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Generations Winter 2022 - Inflation Roundtable

On February 17, Day Pitney partner Sarah B. Jacobson led a roundtable discussion* on inflation with Jeff McGrew, chief investment officer at Foster Dykema Cabot & Co. in Waltham, MA; Jay Winthrop, a partner at Douglass Winthrop Advisors LLC in New York, NY; and Aron Weingard, CFP®, CEPA®, AAMS®, financial advisor at Weingard Wealth Management of Raymond James, with offices in New York, NY and Boca Raton, FL.

Sarah Jacobson (SJ): Thank you for joining us today! Let me make brief introductions.

Jeff McGrew has more than 25 years of experience in the investment management industry. He chairs the Investment Policy Committee at Foster Dykema Cabot. Jeff is responsible for leading the investment team and overseeing all aspects of the investment process, including asset allocation, research and the selection of investments.

Jay Winthrop is a partner at Douglas Winthrop Advisors LLC, a New York City-based registered investment advisory firm serving individuals, families and trusts, with $5 billion under management. Before founding Douglas Winthrop Advisors in 2000, Jay was an investment banker at JPMorgan Chase and predecessor firms. He is currently chairman of the Conservation Fund and is a former chairman of American Farmland Trust.

Aron Weingard, Managing Partner of Weingard Wealth Management of Raymond James, focuses on wealth planning and investment management for individuals and multi-generational families and specializes in guiding business owners with succession planning and exit strategies across the United States. He began his career with KPMG Management Consulting, helping global clients with matters of financial management, merger integration, employee engagement and customer strategy.

Jeff, why don't we start with you? Please tell us how we got here with inflation [and] what is causing this spike that we're experiencing.

Jeff McGrew (JM): When you think about the pandemic, the Federal Reserve and Congress had to do something to stimulate this economy. They did that by making money very cheap and available to everyone. The order of magnitude of fiscal response and the amount of capital that was injected into the economy [were] unprecedented. The United States has never before expanded the money supply by 40 percent. That clearly will create inflationary pressures.

The Fed has increased its balance sheet by $5 trillion in just two years. To put that into perspective, when the financial crisis hit in 2008, the Fed took six years to inject a little [more than] $3 trillion into the economy. On top of that, the supply chain issues that we're seeing now exacerbate this supply and demand imbalance.

SJ: Do you feel this is specific to certain industries—for example, used cars?

JM: It is increasingly broad. Seeing what is happening in the new and used car market is very tangible. People can drive by a car dealership and notice there are no cars. This is really getting the Fed's attention. [It is] tacitly admitting that [it is] behind the eight ball. We are going to see an interest rate increase in March, which will be the first of a series of interest rate increases.

SJ: Jay, what's your take? Do you share that view?

Jay Winthrop (JW): I really do. I was just thinking about a quote from Milton Friedman. He said, "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." In other words, there is too much money chasing too few goods. The Fed's balance sheet

has more than doubled in two years, and that's driven the money supply to levels that we haven't seen in a very long time. It's demand-side stimulus, if you will, on both the monetary side and the fiscal side. The government has been active, and not just the Fed, at the same time that supply chain issues hit. There are too few goods, [so] there is no supply of things that could soak up all the dollars injected into the economy.

There were several things that restricted the supply of goods. The pandemic was the underlying cause. In the first instance, there [were] too few workers. A lot of people accelerated retirement. You have too few workers doing everything from cutting hair to making product. On top of that, China's total lockdown during COVID-19 really constrained the amount of goods, because China is a major supplier to the global economy. The movement to "just-in-time inventory" that many companies adopted has also contributed to the problem. Those companies do not have lots of inventory lying around for sale. When demand gets too hot, they can't just sell things they have on hand. They have to wait for the inventory to be replenished, and that has been difficult. Finally, there has been some underinvestment in critical parts of the supply chain—for example, transport and microprocessors. It is that imbalance between the demand side really being stimulated by the government and the supply side being pinched that has created the problem, because there are just too few things to buy. In the pandemic, people are not spending money on services; they are spending money on things.

