HBKS Wealth Advisors

Equities and Inflation: Looking Ahead

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WE'RE READING A LOT MORE ABOUT INFLATION THESE DAYS. It's a hot topic for writers of financial articles. One cause for jittery nerves is the Consumer Price Index, which in April rose 4.2 percent over the same period in 2020. It was the sharpest month over previous years' month jump in consumer prices since 2008, even if the increase is somewhat skewed by a couple of factors: one, this time last year the COVID-19 pandemic was laying waste to the economy and inflation was unusually low; two, the significant amount of government stimulus rolled out during the pandemic led to more spending, and greater demand drives prices higher.

From February 2020 to February 2021, the M2 money supply — that is, the amount of currency in circulation — rose 26 percent, the largest annual percentage increase since 1943. M2 includes physical cash, checking deposits, and easily convertible "near money," such as money market securities and savings deposits. Inflation is often viewed as too much money chasing too few goods. When this occurs, we would expect prices to rise. The decrease in production that accompanied the pandemic has compounded that condition.

Equity markets are sensitive to inflation concerns. Higher inflation numbers lead to higher interest rates, and higher interest rates reduce the demand for stocks and shrink the "risk premium," the difference between a risk-free investment like a Treasury Bill and what an investor might expect to earn on a particular stock. Equity markets would be expected to move higher on low inflation data and decline, at least in the short term, on an increase in prices. The Federal Reserve has opined that the price increases of the past few months are a short-term phenomenon, as production will eventually catch up to demand. In the meantime, expect the inflation numbers to be choppy to say the least.

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For now, there are plenty of reasons to remain bullish on equities. Opening up the economy as the pandemic subsides is likely the most powerful fiscal stimulus, and the economy is still a long way from being fully open. We continue to expect 2021 to be a

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strong year for corporate profits and equities given the amount of cash in circulation. The increase in stimulus-driven spending — in effect, borrowing from the future and pulling future growth into the present — will support profits.

Looking to 2022 and beyond, we expect less government stimulus spending and muted growth compared to current conditions. The U.S. economy is likely to look more like it did in 2011 to 2015, following the Great Recession, when the economy grew but at a comparatively slow pace.

Technological advances, population growth, and low inflation are three factors that drive financial markets higher. These influences on the market promise to remain in play long term. Some government policies can provide tailwinds to these factors; others, headwinds. In the short term, increased government spending will spur economic growth, but likely lead to higher taxes and increased austerity in the future. In such an environment, including increased corporate profits as well as rising interest rates and higher prices, there is no substitute for a diversified portfolio and periodic rebalancing to reset your portfolio and lock in gains for growing and protecting wealth.

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