VIEWPOINT

Inflation is here. What should investors do?

Key takeaways

- Investment strategies assuming a temporary inflation environment should incorporate the risks of prolonged higher inflation.
- We remain bullish on stocks, as the showdown between inflation and the Fed is a longer-term event.
- Rate positioning and the credit markets offer the best fixed-income opportunities—assuming a variety of inflation scenarios.
- Stronger economic growth and a ‘new Fed regime’ favor the prime space in the liquidity markets.
Inflation is here. What should investors do?

Everyone was expecting inflation to run hotter this year. It hasn’t disappointed. The Core Producer Price (PPI), Consumer Price (CPI) and Personal Consumption Expenditures Price (PCE) inflation indexes are at multi-decade highs.

The question is, how long do the inflationary pressures last? The Fed contends the broad-based price increases ultimately will prove transitory, and it’s sticking with policy rates near zero and $120 billion in monthly bond purchases—even as economic growth is roaring. Some investors, particularly those veterans who were around when double-digit inflation was the bane of all assets, aren’t as sanguine. With inflation proving difficult to rein in once it breaks out, they fear the Fed may be forced to act far more aggressively, with rapid and growth-crippling rate hikes sooner rather than later.

At the root of this tug of war between policymakers and market participants is the pledge of a so-called “new Fed regime.” The goals of the new Fed regime are to be more inclusive in the definition of “maximum employment”—the Fed wants to see significant progress among lower-income households—and to be more patient before tightening policy levers. It wants to lift long-term average PCE inflation to 2%, a level reached only once in the last dozen years, meaning inflation would need to run higher for some time. If inflation falls back to its pre-pandemic pattern, the Fed worries growth—and improvements in less fortunate sectors of the economy—could unnecessarily suffer.

Deborah Cunningham, Robert Ostrowski and Stephen Auth, Federated Hermes chief investment officers for global liquidity products, fixed income and equities, respectively, see challenges—and opportunities—in this conundrum. What isn’t in dispute is that, regardless of whether inflation’s current run-up proves transitory, the markets must play the inflationary hand being dealt.

The Equities Market

For equities, there’s time, but two scenarios loom

With the economy running full bore, Stephen Auth, Federated Hermes chief investment officer for equities, remains bullish on equities in the nearer term and expects value and cyclical stocks to extend their leadership, though in a choppier fashion amid unpredictable economic news. Federated Hermes’ S&P 500 Index forecast of 4,500 for 2021 remains intact, as does its longstanding target on this secular bull of 5,000 in subsequent years, with the potential for more upside.

But potential inflation risks are hardly being ignored. Auth breaks it down as investors being being presented with a “free lunch” by fiscal and monetary authorities, with the word “trillion” rolling off our representatives’ tongues as smoothly as “billion” once did, and a Fed determined to continue easy policy until full employment is reached in all income cohorts.

With record levels of cash piled everywhere, and the psychological relief of the vaccines lighting the spark, economic growth is currently taking off like a rocket ship. Supply shortages, logistics challenges and reluctant-to-return workers are together leading to this sudden burst in inflation, an outcome Federated Hermes expects to continue through the year. Our macroeconomic policy team projects core PCE to average 2.6% this year and a still elevated 2.4% in 2022.
In periods of heightened inflation, which investments performed better than others?

Federated Hermes analyzed the betas to the U.S. Consumer Price Index (CPI), displayed here by major asset class and sector indexes since 2001. The indexes are ranked below by positive price changes relative to changes in the CPI. The ranking could signal the kinds of investments that may perform better or worse during periods of heightened inflation.