Aron Weingard (AW): I agree. The recent inflation spike was driven by pandemic-related issues, which affected the supply chain. Activity moved to e-commerce, which further stressed the supply chain. Also, bottlenecks were created, stemming from factory shutdowns and employees having to stay home. All these factors drove up costs. We saw a meaningful surge in durable goods prices, such as housing [and] home appliances, as well as new and used cars. All served as drivers [of] the increase in inflation. Since people were not going to restaurants, bars, theaters or sporting events, money flowed into e-commerce.

For a good portion of 2021, we experienced a reopening of the economy, and the Fed suggested that we were in "transitory inflation." Over the past couple of months, we started to see a broadening of inflation, beyond pandemic-related goods and services, leading the Fed to pivot and stop using the word "transitory." This has caused a recalibration in the Fed policy outlook, upward pressure on interest rates and stock market volatility.

We have had an extraordinary amount of stimulus pumped into the economy during the pandemic to keep the economy afloat, with cash payments going directly to households and companies to compensate for job losses and shuttered businesses. This created a temporary lift in demand—hence the sharp post-pandemic bounce and rise in inflation, as the supply side remained constrained due to the lockdowns.

Now that the pandemic-related fiscal measures have expired and households and businesses are no longer receiving cash payments or unemployment benefits, the strong rebound in spending should start to subside. We are not expecting consumption to crater, as the consumer will still be supported by a strong labor market and solid wage gains. Rather, we see demand cooling from here to more of a steady state, which should take some of the pressure off inflation. The eventual normalization of the supply chain should also help.

SJ: Jeff, you mentioned that interest rates were going to be going up. Do you see this as a temporary thing, or do you feel we are going to be dealing with this for a while?

JM: That's the magic question. When we say "inflation," we are really talking about the Consumer Price Index basket. When you break that into pieces, you can identify things that are probably temporary, but there are other things that could take longer to reverse.

Automobiles are 8 percent of that basket. Given what we are seeing in that supply chain, that is not structural. Used car prices are not going to be this high forever, and I would say that is an example of something temporary. Energy is another big piece. It is also around 8 percent of the basket. We all know how fast energy prices can move. So those are two examples of temporary things.

One of the things that is more structural and difficult to slow down is the cost of housing. Housing is about a third of that entire CPI basket, and it is growing at around 4 percent.

SJ: I just read that the housing market in Miami, where I am, has probably even exceeded New York at this point in terms of cost.

JM: Exactly. Zillow publishes a measure of annual rent increases around the country, and right now, it is a 14 percent year-over-year increase in rents. It is an example of something that is longer term in duration and more challenging to address, because what the Fed will have to destroy [is] some of that demand for housing. [It does] that by making things more expensive, particularly mortgages. It is dangerous when you mess with the housing market, as we all have seen, but that would be an example of an area that is a bit more structural and is going to be more difficult.

SJ: Jay, what's your take? Is this something that's going to be with us for a while, or do you break it down into categories?

JW: I agree with so much of what Jeff has said. Over the medium term, elevated prices are likely to remain. Some of the things that could slow down rising prices—like adding semiconductor supply, finding new energy sources and building out new capacity—do take a while. Even though energy prices might move around a bit in the short run, there are going to be some parts of the economy that require a long time to fix.

Longer term, though, inflation really should come down, and it's important to remember that inflation is the rate of change. Elevated prices may stay for a while, but are they going to continue to rise at the current pace? I think that is unlikely.

SJ: That is good news.

JW: We look at it that way. We are thinking that inflation is going to moderate, and in the longer run, there are some structural reasons why a return to a lower level of inflation makes a lot of sense. We all know about the action by the Fed to signal that [it is] raising rates to reduce the size of [its] balance sheet. This will obviously have an effect on inflation.

The second piece is the pandemic. We are hopeful now that will ease. If we get into more of an endemic phase, we can learn to live with it. You might have people spending more on services and less on goods, maybe more people coming back to the workforce. That is likely to contribute to an easing of inflation.

The final piece, and perhaps the most significant, is that we live in a very different economy now than we did in the late 1970s. We are a global economy. There is global cross-border capital flow, and, importantly, there is a lot of automation. It is hard for a manufacturer to sustain high prices in that environment. You do not have to buy a book from one local bookseller. You are able to find that book anywhere in the world using technology. The ability to sustain high prices today is more difficult.

The combination of these factors should bring down inflation, but in the short run, it will be hard to turn the train around as quickly as we would like. I think we are certainly in for a quarter or two of very elevated prices and tougher inflationary readings until the new policy begins to kick in.

