The Impact of Inflation

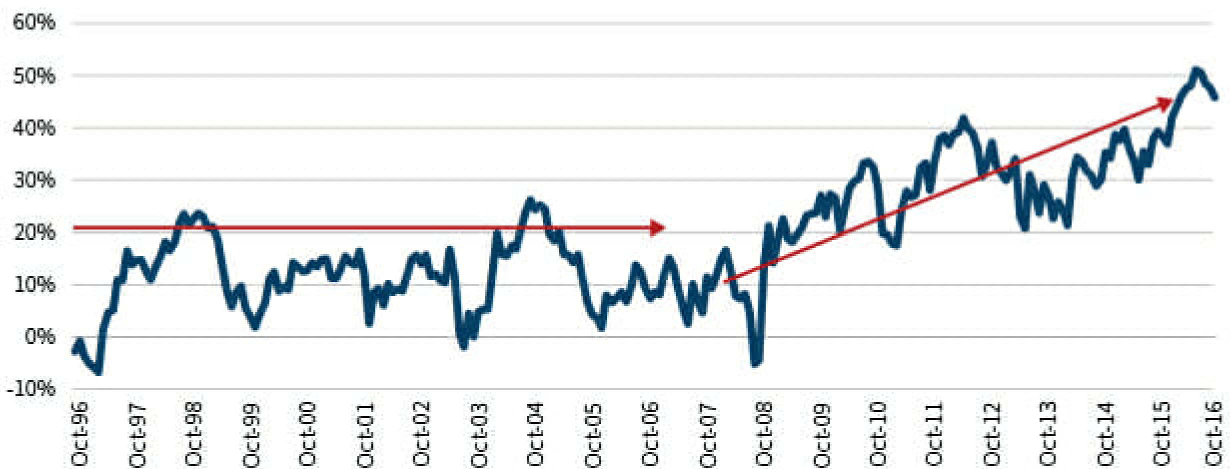
February 21, 2017

Previously, I explained that the inflation we are currently seeing in the U.S. economy is not hyperinflation that many of you may have been thinking about; it is benign, long overdue, and cyclical. But it will most certainly affect the financial markets.

Rising inflation is only just beginning to be felt in the bond markets. Since 2009, when interest rates were slashed and fears of deflation were high, the bond markets had continued to provide good returns. These returns were increasingly driven by capital gains rather than yield, as the chart below illustrates.

In other words, bonds were behaving more like equities. Now that inflation is becoming more apparent, I believe that repricing in the bond market has only just begun.

10-Year U.S. Treasury–Share of Capital Gains Income Returns



Source: Bloomberg Barclays as of 10/31/2016. Shows Bloomberg Barclays U.S. 10-Year Treasury Bellwether Index share of capital gains.

Higher inflation also matters for equity returns. At a minimum, higher inflation implies higher interest rates, which influence the discount rate for future cash flows. In practical terms, we have already seen a rotation more toward “value” stocks, including cyclical sectors such as industrials and financials, which had underperformed for several years before 2016, making them relatively “cheap” or “value-like.”

In Europe and Japan, this rotation came in the second half of last year, but in all cases it was well advanced before the U.S. presidential election, as the chart below shows

U.S. and Developed ex-U.S. Equity Growth vs. Value Active Return

Source: Russell 3000 Growth, Russell 3000 Value, MSCI Europe ex-UK IMI Growth, and MSCI Europe ex-UK IMI Value indices as of 11/18/2016.

The best growth companies have generally achieved a revenue growth premium of 15% versus the market over the past few years. The question has become, “What do you want to pay for that growth?” In an environment in which growth is scarce, the premium will rise significantly.

If growth is broadening, there should be more places to go. Our portfolio managers see this as a positive in that the available universe is expanding. As growth investors, we now get to play in a larger sand pit, and the premium we are paying for companies that are able to execute is markedly different.

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