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Artemis Brief: No. 32

Should We Worry About Inflation?

By Scott Gillespie, CFA

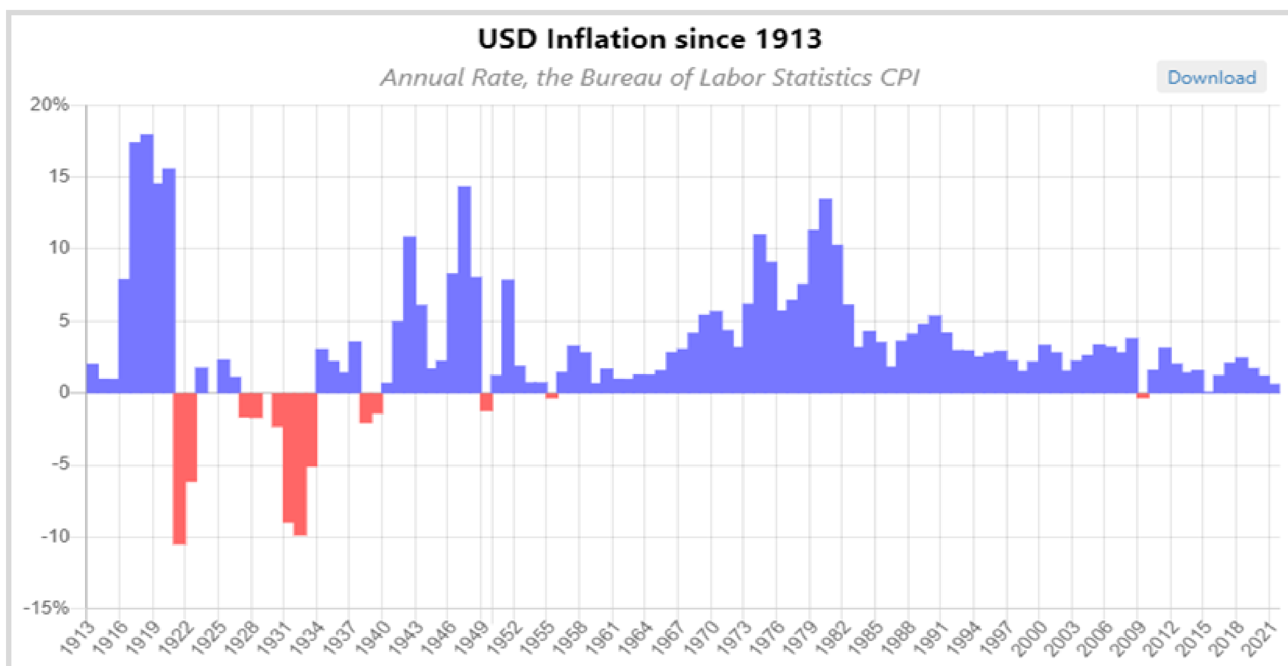
In this brief I will be sizing up the likelihood of rising inflation, the risks, and how we view inflation in relation to our portfolio positioning.

Inflation, the good and the bad

Some inflation is good. Inflation plays an important role in the economy, affecting everyone's finances. Since 2010 the pace of inflation has been a modest 1.63%[1], well below the long-term Federal Reserve target of 2%. Steady price increases are expected over time due to a number of dynamics. The five major factors impacting inflation are (1) a growing economy, (2) expansion in the money supply, (3) government regulation, (4) national debt levels, and (5) exchange rates.

Moderate inflation is healthy because higher demand (or costs) increases prices and profits, which in turn leads to more jobs and higher wages, putting more money and investment back in circulation. In a healthy economy this can be a positive self-perpetuating cycle.

Where economies get into trouble is when inflation runs substantially higher than what the Federal Reserve believes is healthy (currently about 2%). A concern looking forward is whether we are in an environment where inflation runs



mildly higher, or substantially higher for an extended period of time. The last such period of substantially higher inflation in the U.S. was in the late 1970s/ early 1980s when inflation hovered around 6%, occasionally reaching double digits. It is worth noting that we experienced a recession in that time period.