AW: While the Fed continues to monitor inflation, it believes that inflation will be on a clear, decelerating path as we go through the end of the year. We do think that we could still have upward inflationary pressure through March. However, we expect it to decline precipitately after March.

SJ: That is really interesting. The inflation rate may not continue to go up, but it does affect people if prices stay high. Besides what you have heard coming out of the Fed, are there any other indicators of how this is going to break?

AW: We would look at the decline in prices of the pandemic winners, such as home improvement and athletic equipment—for example, Peloton. In January, we started to see the first drop in used car prices.

In addition, the manufacturing report is telling. With respect to backlogs of orders, it shows six consecutive months of declines, which means that some of the supply chain pressures are receding. Moreover, the suppliers' delivery index has declined each month since October. New orders and production are off their peaks. The Manufacturing Prices Index also shows a decline. The Baltic Dry Index, a helpful indicator of global shipping costs, is down 75 percent from its October peak. We will watch these indicators to see whether these trends continue. In summary, we do believe that inflation will decelerate. We are watching the level at which inflation stabilizes and how that impacts the Fed's appetite to raise interest rates.

JM: I will tie that to how important the housing market is to that CPI basket. That would be the first place I would be looking. It is important to be careful what you wish for, but you really do want to see some demand destruction there, so you would look

for housing starts beginning to decline, average home sale prices beginning to decline, rent growth. As I mentioned, we are beginning to see that.

Then, you just keep thinking through what other components there are, such as energy, seeing oil prices begin to come back down. That is a great leading indicator of economic activity. We talked about cars. I would like to see some more inventory on car lots.

And lastly, I would say the labor market. The supply of labor is so tight. We are beginning to see some of the job-opening data points come down, which is another sign that that supply-demand imbalance is beginning to come back into balance.

JW: A couple of things that I will be looking at are the PPI versus the CPI—the Producer Price Index versus what consumers are seeing. At the moment, the PPI is higher, and you would want to see that get a bit more even.

We also are always looking at the yield curve and whether long-term rates keep rising. They have been very low for a long time. To the extent the yield curve flattens a bit and longer-term rates are not so high relative to short-term rates, it suggests that inflationary expectations are moderating. Also, we listen really closely to management, to companies. It is often a good place to get an early read on what they are seeing.

SJ: When you say you are talking to management of companies, what sectors are you looking to for that information?

JW: We are just listening to management when we are doing our quarterly calls with companies. We are listening to the companies talk about their quarterly earnings reports. You are going to see inflationary pressure much more in companies that make things, that have a lot of consumption of raw material, than you would in, say, a Google. We are listening closely to those companies and how they are seeing the inflationary pressures in their own businesses.

SJ: That makes sense. So what should we be doing? What should family offices do?

JM: Everyone is looking for the silver bullet for this inflationary environment, and it really does not exist. Gold is often offered as an example, but you can find plenty of examples where gold did not do what it was supposed to do as inflation accelerated.

I think the two areas that we would highlight are equities and real estate. On the equity front, an example of what you would avoid would be expensive growth companies. When you think about the value creation of those companies, it is happening much further out into the future. You have to discount that back to today's value, and when interest rates are going up, you have to use a bigger discount rate.

On the real estate side, very often the publicly traded real estate stocks do not behave the way you want. They are very sensitive to interest rates. We would recommend getting exposure to the real estate market through private investments, through a private equity fund.

AW: Agreed; there is no silver bullet for how to invest in this type of environment. The asset classes that historically tend to defend in a rising inflation environment are not as appetizing this time around. Gold went nowhere in 2021. It has been flat over the [p]ast 12 months, and that is likely due to bitcoin and crypto taking a larger share of investments by folks looking to find an uncorrelated asset class. Another area where people tend to flock is commodities; however, we see headwinds from tightening policy and U.S. dollar strength. The appreciation of commodity prices is likely behind us.

Real estate is a sector that has historically done better in inflationary environments. In fact, the publicly traded sector was up significantly in 2021, correcting what had been an undervalued sector. It is important to keep in mind that REITs trade with significant interest rate sensitivity, as evidenced thus far in 2022. Real estate is down nearly 10 percent in 2022, due to rising interest rates. That said, there is reason to remain optimistic on this sector, presenting an opportunity to invest during correction periods. Some direct investments in real estate are also attractive. Investments in property with shorter-term leases [and] strong underlying growth fundamentals can lead to a faster translation of rents into cash flows. One example would be hotels, which offer one-night leases.

