AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Quarterly Investment Commentary

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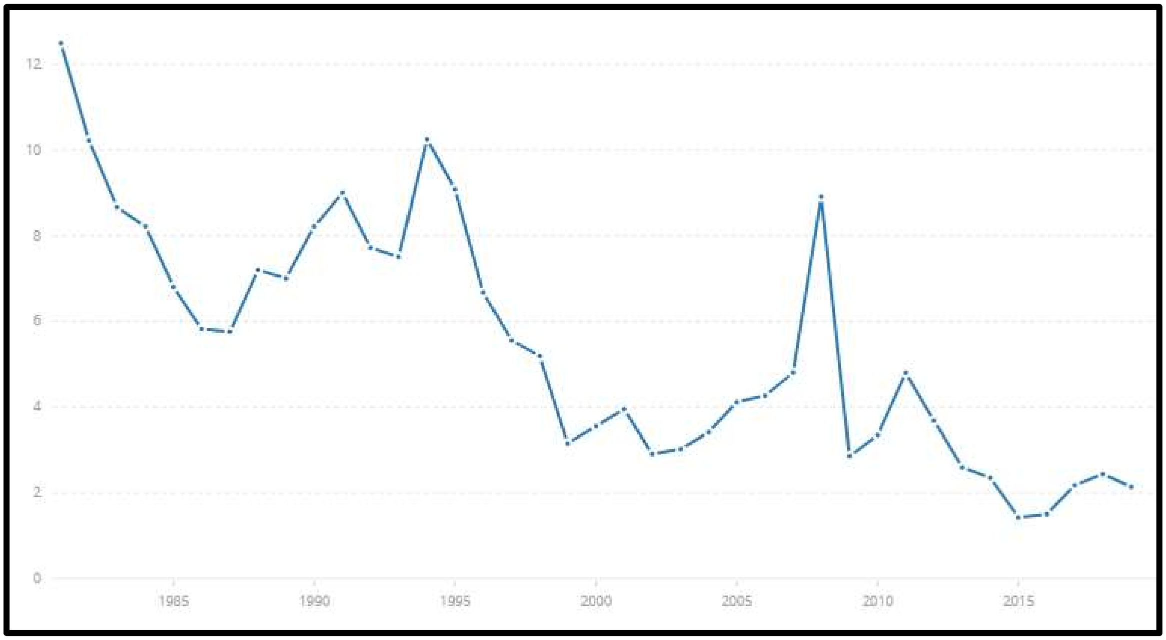
Stocks continued their momentum from last year, returning 6.2% in the first quarter of 2021.[1] International developed stocks returned 3.6% and international emerging stocks returned 2.2%.[2] Bonds fell -1.7% on the back of higher interest rates.[3]

In this quarter's commentary, we want to turn our attention to a topic that has been gone but not forgotten: inflation. For the past several decades, there has been persistent downward pressure on inflation. The following chart shows the global inflation rate from 1981 through 2019:[4]



This global "disinflationary" pressure has been strong and persistent, and surprising to some, especially in light of all the money that has been printed in the past decade by the Federal Reserve. Indeed, in late 2010 a distinguished list of economists and investors penned an open letter to then-Chairman Ben Bernanke that stated:

> We believe the Federal Reserve's large-scale asset purchase plan (so-called "quantitative easing") should be reconsidered and discontinued. We do not believe such a plan is necessary or advisable under current circumstances. The planned asset purchases risk currency debasement and inflation, and we do not think they will achieve the Fed's objective of promoting employment.

Yet the U.S. inflation rate from 2010 to 2020 has been tame, even bordering on "too low" in the opinion of some economists. However, recent events and price movements have some asking whether inflation may be preparing to rear its ugly head again. There is actually a statistic that measures investors' forward-looking expectations for inflation, and the chart below illustrates how these expectations have been rising:[5]

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[1] As Measured by the S&P 500.
[2] As measured by the relevant MSCI international indices.
[3] As measured by the Citigroup 1-10 Year Government Bond index.
[4] World Bank.
[5] Federal Reserve Bank.

Translation: One year ago investors thought inflation would average around 0.5% per year over the coming decade. Today, investors believe inflation will average around 2.3% per year over the coming decade, and expectations have been rising.[6]

Why is inflation so scary to investors? The goal when building an investment portfolio is to construct a diversified portfolio that can not only produce attractive long-term returns but also hold up okay in a variety of environments (for instance, recessions and expansions). The proven way to do this is to build a portfolio around core stock and bond holdings. Stocks have generated strong long-term returns on the back of good domestic and global economic growth. But during periods of crisis or recession when stock prices dropped, high-quality bonds provided a strong ballast to an investment portfolio, generating income and retaining value. Historically, stocks and bonds have acted as strong counterweights in building a diversified, resilient investment portfolio.

But inflation carries risk for both bonds and stocks. In the case of bonds, higher inflation rates typically bring higher interest rates. And when interest rates rise, bond prices fall (especially the prices of bonds with longer-dated maturities). Consider the fact that from 1973 through 1980, long-term government bonds produced annual returns of just 2.6%, despite the fact that inflation averaged 9.3%. In other words, long-term government bonds lost 6.7% of their value each year during that time period after adjusting for inflation.

