FS INVESTMENTS

Research note November 2021

Macro

Higher inflation has come for the 60/40

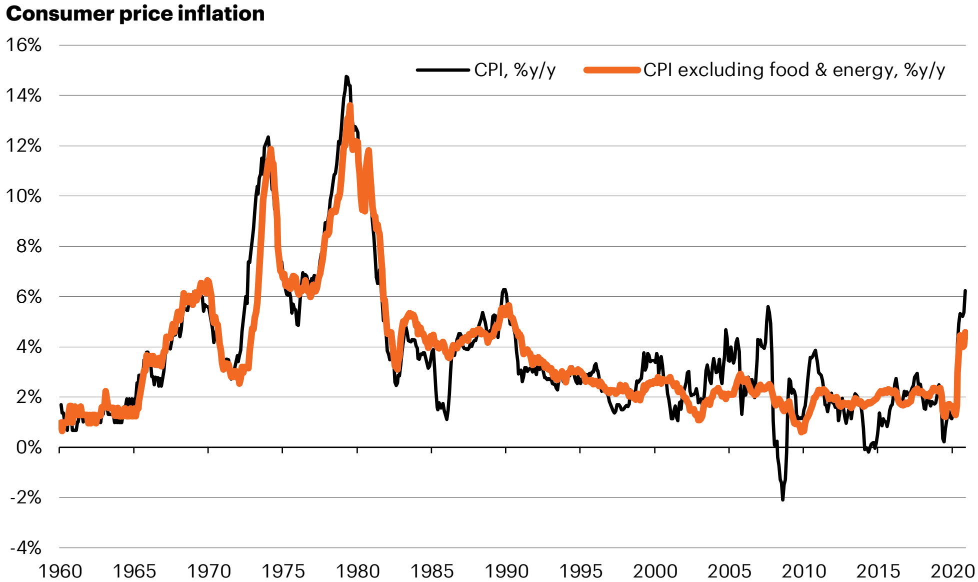
Higher inflation is here, raising questions for investors about the economy and financial markets. We expect inflation to persist well above pre-pandemic levels through 2022, but the arc of this inflationary cycle is highly uncertain. We outline the impact on fixed income and equities, and discuss how higher inflation changes the dynamics of the foundational 60/40 portfolio.

Key takeaways

- The risk to fixed income is significant as real interest rates turn deeply negative.
- Historically, high and rising inflation challenges equity returns in the coming year.
- Inflation above 2% has caused diversification of the 60/40 portfolio to break down.
- The outlook for inflation is uncertain, but even moderately higher inflation can cause significant challenges.

Higher inflation has arrived, and looms as a top challenge for investors in 2022. For two decades, the threat of inflationary pressures has been largely dormant. Low business cycle volatility, including relatively long expansions of the 1990s and the 2010s caused inflation expectations to anchor closely or slightly below 2%. Bouts of surging oil prices briefly caused headline inflation to jump in 2008, but core inflation which excludes food and energy prices remained stable at a low level. This placid backdrop has come abruptly to an end. In October, headline inflation hit 6.2% y/y, the highest since 1990. Energy prices are up 30% y/y and food prices have risen 5.3% y/y. Inflation is bubbling up from varied sectors of the economy outside of the volatile food and energy components. Core inflation is up 4.6% as durable goods prices have skyrocketed 13.2% y/y, but services prices are accelerating, too, led by transportation services.

Consumer price inflation



Source: Bureau of Labor Statistics, as of November 16, 2021.

We see three main causes of rising inflation. First, demand has surged, particularly for goods. This simple statement belies the magnitude in the shift in consumer spending habits during the pandemic. The power of households shifting away from services spending meant a redistribution of over $1 trillion dollars into spending on goods, in particular durable goods. Prior to the pandemic, durable goods spending accounted for 13.3% of household spending, but has now risen to 16.3%.

Second, in the face of rising demand came supply chain disruptions, which clearly put upward pressure on prices. Third, wage inflation is also rising, and is impacting household inflation. Food away from home is up 5.3% y/y, pushed higher by rising labor costs of restaurant workers. Transportation services prices have soared on the back of worker shortages, higher demand for shipping and rising wages.

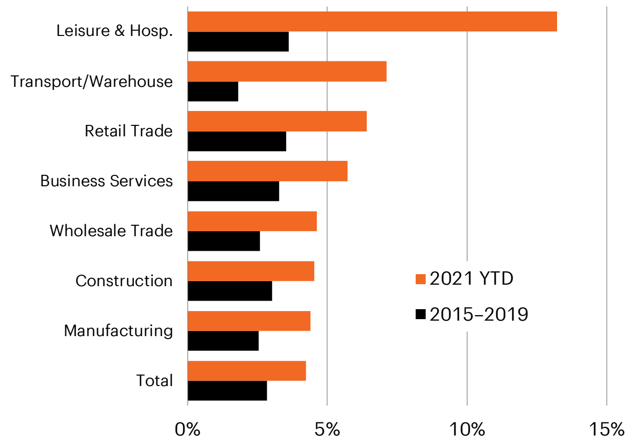
Inflation pressures have broadened
CPI categories, % year-over-year

Note: 10-year average from 2010–2019.
Source: BLS, FS Investments, as of November 16, 2021.