If you are concerned about inflation, the best area of the market may be equities. Within equities, companies with pricing power and stable margins will lead the way. Look at Amazon. [It] just raised the Prime subscription fee and people did not

even blink, because Amazon owns the e-commerce market. Historically, equities have performed well during environments when inflation was between 1 and 5 percent, and we believe we could be in that sweet spot.

History does not repeat itself, but it often rhymes. While headline inflation is currently running at 7.5 percent and core inflation is 6 percent, we do think inflation will move lower as we progress through the year as growth moderates and supply chain constraints start to fade. Also, with the pandemic shifting more toward the endemic phase, labor issues and capacity constraints should start to resolve themselves so wage growth does not get too out of hand. If we are correct, this should bring inflation comfortably back into that 1-to-5-percent window, where equity markets have performed well in the past.

SJ: Thanks. And Jay, what is your take?

JW: Well, it is colored to a great degree by our own bias as high-quality value equity managers. My answer is going to be similar in that I think that quality equities are the place to go, and I share the concerns about other so-called hedges against inflation.

It is important to note that many of these so-called hedges, whether they actually work or not, are hard for investors to access. You could, I suppose, make the case that crypto is an asset class to consider, or gold is, or real estate, or private equity and venture capital. A lot of those asset classes are really difficult for investors to access because they cannot store gold, or they do not have the capital to buy real estate, or they are not able to lock up their capital in a 10-year venture fund.

One consideration is not just what the best hedge might be, but what the most practical solution is. On that front, there is no question that the long-term ownership of very-high-quality equities is the way to go. That approach offers liquidity, transparency and low costs, but within that asset class, I emphasize the words "high quality."

If you can own companies that have pricing power, you are going to be able to ride this thing through. It may not be next month or the month after that, but if you can own wonderful businesses, you are going to do just fine. We look for companies that have a lot of demand, that do not have high capital reinvestment requirements, that have wide economic moats and high return on invested capital, and, very importantly, that have pricing power. Those companies are going to do just fine.

SJ: Can you give us some examples?

JW: Mind you, I am not making a stock selection or stock pick, because some of the companies I will mention have done very well in this current environment. Two companies on the consumer tech side—Amazon and Costco. Both have some sort of a membership model. They have an extraordinary ability to raise that membership fee and get a really large uptake from their client base. The client base feels a lot of value in participating in that model because they can get access to great shipping, great distribution and a huge amount of product at low prices. Businesses like that—again, not picking particularly those stocks at this moment—are going to be worth more in the periods ahead as inflation moderates.

I would also point out Nestlé, which is a food company. I will mention Alphabet, Aon, Canadian National Railway [and] Mastercard, one of the largest payment processors. These are all businesses that have a great degree of pricing power and very wide economic moats that will allow them to raise prices without losing customers.

SJ: If investors are not heavily invested in that direction now, should they trade their portfolios now, or should they hang onto what they have and make gradual shifts?

JM: I do not think anybody should be overly reactive, and I am saying that in a general way. However, if an investor was overly positioned toward, for example, very expensive growth stocks, then he or she might want to be more reactive. I would add that if there is also a structural driver behind a particular company's growth, that is an additional element to the story. That supports the ability to have pricing power.

An example of that is Nike. The fact that [it is] changing [its] distribution channel and going directly to the consumer is incredibly additive to [its] profit margins. It was going to happen whether we were in an inflationary environment or not. As long as you own those types of stories and some longer-term growth drivers, you are going to be just fine.

JW: We own Nike as well, but I would also suggest upgrading the quality of the equity portfolio. It's not to change strategies, unless you are invested in companies without a profit that trade at stratospheric multiples or that are heavily leveraged and require access to the capital markets to fund their operations. If you're in bonds, this is a great time to get out of them. That's

a really dangerous asset class at the moment. The old kind of 60/40 asset allocation, whatever the old balanced portfolio idea was, for a while that's maybe not where I would counsel people to go.

* The views expressed in this roundtable discussion do not constitute investment advice. Each investor must make investment decisions based on his or her particular circumstances.

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