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Counting on an Investor-Friendly Inflation Outlook

Key takeaways

- We are expecting global inflation in coming years to navigate a path between declines and a sustained rise, leaving its projected rate of approximately 2% within a range that we think is ideal for financial-asset returns.
- Unused capacity, structural restraints, and an unusually loose link between the Federal Reserve's aggressive stimulus and spending are important lines of defense against inflation's sustained rise.

What it may mean for investors

- Within a well-diversified portfolio, we believe that high-quality non-Treasury bonds in the U.S., along with earnings-resilient, large-cap U.S. growth stocks, are well-positioned for the modest inflation and moderate growth that we expect in coming years.

On its back

Nearly lost in the debate over the U.S. economy's growth prospects is an equally uncertain inflation outlook. "Deflation" (or declining prices) worries linger, even as concern over scattered supply shortages and fallout from unusually aggressive monetary and fiscal stimulus keep inflation worries on the front burner. Our view is that inflation's most likely path is between "disinflation" and a steady rise, averaging less than 2% over the next year or two and about 2% in the decade beyond that.

June's outsized increase in U.S. consumer prices said more about inflation restraint than gathering pressure. The largest monthly increase in 8 years, centered on volatile fuel costs, still left its 12-month rate below 1% and the more stable "core" rate (excluding food and energy) at a 9-year low of little more than 1.3%. Equally subdued June wholesale and import cost increases seemed to be signaling an "all clear" as well. The U.S. isn't alone in grappling with slowing inflation from an already historically low rate. For example, June's consumer prices in the eurozone were up just 0.3% from a year earlier.

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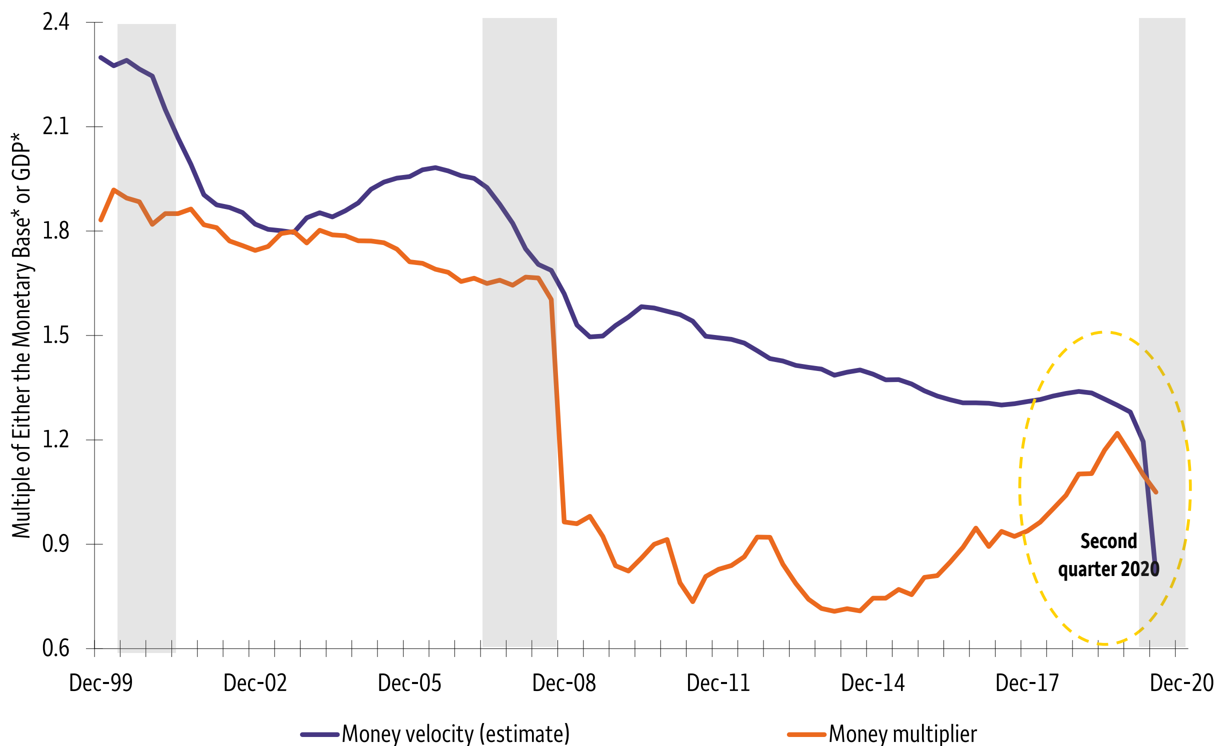
Inflation expectations have edged higher in the U.S., although Wall Street's outlook is more guarded than that of Main Street. While they have risen in recent months, investors' inflation expectations remain below pre-pandemic levels. That is based on the breakeven rate for 10-year Treasury Inflation Protected Securities (TIPS) equating the yield on a conventional Treasury security to the all-in yield (that is, the stated yield plus the inflation adjustment) on a comparable TIPs issue. Households have taken a different view of the near- and longer-term inflation outlook, sending both to the upper end of their five-year ranges in recent months, according to a University of Michigan monthly survey.

