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Practical Reflections on Inflation

Even the most casual of observers are likely aware of the inflation debate roiling the capital markets, one that has seemingly accelerated with each economic report. Those who recall the 1970s may have a different perspective than others whose sole experience has been benign inflation. This letter's intent is not to dissect CPI, PPI, or money supply growth; instead, we discuss investor implications should problematic inflation materialize.

Why Fear Inflation?

Sustained price acceleration risks creating financial hardships, including imposing a regressive burden on those of lesser financial means given their propensity to spend a high percentage of income. Inflation may also penalize savers and those on fixed incomes due to its corrosive effect on the future value of assets. Rising price expectations also typically pushes up the cost of capital, thereby hindering capital spending. How this ultimately plays out is yet unknown, although the Federal Reserve on June 16th raised its inflation expectations and accelerated the time frame of initial anticipated rate hikes to 2023.

Making Sense of Price Volatility

In economics certainty is only obtained in hindsight; nonetheless, distinctions between healthy reflation and troublesome inflation are worth noting. The former is indicative of economic recovery marked by a resurgence in demand and has been a policy objective for more than a decade. May's Core CPI reading surged at a greater than 5% annualized YoY rate, although the Fed's revised headline inflation expectation for 2021 is currently a more modest +3.4%. Recent price increases have so far been led by a rebound in transportation costs, supply chain disruptions, and comparisons with cyclically low 2020 levels. Price volatility that reflects pandemic recovery is a good thing, although inflation hawks point to factors such as large public deficits, highly accommodative monetary policy, and wage pressures in raising alarms.

Troublesome inflation is generally characterized by excessive money supply relative to economic output, or aggregate demand significantly exceeding supply, imbalances that can snowball if not contained. By contrast, deflation is a feared economic regime associated with sustained price declines and anemic economic conditions. Falling prices harms those with fixed rate debt and other future liabilities, while also creating capital investment disincentives. Avoiding these risks is at the root of fiscal and monetary stimulus and factors into the Fed's willingness to let inflation run above their longstanding 2% annual target after years of sub-optimally low levels.

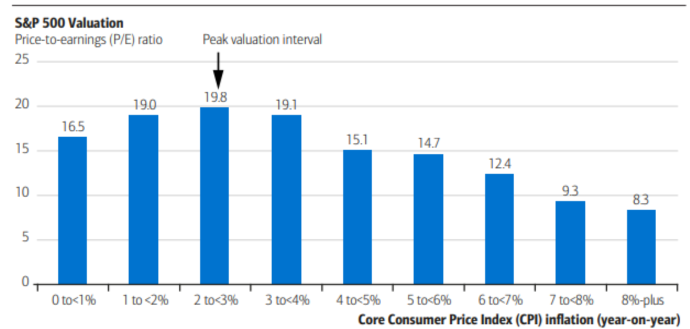
Transience vs. Sustainability: The Great Debate

The extent to which price pressures persist is an open question. The White House and Federal Reserve are in the transient camp in which we also reside, with Treasury Secretary Yellen stating on June 6th that "We have in recent months seen some inflation. . . But I personally believe that this represents transitory factors." These sentiments were echoed by Fed Chairman Powell during June 22nd Congressional testimony. Reading the inflation tea leaves is inherently speculative, as magnitude, nature, and duration are usually not evident in real time. For the sake of argument, let's accept that inflation could be a risk. If so, how might this impact asset allocation strategy?

Portfolio Strategy Considerations

Equities have been one of the better long-term inflation hedges. Although sharp increases in inflationary expectations can compress valuation multiples, equities have generally navigated price increases well. Modest inflation has historically been associated with healthy price-earnings ratios, whereas deflation presents more serious challenges. That is a contributing factor in the Fed's prioritization of economic growth relative to inflation risk.

Exhibit 7: Equity Market Valuations Tend To Decline As Inflation Moves To Higher Levels.



Source: Bloomberg. Data as of April 2021. P/E ratios are averages within inflation ranges based on monthly data from January 1958 to April 2021.

Source: Bank of America

Sector and individual stock performance in differing price environments is a topic unto itself, although cyclicals, strong growth franchises, and other companies with an ability to pass along cost increases typically fare better than those with longer duration cash flows and greater input cost sensitivity.

Real estate is a tangible asset with both income-producing and appreciation-oriented characteristics. Inflation erodes the present value of future cash flows and hedging against this with REITs can be advantageous given their tendency to benefit from rising rents and property values. REITs pass through income, and a rising stream of dividends coupled with potential capital appreciation has offered considerable value during inflationary periods.

Commodities, another "real asset," can add value in an inflationary environment as commodity prices have historically tended to increase as overall prices rise. Furthermore, commodities offer diversification benefits given a relatively low correlation to the broader equity and bond markets.

Floating rate investments, or variable rate bonds, adjust interest payments based on a reference benchmark such as Fed Funds. As price pressures across the economy rise those rates are likely to move up, thereby increasing income streams that help offset or reduce inflationary impact.

