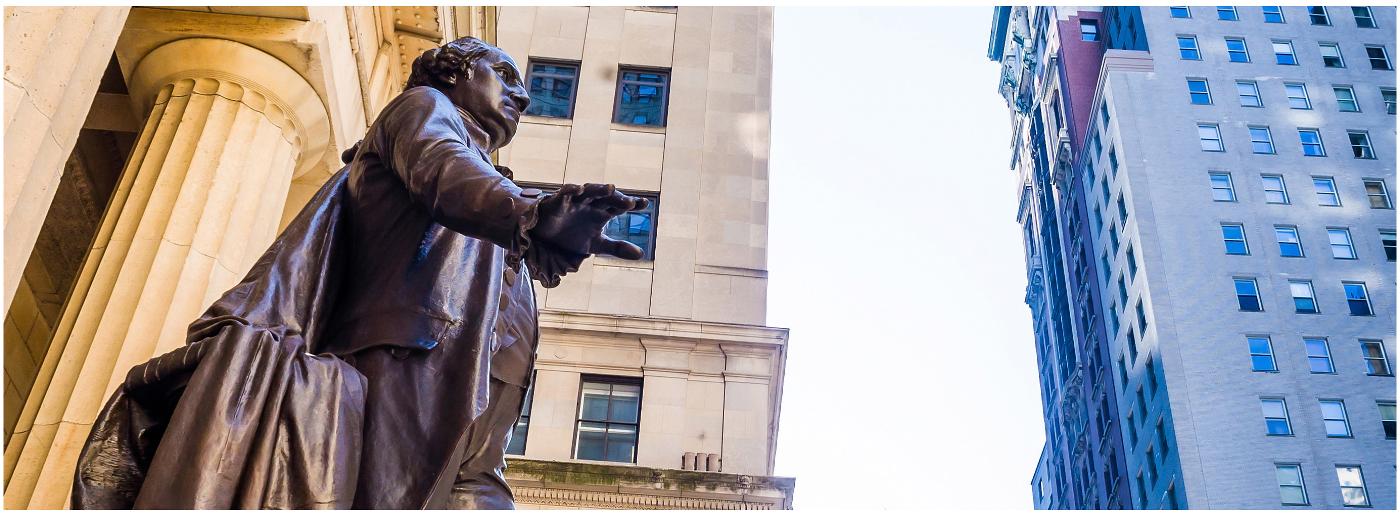
MARKET COMMENTARY

THE INFLATION THREAT



A central motive for investing is to avoid holding cash, whose value is eroded by inflation. While stocks have often been an excellent way to guard against inflation, high inflation can prove a challenge to building wealth. Inflation is again on the upsurge, and we want to take a minute to look at what inflation has meant to stock investors over time. Consider last week's eye-catching data. Headline inflation in May rose to 8.6% from 8.3% on a year-over-year basis, reaching a four-decade high. Surging energy and food prices led the way. Economists were expecting a rise of 8.3%. This reported increase masks the even larger spike measured from quarter to quarter. On this basis, the 3-month annualized inflation rate rose to 10.7% from 9.9%.

Table 1 | U.S. EQUITY RETURNS BY DECADE

	Before Inflation (Nominal)	After Inflation (Real)
2010s	13.6%	11.6%
2000s	-0.1%	-3.3%
1990s	18.2%	14.8%
1980s	17.6%	11.9%
1970s	5.9%	-1.4%
1960s	7.8%	5.2%
1950s	19.4%	16.8%
1940s	9.2%	3.6%

Source: Bloomberg, WCA

STOCK INVESTING AND INFLATION

Inflation represents the rate of erosion of the real value of an investment over time. Inflation also proxies the return investments need to maintain your standard of living. It occurs when too much money chases the volume of economic goods and services. When investment returns fail to pace inflation, wealth declines in a real sense. The investment wealth generated cannot buy the now higher-priced goods and services. In real terms, buying the same level of goods and services costs more. Thus, you, as the investor, are losing ground. If inflation is moderate and short-lived, the impact can be manageable. The effect can be hard to manage if inflation is high or carries on for many years.

Consider the last several decades. Table 1 highlights the damage that inflation does to investment returns. When returns are low and inflation high, positive stock returns can translate into negative real returns. In particular, look at the decade of the 1970s.

In the long run, nominal returns tend to obscure short-term trends in real returns. Investors with long time horizons should generally remain fully invested. This is especially true if inflation tends to revert to its long-run average level. But, if inflation persists and the economy weakens, personal consumption may need to be cut, and personal savings may need to increase if households are to meet future goals.

POLICYMAKERS' NEW JOB

The Federal Reserve (Fed) now has to play catch-up to neutralize inflation. The tools they will use to try and do this are interest rates and their balance sheet. They will rapidly increase interest rates and reduce holdings of assets. These actions are commonly referred to as monetary "tightening."

The current Fed Funds rate is 1%. Yet, the market is currently pricing in three rate hikes of 50 basis points each. This would bring the rate to 2.50% with more Fed tightening. With inflation running close to double digits, rates may need to go even higher. Whether or not more hikes are needed will depend on how inflation proceeds from here and how well the economy and markets hold up as the Fed tightens.

PROSPERITY NEEDS LOW AND STEADY INFLATION

We hope, of course, that the Fed successfully engineers a slowdown in the rate of inflation. Yet, the Fed got it wrong when they claimed more than a year ago that the inflation spike was transitory. Ongoing supply and demand imbalances and political turmoil suggest we have not yet seen the end of inflation. Low and steady inflation allows businesses and households to plan and invest, while high and uneven inflation undermines confidence.

Allowing inflation to continue and to undermine confidence would be a disaster, and policymakers know it. Moreover, inflation tends to hurt those at the bottom of the economic ladder more than those at the top. Consequently, "reining in inflation" should remain policymakers' number one job. We expect policymakers to err on the side of too much, not too little, action.

In conclusion, despite inflationary spikes, we continue to buy high-quality stocks. We see owning flexible, durable, and predictable businesses, trading at reasonable valuations, as a sound way to navigate the challenges of inflation.

WCA Fundamental Conditions Barometer Description: We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. The analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions. From each category of data, we create three diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks), while readings below 50 would indicate potential deterioration (potentially favoring bonds). The WCA Fundamental Conditions Index combines the three underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

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S&P High Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.
S&P Low Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

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