Some factors pushing inflation higher could conceivably resolve in coming quarters. There is early evidence that supply chain pressures are easing. While shortages could linger, the private sector is marshaling resources to get goods out of ports and onto shelves. Likewise, some categories have seen prices come a long way. Oil prices more than doubled from $36/bbl in November of 2020 to $84/bbl in October 2021. From here, however, the consensus expectation is that oil will not rise much further. There is uncertainty, to be sure. But markets place an extremely low probability on oil prices doubling again in the year ahead.

But price pressures are coming from virtually every category (medical costs are currently an exception), and some are hard to dismiss as just temporary. Higher wages could risk becoming systemic.

Wages are accelerating post-COVID



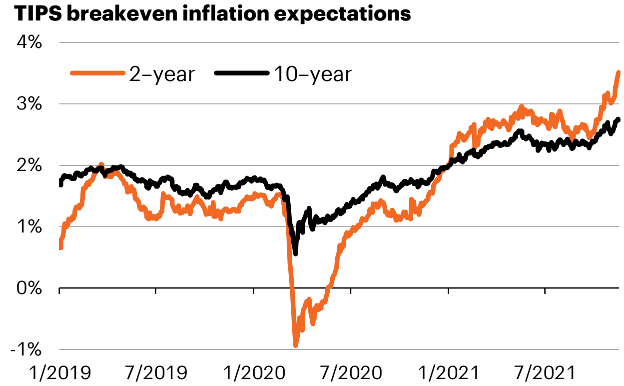
Note: Average hourly earnings annualized monthly gain, average of 2015–2019 vs. Jan–Oct 2021. 2020 excluded due to significant distortions.
Source: BLS, FS Investments, as of November 18, 2021.

Currently, while quit rates are high, most wage pressure is coming from three major categories: retail trade, transportation and leisure and hospitality. The Fed is watching labor costs closely, and concerns about wage pressure is one reason why Fed officials have turned quite hawkish in recent months.

All of this adds up to an inflation outlook that is highly uncertain. Some investors are concerned about a return to the double-digit inflation of the 1970s. We view that as a low probability outcome, however. In the 1970s, the magnitude of the oil shock was much larger than now. Fiscal and monetary policy mistakes and regulatory changes (abandoning the gold standard) piled on to create a perfect storm that drove inflation up.

The market consensus is for inflation to remain significantly higher than pre-pandemic levels for the next two years, but over the long run, to ease back closer to the 2% long-run average.

TIPS breakeven inflation expectations



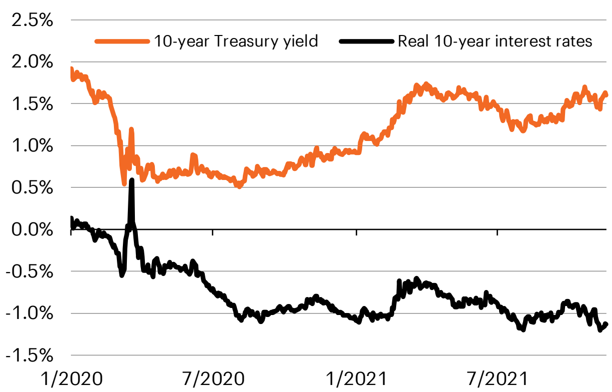
Source: Bloomberg Finance, L.P., as of November 16, 2021.

A little inflation can cause a lot of pain

Fixed income faces enormous challenges in the face of even moderately higher inflation. It doesn't take a 1970s style bout of double-digit price gains to inflict significant pain to fixed income returns when interest rates still hover near historic lows.

Before the pandemic, fixed income had already seen income gains diminish, even as investors realized decades of solid returns from price appreciation. For much of 2019, the 10-year Treasury averaged around 2% and ended the year at 1.92%. Inflation averaged 1.8%, leaving real interest rates at zero.