Index betas to CPI

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Index</th>
<th>Beta to CPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodities</td>
<td>Bloomberg Commodity Index</td>
<td>10.54</td>
</tr>
<tr>
<td>Emerging-Market Stocks</td>
<td>MSCI Emerging Markets Index</td>
<td>8.23</td>
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<tr>
<td>Global ex-U.S. Stocks</td>
<td>MSCI ACWI ex USA Index</td>
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<td>International Developed</td>
<td>MSCI EAFE Index</td>
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<td>(Small-Cap Stocks)</td>
<td>MSCI EAFE Small Cap Index</td>
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<td>Small-Cap Value Stocks</td>
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<td>3.54</td>
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<td>Small-Cap Growth Stocks</td>
<td>Russell 2000® Growth Index</td>
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</tr>
<tr>
<td>Large-Cap Growth Stocks</td>
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<td>3.18</td>
</tr>
<tr>
<td>Dividend Stocks</td>
<td>Dow Jones U.S. Select Dividend Index</td>
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</tr>
<tr>
<td>Developed International</td>
<td>Bloomberg Barclays Global Aggregate ex USD</td>
<td>2.22</td>
</tr>
<tr>
<td>(Bonds)</td>
<td>Index</td>
<td></td>
</tr>
<tr>
<td>Large-Cap Growth Stocks</td>
<td>Russell 1000® Growth Index</td>
<td>1.84</td>
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<tr>
<td>Treasury Inflation-Protected</td>
<td>Bloomberg Barclays US Treasury Inflation-Linked</td>
<td>1.53</td>
</tr>
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<td>Securities (TIPS)</td>
<td>Bond Index</td>
<td></td>
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<tr>
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<td>JPM Emerging Markets Bond Index Global (EMBI Global)</td>
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<tr>
<td>High-Yield Bonds</td>
<td>Bloomberg Barclays US Corporate High Yield Bond Index</td>
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<td>Cash</td>
<td>ICE BoA 3-Month Treasury Bill Index</td>
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<tr>
<td>Government Bonds</td>
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<tr>
<td>Mortgage-Backed Securities</td>
<td>Bloomberg Barclays US Mortgage Backed Securities (MBS) Index</td>
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<tr>
<td>Corporate Bonds</td>
<td>Bloomberg Barclays US Credit Index</td>
<td>-0.41</td>
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</table>

For illustrative purposes only and not representative of any specific investment.

Past performance is no guarantee of future results.

Inflation beta is a measure of the responsiveness of an asset class’s (represented here by the indicated indexes) returns to changes in inflation. Instead of calculating the risk of a stock to the overall market, this beta calculation reflects the risk of the asset class to CPI. For example, beta of 1.1 would indicate that if there were a 1% change in the CPI, the index would change 1.1% (or 10% better in times of inflation and 10% worse in times of deflation). Higher betas indicate higher risk to CPI, and potentially a better hedge in times of inflation. The beta is calculated using the year-over-year changes of both the seasonally adjusted CPI and each representative asset class index. The underlying data utilized for this analysis ranges from 1/31/01 to 4/30/21 (Y/Y returns from 1/31/02 to 4/30/21).
Inflation is here. What should investors do?

Nominal earnings have exploded amid the supportive environment of easy money and robust economic growth, prompting our equity team to raise its 2023 forecast again to $250 a share on the S&P 500 Index. With the discount rate on stocks, i.e., the 10-year Treasury yield, being held artificially low, many components of the S&P 500 are trading at attractive valuations, creating fertile ground for active strategies.

Secular bull vs. policy error

Ultimately, we see two scenarios for equities in 2021. The first is our base case “secular bull lives on” option: the Fed is right, inflation quickly recedes to the targeted 2% pace and there’s no need to tighten rates by more than 100 basis points or so—an outcome that likely would force our equity team to raise its longer-term S&P 500 Index target above 5,000.

The second is our “policy error” scenario: the Fed is wrong, inflation and nominal earnings accelerate but policymakers put off tightening or at least tapering. This likely would lead to a speculative blow off, potentially driving the S&P temporarily higher than our longer-term 5,000 base case as earnings explode against the artificially low discount rate on those forward earnings. But sooner or later, the “free lunch” would have to be paid for. Inflation running well north of 3% would force dramatic and sudden rate hikes, potentially causing a recession and with it, a precipitous market drop that could far exceed the normal 20% pullback that occurs from time to time in bear-market corrections. It could get ugly.

Our equity team is inclined to give the Fed the benefit of the doubt for now as policymakers have started mentioning the word “tapering.” Importantly, the near-term outcome is likely to stay positive for stocks, prompting a continuing overweight call to equities. Cyclical/value sectors that tend to do well in the early stages of an expansion are favored. Individual stock selection is key in uncovering inflationary winners, including in emerging-market countries whose resource-oriented economies are benefiting from the run-up in commodity prices. We also believe Europe, which lagged the U.S. for much of the recent run in stock, offers potential as its economy is starting to reopen rapidly.

Valuation opportunity?

The consensus earnings estimate for the S&P 500 Index are surging, while its P/E is toward the bottom of its recent range.
The Fixed Income Market

With bond yields so low, even small increases are disruptive

Despite inflation’s breakout and pandemic-related fiscal stimulus totaling more than $5 trillion so far, 10- and 30-year Treasury yields remain below March highs and well below pre-pandemic cycle highs. This means the bond market, particularly the government end, is priced with little room for error.

