Inflation Proofing Your Investments

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As of May, the annualized rate of inflation hit 5%. We believe that it is time to start inflation proofing your investments before the ten year Treasury goes to two percent, the Fed starts tapering its stimulus measures, and stocks sell off by fifteen percent or more. The first step is to understand what will be happening in the bond market and with the Fed as the year moves on.

Investing As Interest Rates Go Up

When the yield on ten-year Treasuries hit 1.7% earlier this year the market panicked. It could happen again or ever be worse when they hit two percent. Predictions of 2.25% or 2.5% by the end of 2022 are realistic. The labor market is tight so wage growth is very likely. Higher rates will stress many businesses that have been beaten down by the pandemic-driven recession. The decade-long stock market recovery and rally has been largely driven by low interest rates and as that comes to an end investors will start looking at bonds and other interest-bearing investments instead of uncertain stocks.

Investing As the Fed Tapers Its Stimulus Measures

Although Mr. Powell, the Fed chairman, has said that there is no immediate need for tapering, half of the members of the FOMC (Federal Open Market Committee) have admitted to discussing the possibility. The Fed's balancing act of continuing to support economic recovery versus heading off inflation will become more and trickier as inflation pressures increase. Reducing stimulus measures will mean cashing their bond purchases as they come due and not buying new. This will serve to tighten money supply and slow economic growth. Be ready for another so-called taper tantrum when this becomes evident.

How to Prepare Your Investments for Inflation

How will stocks respond to higher yields on bonds and Fed tapering? Although the general view is that this will choke off economic growth that is not really true. When the Fed tightens for good reasons, market valuations will reset after an initial panic selloff. Dealing with inflation will result in stronger economic growth, a stronger market, and stock valuations back down to less-stratospheric levels. This will bring money back into the market. Expect P/E ratios to come back to what was normal from 1990 going forward, about 18 or 19 on the S&P 500.

Steps to Inflation Proofing Your Investments

Be careful of so-called defensive stocks when the economy is growing. Jumping into utilities, for example, as rates go higher is self-defeating because these stocks are interest rate-sensitive as so much of their value is tied to the dividends they pay. Rather look to which companies will prosper as the economy digs itself out of the K-shaped recession and which will benefit as the Biden infrastructure proposals bear fruit. Likewise be careful about dumping all of your stocks and jumping into bonds as your bonds will lose value as rates go up.

Companies that benefit from economic growth are commonly industrials, some international stocks, selected small-caps, and basic materials. Cruise lines have been moribund due to the pandemic and will benefit from all of that money on the sidelines as wealthy retirees start to travel again. Credit card companies like VISA will prosper as spending picks up as well.

Although there will be overpriced stocks that you probably ought to dump, the better choice will be to apply what you know about intrinsic stock value and pick up bargains when the market has its next taper tantrum. Now may be the time to build up a cash reserve instead of pouring money into more stocks that are likely to correct but inflation proofing your investments does not mean getting out of the stock market at this time.

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