Real interest rates turn negative



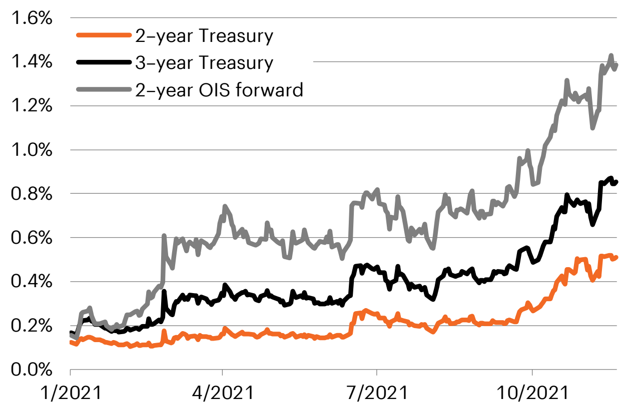
Source: Bloomberg Finance, L.P., as of November 16, 2021.

Now, however, the picture has changed due to rising inflation, and higher inflation expectations. The 10-year Treasury yield has recovered much of its pandemic decline and has been around 1.60% for much of November. Yet real interest rates have gone from zero to negative 120 bps. The graph above shows the yield on the 10-year Treasury inflation-protected securities (TIPS), the inflation-adjusted Treasury instrument that is currently trading at a premium as investors hedge against future inflation.

One misconception is that with high inflation and the Fed set to raise rates, long-term yields will naturally correct higher. As we wrote in **"An inconsistent truth: Interest rates and inflation can diverge,"** interest rates and inflation have a complicated history that shows little correlation over the long run. Currently, many factors continue to put downward pressure on long-term interest rates, including yields that are even lower or negative in much of the developed world, concerns about global growth, and the structural demographic trend of low potential growth.

Short-term rates, however, have been more responsive to rising inflation and what that implies for Fed policy. Fed rate hike expectations have accelerated sharply. Just three months ago, the markets were dabbling with one rate hike by the end of 2022. Now, markets have close to three rate hikes priced in over the same period. At the end of the day, one reason that long-term rates have stayed low is because markets recognize that aggressive Fed rate hikes could dampen long-run growth prospects.

Short-term rates on the move



Source: Bloomberg Finance, L.P., as of November 16, 2021.

Inflation and equities: An awkward past

At first glance, equities would seem to be less vulnerable to inflation. Rising costs are often cited as a challenge to corporate margins, but the last several quarters have shown companies have easily navigated higher input prices with soaring earnings.

But history shows that inflation matters quite a bit. It isn't simply a matter of whether inflation is high or low, but whether investors are making decisions in a rising or falling inflationary environment. This is where we see historically meaningful results for the subsequent 12-months of equity market returns.

Consider an environment where inflation is low (third row of the table on the following page). Subsequent equity returns show strong results, whether inflation has been on an upward or downward trajectory. Similarly, when inflation is neutral—as it has been over the majority of the last 25 years—equity markets have historically done well over the following year.

When inflation is high, however, equity returns have historically been more challenged. Right now, inflation checks the box as high, and it has been increasing. Current economic conditions put us in the upper left-hand box. Historically, this has led to equities falling slightly over the following 12-months.

Nominal total return (forward 12M)

	Trailing 12M CPI Level Change		
CPI Level	Increase	Neutral	Decrease
High	-1.70%	7.21%	10.26%
Neutral	13.67%	15.16%	9.14%
Low	18.16%	19.65%	13.31%

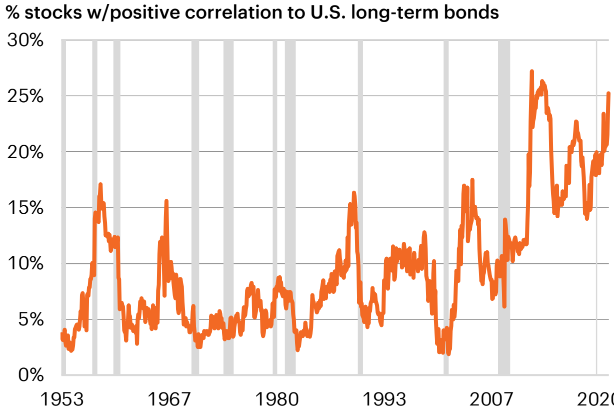
Source: Table based on CPI data from January 1988–September 2021. Defines a "high" inflation level over 3.2% y/y (top quartile), "low" inflation of below 1.7% y/y (bottom quartile), and all other cases are "neutral." An "increasing" environment reflects a greater than 0.9% level change in trailing 12-month CPI, a "decreasing" environment reflects a -0.8% decline in level CPI in the trailing 12-months. A "neutral" environment is all other cases. Nominal Total Return forward 12 months is the following 12-month performance of the S&P 500. As of October 21, 2021.

Other research bears this out. The San Francisco Fed explored which macroeconomic variables impacted CAPE ratios and concluded that inflation has a statistically significant negative coefficient. They conclude that "stock investors fail to properly account for inflation in their present value calculations."[1]

From a practical standpoint, it is not surprising that high inflation would catch investors off guard, particularly after decades of low and stable inflation. The fact that long-run interest rates have remained low continues to enable high growth companies to maintain lofty valuations.