So, if the market begins to perceive inflation might run higher for longer and/or sniffs that the Fed’s taper may come sooner than expected, these range-bound yields could move rapidly, undermining whatever income benefits investors receive from higher Treasury coupon rates. With the 10-year breakeven rate around 2.5% and real rates continuing to run negative across most of the yield curve, it’s all about what is and isn’t priced in—and moves in policy rates that come earlier than the 2023 futures markets are indicating and/or a taper that occurs before 2022 almost certainly aren’t priced in.

Bond market is pricing in inflation

10-year Treasury breakeven rate

As of 6/8/21. Source: Federal Reserve Bank of St. Louis, 10-Year Breakeven Inflation Rate (T10YIE), retrieved from FRED.

Breakeven rate is the difference in yield between inflation-protected and nominal debt of the same maturity. If the breakeven rate is negative it suggests traders are betting the economy may face deflation in the near future. The latest value implies what market participants expect inflation to be in the next 10 years, on average.

“It’s not going to take Volcker-like 21% (federal fund target) rates [when the former Fed chair pushed rates to historical levels in the early 1980s to quash inflation] to create a lot of pain for the bond market,” says Robert Ostrowski, Federated Hermes chief investment officer for global fixed income. Even a move from current 10-year Treasury yields to historically modest yields of 2.5% or 3% would represent costly nominal increases for a market already on edge due to pandemic-fed record deficits and the Biden administration’s push for continued spending.

Guns and butter

Ostrowski draws parallels with the “guns and butter” era of the 1960s, when the nation was financing the Vietnam War and a rash of new domestic programs. Only this time, the war is Covid and unprecedented fiscal and monetary stimuli is the response, with an increased focus on disenfranchised segments of the economy taking center stage. To be clear, Ostrowski sees neither rates nor inflation approaching near-crazy 1970s-early 1980s’ levels. But, ever-rising fiscal spending, and the new issuance that entails, almost certainly won’t be positive for government bonds.

Of course, yields’ inverse relationship with prices is just one factor in determining bond returns. By acting to capitalize on rate trends and the differential between shorter- and longer-term rates, bond portfolios can generate positive absolute returns during periods of rising rates. Positioning portfolios for a steepening yield curve or setting duration short of the benchmark can seek to generate potential alpha if longer rates are rising—strategies Federated Hermes has been deploying across fixed-income portfolios. On the international front, a non-dollar bias also can generate potential returns when inflation is breaking out.

Certain sectors of the bond market more closely aligned with the broader economy can benefit from rising inflation and rates, too, depending on the reasons for the increases. High yield, emerging markets and other credit sectors that have a higher beta relative to inflation versus other sectors of the bond market have benefitted this past year on accelerating growth, rising earnings, declining default rates and increasing consumer demand. These are all characteristics of a recovering global economy that’s earlier rather than later in its cycle. Specialized credit segments linked to global growth, such as bank and other floating-rate loans, trade finance and fixed-income strategies with equity exposure also have offered attractive opportunities.

The Liquidity Market

It’s all how you define “transitory”

“Even a temporary spike in inflation can have lasting consequences,” says Deborah Cunningham, Federated Hermes chief investment officer for global liquidity markets.

Consider these inflation scenarios. While employment remains nearly 8 million jobs short of pre-pandemic highs and the Fed wants to wait until it is running hot before acting, costs from increasing wages often are passed on to the market as price hikes that stick around. If they don’t, company margins shrink. Either scenario could be damaging to the economy.

More to the point is the prevailing narrative that a lot of pent-up consumer demand will be exhausted come fall. Cunningham doesn’t think that is likely. While many Americans have booked summer vacations, shelled out to renovate their homes and bought tickets to concerts, sporting events and other entertainment, they can’t spend everything at once. A personal savings rate that skyrocketed with all the stimulus and forced hibernation is high enough to support many months of trips and activities.
Consumers have money to burn...

**Personal savings as a percent of disposable income (%)**


Personal savings rate is personal saving as a percentage of disposable personal income.