Financial Planning Implications

Armchair economists may enjoy prognostication although we recommend instead focusing on more personal matters. Investing is ultimately about reaching your long-term savings goals and funding future liabilities. Real returns net of inflation and taxes builds wealth, and should inflation rise, portfolio performance must at least keep pace to maintain the purchasing power of savings. Refining asset class exposures in consultation with your portfolio manager could be warranted as market conditions evolve. On the liability side of the balance sheet, in a rising rate environment consider converting variable rate debt to fixed obligations as a means of managing your interest burden. At Appleton, we do not believe in cookie cutter solutions and emphasize sticking with investment and financial planning strategies built around your needs and risk parameters.

MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- UST strength and strong demand for municipals caused longer maturity tax-exempt yields to fall over Q2, resulting in curve flattening. The 10Yr AAA dropped 13 bps while the 2Yr AAA rose 2 bps, reducing the 2 - 10Yr spread to 83 bps from 98 bps.

	3/31/21	6/30/21	QTD change
2Yr AAA Muni	0.14%	0.16%	+2 bp
10Yr AAA Muni	1.12%	0.99%	-13 bps
30Yr AAA Muni	1.75%	1.50%	-25 bps

- Despite June municipal issuance that fell 19% vs. the same period of 2020, YTD new supply through Q2 is up 6%. Full year consensus expectations have dropped from $500-550B to $460-515B. Issuance will have to pick up significantly to exceed $500B.
- Negotiations concerning the Biden Administration's $1.2T infrastructure plan are ongoing. The bipartisan proposal includes a provision to repeal the ban on tax-exempt advanced refundings (roughly 25% of issuance prior to its 2017 repeal), a development that could add significant, sought-after new supply.
- Another $27.8B of net cash flow came into municipal mutual funds in Q2 raising the YTD total to $59.5B. Term was in favor as Long funds received almost 75% of net flows with Intermediate funds gathering 15% (Lipper).
- Strong sustained demand left Muni/UST ratios in a tight mid-60s range for much of Q2. Expectations for higher tax rates are highly supportive of the bid side, and net negative supply is also a favorable technical factor as maturities and calls are outpacing issuance. We believe the 10-year ratio can remain in the 70s or lower during Q3 and possibly longer.
- Credit benefited from robust demand as AAA – A spreads tightened 7 bps to 25 bps and AAA – BBBs tightened 12 bps to 63 bps.
- Along with credit, duration also greatly influenced performance during Q2 and YTD. The Bloomberg Barclays Municipal Bond Index returned +1.42% during Q2 with the Long Bond index the best performing segment at +2.82% and the 1-year segment the worst at +0.10%. BBB rated credits led with a +2.60% Q2 while AAA rated credits returned +0.97%.
- Falling 10Yr UST yields have pushed our trading range to 1.10 – 1.75%. We could see sustained trading at the lower end of that range this summer with yields ticking up later in Q3. We are duration neutral on our Intermediate Municipal portfolios at 4.50 years and are focusing on high grade issues in a 6 to 12-year maturity range.

Investment Grade Corporates & Treasuries

- During Q1 the UST 10Yr rose 83bps to close at 1.74%, which remains the YTD high. Since that time, a rally in UST yields has driven the 10Yr to 1.47% as of the end of Q2 and 1.34% on 7/9. Yields are at their lowest levels since February as market concerns about the pace of recovery have increased, while inflation and potential Fed policy risks have somewhat receded.
- The tight IG credit spreads that have characterized markets over the past year remained in place during Q2. The Bloomberg Barclays US IG Corporate Index closed June at +80 OAS, a level last reached in February 2005.
- Although IG mutual fund flows fell sharply towards the end of June, YTD (+$100B) and Q2 (+$38B) net flows remain very healthy. Investor appetite for high quality bonds continues to be exceptionally strong and offers a solid technical backdrop for new issuance and credit spreads.
- After a banner year of new supply and with corporate balance sheets largely fortified, YTD gross issuance is 32% behind 2020 but well ahead of prior annual averages. We anticipate slowing 2H issuance which would be favorable for IG spreads.

Equities

- The S&P 500 rose 8.5% in Q2 to close the 1st half of 2021 at an all-time high after a 5th straight quarter of >5% returns.
- The extent to which volatility has declined of late is noteworthy. The VIX ended June at 15, the lowest level since pre-pandemic, and the largest YTD S&P 500 drawdown is only -4%.
- Complacency is a risk as investor enthusiasm grows. Retail flows have accelerated with >$350B of net equity ETF inflows during the first half of the year, more than any full year on record.
- Valuation is also on our radar with the 12-month forward P/E on the S&P 500 at 21.4x. Despite peak earnings fears, we are still seeing healthy corporate earnings with YoY growth of 63.6% projected in Q2 coming off a low prior year base. This earnings season will be closely watched as companies face increasing cost pressures.
- Style and sector rotation have received a great deal of recent attention as markets grapple with the economic outlook. 10Yr UST yields peaked on 3/31 before falling nearly 30 bps by quarter-end, a trend that has continued early in Q3. The decline in rates prompted Large Growth to outperform Large Value by over 6.7% during the past quarter.
- We still favor growth-oriented stocks in our portfolios while also maintaining some cyclical exposure.

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