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We have been getting questions recently about the potential of unexpected inflation in the future, given the massive amount of fiscal and monetary stimulus being applied to the U.S. economy. The Fed's latest forecast for this year's GDP growth is 6.5% and the Consumer Price Index for March was reported last week to be 2.6% annualized, both of which are sparking concerns of higher inflation going forward. The fear is that the trillions of dollars of injected government stimulus could push the economy forward too fast, causing it to overheat.

Before we get too concerned however, we must acknowledge that the inflation rate reported for March occurred in a month that was not statistically normal. The economy is recovering from a pandemic-led shutdown, which leads to all kinds of data distortions. To illustrate, consider gasoline prices. They were up 12.3% annually as of February, but increased to a whopping 22.5% when measured in March. This statistical result was caused by energy demand falling dramatically a year ago and then suddenly increasing in recent months. Producers are now struggling to meet new demand as it recovers. Prices have spiked unnaturally because it takes time for gasoline production to increase sufficiently to meet the new demand.

Food price changes for February and March show a similar pattern, which is why economists tend to discount or completely ignore volatile food and energy prices when evaluating the base rate of inflation. We will continue to see distortions in coming months because price declines in some sectors of the economy did not bottom out last year until April or May.

Economists expect a one-time reset with prices spiking and then normalizing into 2022. For example, the First Quarter 2021 Survey of Professional Forecasters projects inflation over the next 10 years to be just 2.2%. Market prices are in accordance with this view. As of April 6, 2021, the spread between 10-year nominal treasuries and 10-year Treasury Inflation Protected Securities (TIPS)—a good measure of the market's expectation for future inflation—was 2.32%.

In short, we should expect to see inflation reports higher than the Fed's 2% target in coming months, with a reduction and steadying of the rate closer the target into 2022. The Fed has indicated that it will allow, and in fact desires, inflation to temporarily go above their 2% target so that it will average 2% over the longer term.

All of this not withstanding, there are some economists who are worried about the effects of too much stimulus. It is comforting to know that if unexpected inflation occurs, there are parts of a diversified portfolio that should provide protection. Short-term bonds, for example, tend to do better than longer-term bonds as interest rates rise, and U.S. investors holding international stocks benefit from a falling U.S. dollar, which is common in periods of high domestic inflation like we experienced in the 1970s. While equities in general can struggle in a rising interest rate environment because increased discount rates applied to future expected earnings decrease present values, this can be moderated over the longer term to the extent companies can pass along price increases to customers.

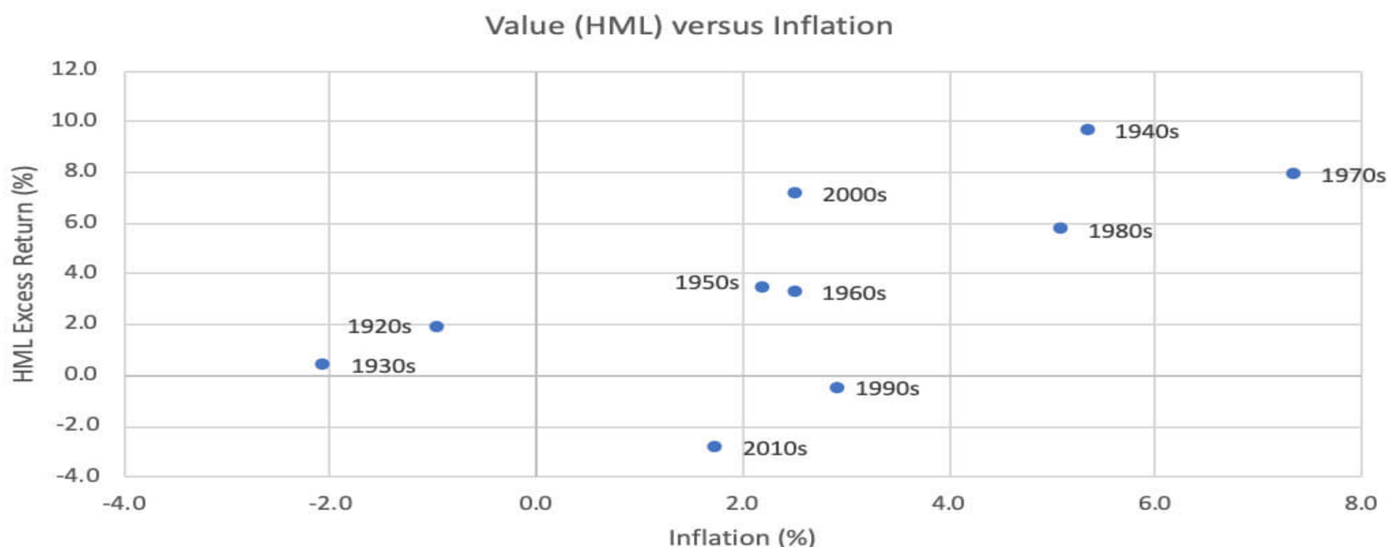
Additionally, Andrew Berkin of Bridgeway Capital Management recently published a report showing that value stocks have historically done best in periods of higher inflation. Value stocks have low stock prices relative to underlying measures of valuation like earnings or book value. Berkin noted that from 1927-2020, the average

annual difference in return between value stocks and growth stocks, (known as the value premium) was +4.0% in favor of value. These higher returns are why it is wise to include value stocks in your portfolio.

But the really interesting part of Berkin's work shows that the value premium has had a positive correlation with inflation, yielding the following results:

- When inflation was between 0% and 3%, the value premium was 3.1%
- When inflation was greater than 3%, the value premium was 6.6%
- When inflation was greater than 4%, the value premium was 6.2%

The chart below shows the historical relationship between the excess performance of value and inflation by decade. Berkin uses long time periods, rather than monthly or annual data points, to more clearly show the relationship between higher inflation and higher value premiums. The most recent decade of the 2010s had a negative value premium with slow economic growth and low inflation coming out of the Great Recession.



Source: Ken French data library, Federal Reserve Bank of St. Louis, 7/1926-12/2019 (most recent decade data available)

For further evidence consider the relationship between the global value premium and inflation from 1985-2019 as reported by Brandes Investment Partners. They found that during periods of rising inflation, the global value premium was 2.2% compared to -2.1% when inflation was falling. They also examined the relationship between the performance of the Russell 1000 Value and Russell 1000 Growth Indices from 1979-2019. They found that the value index outperformed growth by 2.7% when inflation was above average and underperformed by 3.2% when inflation was below average.

After a long period of underperformance of value stocks worldwide, we now have an overall economic environment with record stimulus measures and the Federal Reserve pushing for more inflation that may favor value and restore the value premium. At the very least, if you are concerned about inflation, having exposure to value stocks should provide some comfort that they have done well in past inflationary conditions.

As always, thank you for you continued trust and confidence.

Warm regards,

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