U.S. Large-cap stocks relative returns

% stocks w/positive correlation to U.S. long-term bonds



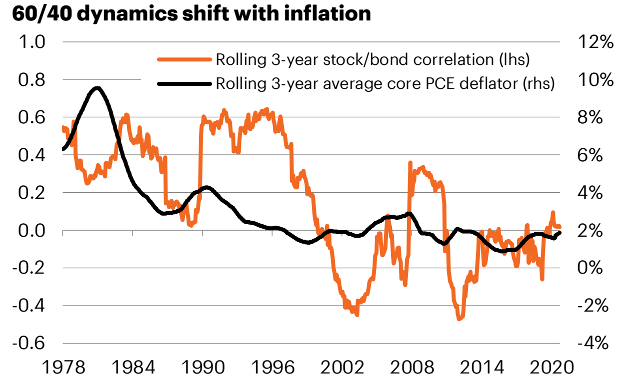
Source: Bloomberg Finance, L.P., FS Investments, NBER, as of September 30, 2021. Large-cap stocks are based on a custom stock universe of approximately 800 stocks based on market capitalization. Shaded areas represent NBER dated recessions.

The correlation between large cap growth stocks and long-term interest rates has only gotten stronger. The change in the composition of the S&P 500 has changed sharply. Since 2015, FANG+ stocks have gone from 12% share of total S&P 500 market cap to 25% as of time of writing. Should long-term interest rates rise even marginally, it could have a significant impact on broad index performance. For now, low interest rates may enable high valuations to persist in the equity market, but investors must tie returns back to a world of higher inflation.

Inflation shakes the 60/40 foundation

Finally, one critical impact of inflation on the 60/40 is that higher inflation changes the dynamics of the way equities and fixed income move with each other. We often start with the simple foundation of a 60/40 portfolio because, historically, it has provided solid diversification. However, this has really only been true for the 1990s to the 2010s.

60/40 dynamics shift with inflation



Source: Bureau of Economic Analysis, Bloomberg Finance, L.P., FS Investments, as of October 29, 2021.

During this period, when inflation was steadily averaging 2%, the negative correlation between equities and fixed income broadly held or correlation was close to zero. When equity prices rose, yields rose, as well. It is increasingly apparent that this dynamic is highly dependent on the inflationary conditions present in the macro backdrop.

Indeed, through the 1970s and 1980s, when inflation was well above 2%, the 60/40 provided poor diversification. Equity prices and bond prices moved together—when yields rose, equities fell. This is what we have observed throughout much of the past year.

[1] "Stock Market Valuation and the Macroeconomy," Lansing, Kevin J., Federal Reserve Bank of San Francisco, November 13, 2017.

Inflation takes away the punch bowl

Inflation has shattered its 25-year range and rising prices are being caused by factors that could prove transient or could become more prolonged. Looking ahead, the outlook for inflation is still highly uncertain. We continue to expect inflation to persist well above pre-COVID levels until end-2022. Base effects could keep year-over-year calculations at or near current levels into the first quarter, after which we expect inflation to gradually settle closer to 3–4% by the end of 2022.

For investors, it is important to recognize that even moderate inflation can impact both fixed income and equity portions of a portfolio. Short-term interest rates are rising, offering an opportunity to shorten duration to navigate the upcoming Fed rate hike cycle. But with interest rates near historic lows, inflation quickly erodes income.

On the equity side, inflationary periods have historically not been an environment of easy returns. The combination of high inflation and a rising inflation environment has been the most challenging. As investors address the implications of inflation to both sides of their portfolio, an added complication comes from the fact that inflation changes the nature of how these two broad asset classes interact with each other.

Inflation is unlikely to evaporate, and thus we can expect inflation to continue to dominate the discussion in markets, among policymakers, and at home in the economy. If higher inflation feels different, it is because it is something investors have not truly had to contend with in decades. It may be time to recalibrate portfolios with the implications of higher inflation in mind.

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Lara is Chief U.S. Economist and Managing Director on the Investment Research team at FS Investments, where she analyzes developments in the global and U.S. economies and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the boards of the Economy League of Greater Philadelphia, Hyperion Bank and Starr Garden Park.

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Brian is a Managing Director at FS Investments where he also serves as Head of Quantitative Research for the firm's Chiron Funds. He joined FS Investments in 2020 when the firm acquired Chiron Investment Management, where he was a Partner, Co-Portfolio Manager and Head of Quantitative Research since its launch in 2015. Prior to joining Chiron, Brian co-founded Empirical Research Partners LLC where he managed all quantitative research efforts for the firm. Brian is a CFA charter holder and graduated from MIT in 1990.

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