No fire this time

Inflation worries are based on aggressive fiscal and monetary stimulus, raising fears of the same "too much money chasing too few goods" that was responsible for rising inflation in the late 1960s and 1970s. Moreover, supply shortages from the pandemic's disruptive effect leave the economy vulnerable to scattered price "spikes" with a rebound in demand, risking higher inflation.

However, the greater threat from price spikes in a low inflation, weak pricing environment is further "disinflation," as businesses and consumers respond by cutting costs or diverting spending. And despite the government's aggressive pump priming, a loosened link between funds supplied by the Federal Reserve (Fed) and money created by banks and spent has prevented a buildup of inflation. Both are captured in a historically low money multiplier (the ratio of the money supply to funds created by the Fed) and money velocity, roughly defined as the number of times money changes hands to finance a certain level of transactions (see chart below).[1]

Behind the weak link between Fed stimulus and U.S. inflation



Sources: Federal Reserve Board, July 2020; U.S. Commerce Department, June 2020. GDP = gross domestic product. Second-quarter GDP is a Wells Fargo Investment Institute estimate. Shaded areas represent recessionary periods. Monetary base = currency plus bank reserves. Money multiplier = money supply divided by the monetary base. Money velocity = GDP/MZM money supply. Money of zero maturity (MZM) is a measure of "transactions-based" money readily available for spending.

[1] The more often the dollar changes hands, increasing velocity, the more likely that a policy injecting money into the market will boost demand and raise inflation.

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Structural changes form an even more imposing second line of defense against rising inflation in the U.S. and abroad, as outlined in a Wells Fargo Investment Institute report titled "Inflation: The Economy's Dog that Didn't Bark."[2] Among the many changes reversing the "great inflation" of the late 1960s and 1970s are globalization exposing established players to low-cost producers, deregulation, and cautious spending by an aging population. Costs also have been contained by the growing importance of less capital-intensive technology and services industries, lowering entry barriers for new and, at times, more innovative firms.

Technological change has weighed in with the rise of lower-cost, online shopping and rapidly growing technology and social media firms relying on less apparent charges to avoid price increases, while creating value. Subdued inflation's pressure on business pricing power has encouraged aggressive cost-cutting by businesses to maintain margins in a weak pricing environment through sales of less costly, private-label goods and through efforts to undercut the power and influence of unions.

Behind inflation's high-stakes outlook

Inflation is at the core of investment returns, so the stakes in its outlook are critical to asset performance. Stocks are affected by inflation's effect on business pricing power, profit margins, and earnings. Inflation also affects stock valuations, through its close tie to interest rates and the value of competing bonds. Elevated stock and bond valuations at these historically low interest rates make the financial markets all the more sensitive to even modest changes in the interest rates and inflation typically driving them. The economic link between gold and other commodity prices to inflation tends to be barbelled—support both from low inflation suppressing yields on competing financial assets and from unusually rapid price increases attracting investors to gold as an inflation hedge.

Despite elevated valuations, financial assets stand to benefit from prospects for modest inflation, much like they have in recent decades. Our view is that the fixed-income investments that are in position for the moderate growth and inflation environment that we expect in coming years are high-quality non-Treasury bonds in the U.S. (within a well-diversified portfolio). We believe that more liquid, earnings-resilient, large-cap growth stocks are the best equity fit for this type of backdrop, particularly those in the more technology-oriented U.S. We also believe that the combination of strong growth and rising inflation is less likely to support value stocks and defensive equities.

[2] Wells Fargo Investment Institute, December 31, 2019.

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Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Growth stocks** tend to fluctuate more than the overall market and growth may not be realized. The growth style of investing tends to shift in and out of favor. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. **Treasury Inflation-Protected Securities (TIPS**) are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until maturity. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

Definitions

An index is unmanaged and not available for direct investment.

The **Consumer Price Index (CPI)** produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

Gross domestic product (GDP) is the monetary value of a country's finished goods and services produced during a specific time frame. GDP is usually calculated on an annual basis and includes private and public consumption.

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