Client's Corner

Inflation's Back—and That's Why You Own Equities

THE ANNOUNCEMENT ON NOVEMBER 10 THAT THE CONSUMER Price Index had soared 0.9% in October—and was up 6.2% from a year earlier—came as no surprise to anyone who'd shopped in a supermarket and/or gassed up their car recently. Inflation is back, it's very real, and it's biting into the budgets of every American household.

That's why you own equities.

Set aside for a moment the unanswerable question of how durable this inflation spike will prove to be—whether it is by any sane definition "transitory" or…not. The signs in this regard are, to put it mildly, ambiguous. Yes, headline inflation is at a 30-year high. But interest rates remain relatively subdued, and gold—which is widely believed to be an efficient short-term inflation hedge despite all evidence to the contrary—is no higher than it was a year ago. If we were headed into a prolonged period of '70s-style stagflation, both of these indicators should long since have begun sending up flares. Likewise a rising dollar, which as I write is near a 16-month high: were stagflation imminent, it should already be going south, and with a vengeance.

Set aside as well, if you can, the not insignificant fact that at about 4,650 on the S&P 500, the Index is up 24% this year. If your cost of living is up six percent, and your capital is up four times that much, you may be said not only to have hedged against inflation but to have beaten the living daylights out of it. Yet I say again: set this aside, because such short-term comparisons are for headline writers, not serious investors.

Let us instead—in search of a potentially meaningful comparison—return to the last year in which inflation ran at an annual rate of six percent for 12 months. That year was 1990.

Be assured that every single headline about inflation you've seen this year—and the text of all the accompanying reportage—mirror everything you would have been reading (and hearing) in late 1990, all but word for word. And that was a time when people vividly, personally ***remembered*** the horrors of '70s stagflation, which had crested barely 10 years earlier. Yet here's what happened:

• The S&P 500 ended the year 1990—a recession year, with war in the Gulf just days away—at 330.22. At the current level around 4,650, ***it is up 14 times***.

• The cash dividend of the S&P 500—which is what retired equity investors often use to pay for groceries and gas—was $12.09 in 1990. Data from Bloomberg estimate that for the full year 2021 it will be $61.03. ***Equity income has thus quintupled.***

Be assured that every single headline about inflation you've seen this year—and the text of all the accompanying reportage—mirror everything you would have been reading (and hearing) in late 1990, all but word for word.

• The Consumer Price Index in December of 1990 stood at 133.8. This October—per the most recent report—it was 276.6. Thus, ***the cost of living has barely doubled***.

Allow me to summarize—not because I don't think you got it, but just because I so much enjoy doing this:

• **Mainstream equities up in value 14 times since the last 12-month CPI increase of six percent.**

• **Cash income from mainstream equities up five times.**

• **Cost of living up merely twice.**

• ***That's why you own equities for the long run.***

(Did I mention that since 1990 there have been, by my personal count, six bear markets? Did I mention that two of them—2000-02 and 2007-09—were the deepest bear markets since the 1930s? Is it possible that those episodes had very little effect on the goal-focused, plan-driven, long-term equity investor—other than as buying opportunities? I'll let you decide that, in counsel with your financial advisor, of course. End of digression.)

Why are values and dividends up as much as they are since 1990? That's simple: because earnings have increased more or less commensurately, and earnings ultimately drive equity values. The S&P 500 earned $22.65 in 1990; with a month left, the consensus forecast for this year is right around $200. And why did earnings go up that much? Lots of reasons: new products and services, technological innovation, increased productivity and expanding global markets are certainly some of the big ones. (Remember that there was as yet no internet in 1990, and that the Soviet Union still existed.)

But for purposes of this little essay's central point—mainstream equities as a historically superb inflation fighter—the critical issue is companies' ***pricing power***. The plain fact is that very successful businesses are generally able to pass increases in their costs on to the consumer. Indeed, despite the very significant uptick in producer prices this year, the net profit margin of the S&P 500, at just under 13%, continues to be nearly as high as it's ever been, according to FactSet.

None of this should be taken as a suggestion that mainstream equities are an efficient inflation hedge in the short run. They are not. ***No financial asset is.*** But as Wharton's Dr. Jeremy Siegel concludes in his classic book *Stocks for the Long Run*, "In the long run, stocks are extremely good hedges against inflation, ***while bonds are not*** (emphasis added)."

In a sentence—with the few numerical factoids above thrown in for moral support—that's the message of this essay. If, with your advisor's good help, you can take that message to heart, I believe your path to a financially successful retirement will be that much straighter and clearer.

Sources: Historical S&P 500 Index and dividends: "S&P 500 Earnings History, NYU Stern School." Consensus 2021 earnings forecast: Yardeni Research. Consensus 2021 dividend forecast: Bloomberg. Consumer Price Index: Inflationdata.com. Current net profit margin of the S&P 500: FactSet.