it – for example, business owners may adjust their prices higher in anticipation of increased input costs, thereby, creating increased cost pressures. Also, our debt and deficits have to be financed. Simplistically, a one percent

(713) 572-3366 | (713) 572-8771 Fax
3555 Timmons Lane, Suite 600 | Houston, Texas 77027
www.callahanadvisors.com

increase in average Treasury rates will add $280 billion to total expenditures. (As an aside with a current debt of $28 trillion and another $110 trillion in unfunded social security and Medicare costs, it is hard to imagine finding a way to our fiscal solvency.)

Inflation's Effects on Savings

Many economists are not predicting runaway inflation or even substantially higher continued inflation, but rather a temporary increase in prices at this time related to the spurt in post-lockdown spending. However, even moderate inflation can wreak havoc on savings in the long run. At an inflation rate of 3%, money sitting in your checking account would lose half of its value in just 23 years.

Alternatively, moderate inflation can be beneficial to the economy overall as it is typically accompanied by rising wages that spur GDP growth. A slightly weaker dollar with moderate inflation can make existing debt less of a burden and "cheaper" to pay back – a welcome event, indeed, considering our existing $28 trillion in federal debt.

Conclusion

We re-visited a previous newsletter we wrote in July 2008 (we have attached a copy for your reading) and found the closing excerpt particularly relevant:

> We believe that in the long run inflation has virtually no impact on stock prices since the short term disruptions disappear, and corporate cash flows and profits tend to rise in an amount comparable to the inflation. (…) Generally well-managed companies fare well in times of moderate inflation as they are able to pass along increased costs and pay their financing expenses with cheaper dollars. (…) if you are a long-term stock investor you should not fear the effects of inflation on stock prices. You should, however, consider that investments in fixed income securities other than inflation protected bonds such as TIPS are particularly vulnerable to inflationary losses.

Separately, the lead quote of our newsletter is in reference to a vaccine for Covid-19. It also applies to government spending and fiscal plans, central bank policies, further disruptions from disease, wars and other unknown events, as well as our own financial plans.

As always, please let us know if you have any questions, comments, or suggestions. We are thankful for your support.

Client Letter from July 2008

Performance

The second quarter of 2008 was a poor one for domestic equity markets. The S&P 500 was down 2.7%, the Dow fell 6.9%, and the average diversified U.S. stock fund gained 0.2%. Of the ten S&P sectors four increased and six decreased. The best performing sector was Energy with a gain of about 17%, and the worst was Financials with a loss of approximately 19%. The slowing economy, declining real estate markets, growing fears of inflation, diminishing consumer confidence and especially escalating energy and basic commodity costs all continued to drag down stock prices. Volatility, which was the subject of our last letter, was again extraordinary.

Inflation

Inflation and particularly its effect on investing in stocks are the subject of an increasing number of recent questions from our clients. Inflation is defined as a continued rise in the general price level of goods and services. Each of us faces a different level of inflation depending upon our mix of expenditures. There is demand-pull inflation where increased demand from buyers that is unmatched by a commensurate increase in supply causes escalating prices. An example is the growing demand for oil by consumers. There is cost-push inflation where growing costs to the producer result in higher prices being passed on to the consumer. For instance, consider the impact of oil price increases on the cost of producing plastic goods or operating airlines. Excessive inflation can cause significant problems both for individuals and for companies. Persons living on fixed incomes suffer reductions in purchasing power and thus face lower standards of living. Individuals and companies that are creditors or net holders of financial assets measured in dollars experience real declines in the value of their holdings. Debtors or net holders of financial liabilities on the other hand reap real gains as their debts are payable in cheaper dollars. Companies, such as oil and gas enterprises, with large holdings of non-monetary assets financed with significant levels of debt usually weather inflationary times better than firms, such as financial institutions, that hold high levels of dollar-denominated monetary assets.

