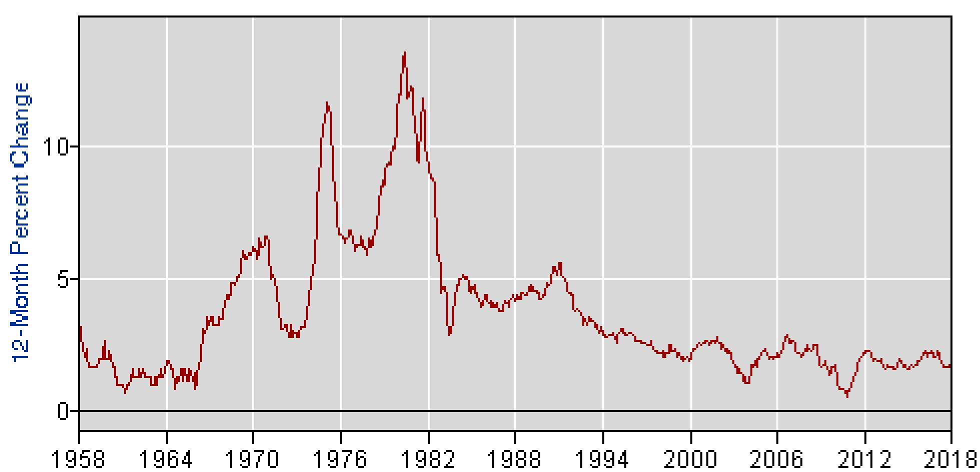
One Eye on Interest Rates, the Other on Inflation
March 8, 2018

Not many of us would envy the Federal Reserve's job of overseeing the U.S. economy. It's a monumental task, one that requires vigilant watch and careful utilization of tools that can have an impact on all Americans. One such tool is using short-term interest rates to spur the rate of inflation to a desired target.

Generally, interest rates and inflation move in opposite directions. If the Fed wants to counteract the threat of rising inflation from a strong economy, it can raise rates in a measured fashion, as it did last year and is expected to do again in 2018. The desired effect would be a tame and manageable level of inflation for the foreseeable future. But this can be a tricky balancing act for the Fed, considering there is about a two-year time lag between changes in interest rates and when we see the ensuing rise or fall in the inflation rate. This is why the Fed can run the risk of acting too aggressively and overshooting an inflation target.

Below is a chart of the historical inflation rate in the U.S. going back to the late 1950s:



Source: Bureau of Labor Statistics – CPI less food and energy in U.S city average

The current inflation rate, around 2%, is low by historical standards. Some of you might remember the roaring inflation of the 1970s and early 1980s. We're nowhere near those levels. But now that the economy is on its own footing and showing growth, the topic of inflation has surfaced in the financial media. One could argue that signs of higher inflation have crept into certain segments of the economy, like housing and employment costs. Even though we're far from the high inflation levels of the past, we felt that it was worth a discussion with regard to how higher inflation might impact your investments.

Inflation & Equities

You might have heard the saying “the market hates uncertainty.” This notion works with inflation as well, since the impact of higher inflation on stocks can depend on whether it is expected or unexpected. Companies can plan for expected inflation levels, but it can be a different story with sudden, unexpected inflation shocks. Corporations would need time to adjust to rising input costs, and stock prices, in turn, would need to reset to new inflation expectations. There tends to be an initial negative reaction from the stock market at the prospect of higher inflation, but after market expectations reset, focus can return to the economy and profits.

Stocks are generally considered to be a hedge during periods of rising inflation, and there are certain areas of the equity market that tend to hold up better. For example, value stocks, like those in the energy and materials sectors, tend to perform better than growth stocks during periods of high inflation. Exposure to other asset classes, such as gold and commodities, can mitigate the impact of inflation on equity portfolios. Therefore, there are ways to shuffle the equity deck and manage risk when inflation rises.

Inflation & Bonds

Higher inflation has the same effect on bond prices as higher interest rates in that both push bond prices lower. While bonds are negatively affected by higher inflation, there are steps that can be taken to offset the impact to fixed income portfolios. These include investing in shorter-maturity bonds, Treasury-Inflation Protected Securities (TIPS), and bank loan funds.

FSA has already begun making adjustments in our income-oriented strategies to manage the risk of a rising-rate environment. These adjustments to the type of bond funds we’ve been using will also help cushion the portfolios from rising inflation. Just as the Fed has one eye on interest rates and the other on inflation, we remain vigilant to watch for signs that it’s time to make further adjustments.

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