Key Wealth Institute

Key Questions

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Inflation: Is it 'Deja Vu All Over Again'?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

Inflation has remained persistent throughout the year, lasting longer than some have predicted. The environment has created unwelcome challenges for both individuals and the Federal Reserve (Fed).

The phrase "Deja vu all over again" is commonly known and often cited in many articles describing a situation repeating itself or being very similar. Moreover, those of us in the finance industry also reference the saying to depict analogous market trends and periods in history, for which we attempt to glean information and draw conclusions about the future. I am not the first to incorporate the quote and I will not be the last.

That being said, the timing of the reference resonates for multiple reasons.

First, the phrase is often attributed to the baseball legend Yogi Berra and we are in the midst of the baseball playoffs. Second, we have written on the topic of inflation multiple times this year and it continues to be a lingering challenge for the economy. Third, many comparisons have been made between the Fed's current monetary policy and former Fed Chair Paul Volcker's harsh stance on fighting inflation in the 1970s. Finally, there are concerns that the current Fed may be tightening policy (raising interest rates) too much, potentially causing negative repercussions for the US economy, as has occurred in the past.

We do not know if the Fed's policies will hit a home run or strike out but there are several questions to consider.

What Is Inflation and How Is It Measured?

Inflation is an increase in the prices of goods and services within an economy – and can be stated in the aggregate or for a specific item, such as food or gasoline. Inflation is a normal, fundamental component of any economy and represents growth over time. Excess inflation exists when prices increase at a rate higher than expected due to demand outpacing the supply and/or the productive capacity for those goods and services, which disrupts the equilibrium. Think of the price of a ticket to the game of your favorite baseball team skyrocketing once they make the playoffs – higher than normal demand and limited supply equals higher prices. Similarly, we have experienced the highest inflation in 40 years as the result of the increased demand for goods and services post-pandemic relative to limited supply.

Long-term, excess inflation hurts consumers and investors because the value of an asset and/or the pricing power of income is reduced. High inflation also affects the overall economy by the reduction in demand for overall goods and services until prices return to equilibrium.

Inflation is measured in multiple ways and can be viewed as a human dynamic or as statistical data. The human dynamic represents the experience that prices are higher in everyday living. In addition, the concept of inflation expectations is important because people often behave based on whether they think inflation will persist or decrease.

The two most common measures of inflation are the Consumer Price Index (CPI), published monthly by the Bureau of Labor Statistics, and the Personal Consumption Expenditures (PCE) Index, published monthly by the Bureau of Economic Analysis. Both gather data on a large list of goods and services purchased by consumers and are expressed in the aggregate as a single number. Examples include prices for medical services, apparel, energy, rent, food, transportation, new/used vehicles, etc.

On Thursday, October 13, the Bureau of Labor Statistics will release its CPI inflation reading for September. In the August report, CPI rose 8.3% over the past 12 months. This represented a slight decrease from its peak a few months ago, but still, rivals levels not seen since the early 1980s. And it's significantly above the Fed's target rate of inflation of 2%.

What Can the Fed Do to Reduce Inflation?

The Fed has a congressional edict known as the "dual mandate" to maximize employment and preserve price stability (code for managing inflation). To address high inflation, the Fed's Federal Open Market Committee has raised interest rates (the "Fed Funds" rate) a total of 300 basis points (3.00%) year to date, intending to slow the economy and thereby reduce inflation. Furthermore, at each of its past three meetings, the committee raised rates by 75 basis points (0.75%) – a pace not seen in recent history and indicative of the severity of persistent inflation.

The resulting effect of interest rate increases has been detrimental to both stock and bond markets year to date. At no other time in history has the stock market declined 20% at the same time the bond market declined 14%.

In addition, interest rate hikes may lead to a slowing of the US economy and the Fed has stated its willingness to sacrifice the employment picture to reduce inflation. Why would the Fed do this? Because it believes the economy is strong enough to handle an increase in unemployment and still provide sustainable growth. Just last week it was announced that 263,000 new non-farm jobs were added to the economy in September and the unemployment rate went down to 3.5%, both indicating a robust labor market.

Right now, the challenge facing the Fed is that it risks pushing the economy into a recession if higher interest rates slow the economy too much. That could lead to unwanted results such as lower economic output and higher unemployment. We do see some initial signs that inflation is cooling, but similar to other moments this year when we thought it would come down further, inflation continued to persist at elevated levels and market participants were disappointed. This means the Fed may need to continue raising rates longer than anticipated, creating future uncertainty.

How Should Investors Position Their Portfolios?

In general, consider that certain investments are more sensitive than others to rising interest rates. For example, long-duration assets, such as growth stocks, longer-duration bonds and some real assets are more exposed to the risk of rising rates; value stocks, shorter-duration bonds and other real assets are less exposed. As always, consider a broadly diversified portfolio commensurate with your goals and risk tolerance.

Key Takeaways

The current economy certainly gives us a sense that we have seen this all before. The Fed is following the game plan set by its former chair in the 1970s, raising interest rates to combat high inflation. And the Fed's hikes keep coming as inflation stubbornly persists at a rate above 8%.

But there are some aspects that are different. The pace of the Fed's rate hikes is almost unprecedented as is the market's reaction to stocks and bonds, with both seeing double-digit declines simultaneously.

We still do not know if the Fed's aggressive tactics will tamp down inflation as they did 40 years ago or if they will spiral us toward a recession.

That is why we will be watching the latest CPI report with both hope and trepidation.

For more information, please contact your advisor.

About the Author

Brian Pietrangelo, MBA, CIMA®, AIF®, is Managing Director of Investment Strategy at Key Private Bank. He has more than 25 years of experience in areas of leadership, investment strategy, investment research/manager due diligence, client relationship management, asset management, and product development. He leads the effort responsible for enhancing the communication and effectiveness of investment strategies, guidance, and solutions tailored to our clients' unique needs. Brian joined Key Private Bank in 2021 and his prior tenure included serving clients and the business for Charles Schwab, Merrill Lynch, and Willis Towers Watson (Towers Perrin/Watson Wyatt).

Brian earned his bachelor's degree in Finance from Miami University (Ohio) and his MBA from the University of Dayton. He also attended the University of Chicago Booth School of Business Executive Education program and holds both Accredited Investment Fiduciary (AIF®) and Certified Investment Management Analyst (CIMA®) designations as well as previously having the FINRA Series 7 license.

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