Because corporations have some ability to pass along higher prices to customers, stocks (which represent ownership interests in corporations) can be expected to fare better than bonds in inflationary environments. But stocks are no silver bullet. As interest rates rise, the valuations that investors are willing to pay for stocks typically falls, as shown in the following graph (which plots how much investors are willing to pay for each dollar of earnings – the "P/E ratio" – versus inflation rates):

[6] The chart displays the "10-year breakeven inflation rate," which plots investor's expectations for inflation over the coming decade by taking the difference the interest rate on a U.S. government bond that doesn't adjust for inflation and the interest rate on a U.S. government bond that does adjust for inflation (called "Treasury Inflation Protected Securities," or TIPS).

From 1973 through 1980 large-cap stocks returned 6.5% per year, which was better than the 2.6% showing from long-term government bonds but still behind inflation by 2.8% per year. In sum, but stocks and bonds fell behind in terms of purchasing power during the inflationary burst seen in the 1970s.

Before we explore some ideas for fighting inflation within investment portfolios, we want to warn you that inflation is really hard to predict and we can't say definitively whether higher inflation is coming or not. Instead, the best we can do is say that the probability that inflation gets hot is higher than it has been in some time. The pandemic wreaked havoc on supply chains. At the same time, both the Federal Reserve and the Federal Government flooded the economy with money. As the economy re-opens and consumers start to release pent-up demand, it seems possible that we could witness too much money chasing too few goods – the classic recipe for inflation. And indeed you are seeing that with huge increases in the prices of various economic inputs (including certain commodities, home prices and types of labor).

That being said, the Federal Reserve's base case is that any spike in inflation will be a temporary phenomenon which will quickly dissipate. Then the long-term trend of sub-2% inflation, driven by industrial automation, changes in demographics, technology (e.g. the "Amazon effect"), and globalization, will re-emerge. It's unclear whether the Fed's prediction will be right or not – again, inflation is hard to predict! – but we shouldn't ignore some of the longer-term trends that existed before the pandemic.

All that being said, assume we had a crystal ball that indicated higher inflation ahead. Then what investments would we want to own? Well, the best thing to own would be an asset that generates a stream of cash flows where prices/revenue could rise with inflation but costs would remain low. This is why so-called real assets – things like commodities and real estate – have typically done well during inflationary environments. Rents usually go up with inflation, but a commercial building in good shape doesn't require much in the way of costs or investments. Likewise, a long-lived oil well is simply a royalty stream on oil pumped out of the ground, with little in the way of operating costs.

Yet we want to be careful to not assume that the future will resemble the past. And in this case, we have some concerns about the ability of rental rates and energy prices to march upward with inflation. The pandemic created a glut of commercial real estate – demand has been impaired for retail, office and even apartment space. And while we think investors are overly optimistic about the timeline for certain clean energy developments, we've nonetheless seen a potential shift in the demand curve for fossil fuels. So while these investments may still do well in an inflationary environment, we have some concern that they won't provide the protection investors have experienced during past episodes of high inflation.

In place of these typical investment ideas for an inflationary environment, we have been working on the following areas of research:

- *Floating-rate bonds*: Floating-rate bonds have much less exposure to higher interest rates than typical bonds. Unlike a typical bond, the amount of interest a floating-rate bond pays adjusts upward with higher interest rates. This is attractive. On the other hand, floating-rate bonds are often backed by less credit-worthy issuers, as more credit-worthy issuers prefer to lock-in lower rates with fixed-rate bonds.

- *Value stocks positively exposed to interest rates*: Growth stocks have outperformed value stocks over the past decade, driven in part by strong growth from technology companies and in part by low interest rates, which benefit growth stocks more than value stocks. If inflation starts to heat up and interest rates rise, this could benefit some value stocks. Certain value sectors, such as banks, specifically benefit from higher interest rates, which increase profits on lending activities.

- *International stocks*: U.S. stocks have outperformed international stocks over the past decade. But if inflation is a specifically domestic issue (or a bigger issue here than elsewhere), then one would expect the value of the dollar to fall versus foreign currencies. This would benefit international stocks relative to U.S. stocks, and could help reverse recent international stock market underperformance.

We hope to gradually build our allocation to these assets throughout the year in our effort to provide some potential protection against the risk of inflation, but will only proceed in cases where we think the specific investments make sense and don't carry excessive risk.

As always, we thank you for your continued confidence!

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
Ryan A. Kay, CFP®, AIF®
Benjamin D. Shively, CFP®, CIMA

We are pleased to announce that **Ben Shively, CFP®, CIMA** has joined our firm's investment team. He is a CERTIFIED FINANCIAL PLANNER™ and has earned the Certified Investment Management Analyst designation.

Ben has 22 years of experience in the investment industry designing and managing investment portfolios for individual and institutional clients. Ben earned his bachelor's degree in finance from Western Michigan University and his masters of business administration from the University of Notre Dame.

Ben is a past board member of the Jorgenson YMCA, past investment committee member of the Foellinger Foundation, and currently serves on the athletic committee for St. Elizabeth Ann Seton school.

Ben and his wife, Sarah, are the parents of a daughter, Claire (13), and a son, Colin (9).

We are excited to have Ben join our team and serve AMI clients. Please join us in welcoming Ben to the AMI family!