The problem is that, while a stable long-term level of inflation between 2.0-2.5% is healthy for an economy, sustained levels of higher inflation can lower the value of money, reduce savings and investment, set off rising interest rates, and increase uncertainties – often negatively impacting stock markets. Consider this, with yearly inflation of 1.63% the value of $100 in 2010 only has the purchasing power of $81 dollars today. If inflation had run at 5% from 2010-2020 rather than 1.63%, the value of your $100 would only be worth $62. Without offsetting increases in wages, investment returns, or profits, that stings.

The risk of inflation in 2021/2022

Currently inflation is running under 2%, but we expect inflation to begin to increase. The unknown factor, and what we'll be closely watching, is whether it increases to a modest 2-3% or runs higher than that. Our thesis is that inflation exceeds expectations, rising 2.5% in 2021 and 3% in 2022. Here are a few explanations for why inflation might increase in the coming years.

1. Consumer Demand and Excess Savings: The deployment of effective vaccines will allow people to return to normal spending patterns in the second half of 2021. The pandemic impacted many industries that will regain pricing power as consumer demand recovers. In addition, there is excess savings waiting to be spent once the services sector is back up and running. If there is a surge in 'back-to-normal' activity accompanied by shortages in supply, prices may rise further.

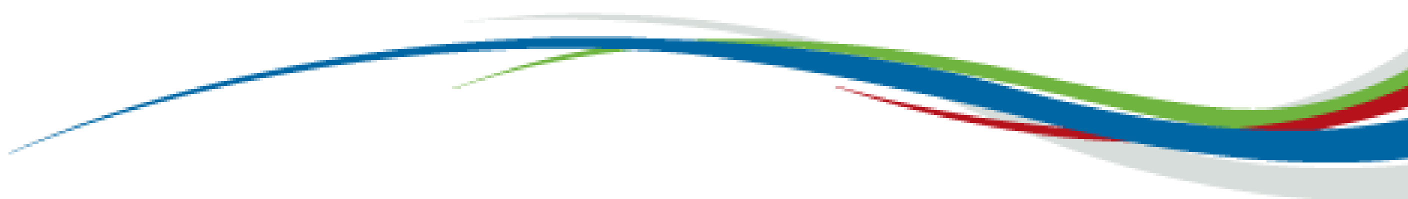
2. Monetary and Fiscal Policy: The Fed revised its long-term monetary policy this year, such that it will allow for inflation to run somewhat higher to offset years of below average inflation. Additionally, government spending and the surge in public debt are expected to persist to support the economy. This leads us to believe higher inflation is on the horizon. Whether this means the Fed plans for 2-4% inflation or will let it run at 4-5%+ before making changes remains to be seen.

Rising Costs: Cost pressures exist, due to lean inventories from the pandemic and the potential for wages and other input costs to rise. For wages, in addition to proposals to raise the U.S. minimum wage to $15/hr and spend on infrastructure, workers left the hardest-hit sectors (restaurants, hotels, etc.) during the pandemic. Restaffing those industries to meet resurgent demand alongside other industries experiencing growth may put upward pressure on wages.

History: Historically, high inflation has followed periods of loose monetary and fiscal policy, which we see globally today, in large part due to pandemic relief measures.

Impact

Bottom line, inflation may be a greater danger today precisely because it is no longer per-



ceived as such. We anticipate inflation of around 2.5% in 2021 and 3% in 2022, which would not be destabilizing. However, should those numbers start to show signs of moving substantially higher, this could be a concern for stocks. We do not believe this could develop until late 2021/ 2022 given unemployment is still elevated, vaccine dissemination will take time, and the economy has not yet begun to experience post-pandemic resurgence. But it is an important factor to consider.

Inflation is not here today and may not be in our immediate future, but as investment professionals and financial advisors we are always looking around the corner to see what may affect our clients and their portfolios. As such, we are preemptively monitoring the potential for inflationary pressures and will likely begin to add some inflation protection to portfolios over time.

[1] Percent Change in CPI, U.S. Department of Labor Bureau of Labor Statistics (note, Core CPI which excludes more volatile food and energy averaged 1.92% over that same time period).

Artemis Financial Advisors
115 Newbury Street
Suite 302
Boston, MA 02116

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