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**It’s all about supply**

A growing number of policymakers are indicating the time may be nearing to start discussing tapering, i.e., a reduction in the Fed’s monthly asset purchases, meaning more supply could soon hit the markets. Historically, just talk of tapering tends to push market yields up. Treasury Secretary Janet Yellen also expects the Treasury to have ample balances on hand when the debt ceiling is hit on Aug. 1, meaning money markets won’t lose as much supply as had been thought.

Both developments—taper talk and little debt-ceiling drama—should prove beneficial for short yields, particularly in the prime, i.e., non-government securities space and in tax-free municipals. Both are linked to the economy’s broader—and improving—performance.

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**In sum**

Every economic cycle is different, and this one could spawn heightened inflation. Disruptions, dislocations and volatility are to be expected. The issue for investors will be determining which strategies and assets work best in the this unique environment, so an asset manager that has navigated all market conditions with broad capabilities is critical.
Inflation is here. What should investors do?

Past performance is no guarantee of future results.
Investments are subject to risks and fluctuate in value.
International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards. Prices of emerging markets security can be significantly more volatile than the prices of securities in developed countries and currency risk and political risks are accentuated in emerging markets.
Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices. High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment grade securities.
Small company stocks may be less liquid and subject to greater price volatility than large company stocks.
Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

Alpha is a measure of excess return relative to the return of a benchmark index.
Value stocks may lag growth stocks in performance, particularly in late stages of a market advance.
Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.
Diversification does not assure a profit nor protect against loss.
The P/E ratio helps investors determine the market value of a stock as compared to the company's earnings. A low P/E ratio might indicate that a stock that has the potential for significant growth is undervalued. P/E ratios are only one indicator of a company's financial well-being.
Core Producer Price Index (PPI) measures the change in the selling price of goods and services sold by producers, excluding food and energy. The PPI measures price change from the perspective of the seller.
Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.
Personal Consumption Expenditures Price Index is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services.
The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.
S&P 500 Index is an unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.
Bloomberg Commodity Index (BCOM) is a broadly diversified commodity price index distributed by Bloomberg Indexes. The BCOM tracks prices of futures contracts on physical commodities on the commodity markets. The index is designed to minimize concentration in any one commodity or sector. It currently has 23 commodity futures in six sectors.
MSCI Emerging Markets Index captures large and mid-cap representation across 27 Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.
MSCI ACWI ex USA Index captures large- and mid-cap representation across 22 of 23 Developed Markets (DM) countries (excluding the U.S.) and 27 Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.
MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the US and Canada. The index covers approximately 85% of the free float-adjusted market capitalization in each country.
MSCI EAFE Small Cap Index is an equity index which captures small cap representation across Developed Markets countries around the world, excluding the US and Canada. The index covers approximately 14% of the free float-adjusted market capitalization in each country.
Russell 2000® Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-value ratios and higher forecasted growth values.
Russell 1000® Value Index measures the performance of the large-cap value segment of the US equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values. The Russell 1000® Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment.
Dow Jones U.S. Select Dividend Index measures the performance of 100 high dividend-paying companies, excluding REITs, meeting specific criteria for dividends, earnings, size and liquidity.

 Bloomberg Barclays Global Aggregate ex USD Index is a measure of investment grade debt from 24 local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. Bonds issued in USD are excluded.
Russell 1000® Growth Index measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment.
Bloomberg Barclays US Treasury Inflation-Linked Bond Index measures the performance of the US Treasury Inflation Protected Securities (TIPS) market. Federal Reserve holdings of US TIPS are not index eligible and are excluded from the face amount outstanding of each bond in the index.
J.P. Morgan Emerging Markets Bond Index Global ("EMBI Global") tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes U.S. dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. It covers more of the eligible instruments than the EMBI+ by relaxing somewhat the strict EMBI+ limits on secondary market trading liquidity.
Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB- or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.
ICE BofA 3-Month Treasury Bill Index is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month, that issue is sold and rolled into a newly selected issue. The issue selected at each month-end rebalancing is the outstanding Treasury Bill that matures closest to, but not beyond, three months from the rebalancing date. To qualify for selection, an issue must have settled on or before the month-end rebalancing date.
Bloomberg Barclays US Government Bond Index is comprised of the US Treasury and US Agency Indices. The index includes US dollar-denominated, fixed-rate, nominal US Treasuries and US Agency debentures (securities issued by US government owned or government sponsored entities, and debt explicitly guaranteed by the US government).
Bloomberg Barclays US Mortgage Backed Securities (MBS) Index tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage.
Bloomberg Barclays US Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supra-nationals and local authorities.

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