Inflation also affects people's behavior. The uncertainty associated with inflation can result in consumers spending less and producers reducing their output. Further, the fear that the Fed will raise short-term interest rates to combat inflation may cause additional uncertainty, which further restrains consumption and production. The result is often an economic downturn and sometimes a recession. Finally, if inflation domestically exceeds that in other countries, U.S. companies will find the pricing of their products to be less competitive.

In the short run, inflation normally impacts stock prices negatively for a number of reasons. Companies often are unable to raise prices to offset rising costs of production either because the ultimate buyer is unwilling to accept price increases or because the companies are just unable to react quickly enough. The result is decreased earnings and a falling stock price. Since the tax code is generally not indexed to reflect inflation, firms are taxed on inventory gains that are not real and are also unable to deduct the true cost of depreciation. To the extent that the net impact is over-taxation, firms' cash flows and stock prices suffer. The fear mentioned previously that the Fed will raise interest rates also impacts investors who often become less willing to purchase equities. Also, as interest rates rise, bonds become relatively more attractive as an investment than stocks. Many people believe that the higher interest rates resulting from inflation also result in lower stock prices. On the other hand our old friend, Wharton Professor Jeremy Siegel, disagrees with that theory. He believes that in the long run inflation actually leads to higher cash flows which can offset the negative impact of higher interest rates. In the short term, however, he does admit that higher rates of inflation do result in lower stock prices for the other reasons discussed above.

We believe that in the long run inflation has virtually no impact on stock prices since the short term disruptions disappear, and corporate cash flows and profits tend to rise in an amount comparable to the inflation. Numerous studies support this theory. Generally well-managed companies fare well in times of moderate inflation as they are able to pass along increased costs and pay their financing expenses with cheaper dollars. We think that if you are a long-term stock investor you should not fear the effects of inflation on stock prices. You should, however, consider that investments in fixed income securities other than inflation protected bonds such as TIPS are particularly vulnerable to inflationary losses. Please refer to an excerpt from our third quarter 2000 letter, which is enclosed, for a discussion of TIPS.

As always we invite you to discuss any of the above with us and thank you again for your support. Further, we will be happy to respond to requests for prior letters.

(713) 572-3366 | (713) 572-8771 Fax
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Third Quarter 2000 Client Letter (Excerpt)

Inflation Indexed Treasuries

A relatively new type of security is gaining popularity since it allows one to overcome a major disadvantage of investing in fixed-income vehicles. Historically inflation has eaten away most of the return from such investments. According to Wharton professor Jeremy Siegel, from 1946 to 1997, the real return (after subtracting the effects of inflation) from long-term government bonds was only 1.1%. Bonds thus have not been effective tools to accumulate wealth. Beginning in 1997 the Treasury began issuing Treasury Inflation-Protection Securities (TIPS) which offer some protection against inflation. TIPS guarantee the owner a real rate of return (currently almost 4%) if held to maturity. They accomplish this result by constantly adjusting the face amount of the bond to compensate for changes in the CPI.

A simplified example can illustrate the basics. Assume you invest $1000 in a ten-year TIPS on January 15 with a 4% real yield.[1] If inflation for the next six months is 2% then on July 15 the face amount would be adjusted to $1020 and your interest payment would be $20.40 ($1020 times 4% divided by 2). If inflation for the next six months is 1% then on January 15 of the second year the face amount would be adjusted to $1030.20 ($1020 times 1.01) and your interest payment would be $20.604 ($1030.20 times 4% divided by 2). Similar adjustments then would be made throughout the life of the security. Although the adjusted face amount can decrease through deflation, the holder is guaranteed at least the initial face amount at maturity.

TIPS, which are issued in five, ten and thirty year maturities, offer a great alternative to traditional fixed rate securities to anyone who desires the diversification or safety aspects of such investments. Since the yearly principal adjustments constitute taxable events with no corresponding cash flow, TIPS are most appropriate for nontaxable accounts such as IRA's or 401K's.

1 As of July 2008, the real yield of TIPS ranged from 0% to 2%

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