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Inflation Expectations are Rising. Implications for Equity Investing

Markets are projecting a sharp economic bounce-back driven by aggressive monetary policy, massive fiscal stimulus and pent-up consumer savings waiting to be deployed as vaccines are rolled out. Estimates for 2021 GDP growth have moved up substantially since the beginning of the year and range from a consensus of 5.5% to as high as 10%. The outlook for a strong rebound has also increased the prospect of higher inflation. Whether inflation will be cyclical or structural is questionable and only time will tell.

Higher inflation will soon appear in the coming months. The first shift investors should expect are easy year-over-year comparisons that will likely show up in a month or two and should elevate CPI readings. Second, supply and demand mismatches are in place and are putting additional upward pressure on inflation. This is already happening in the housing sector where home builders have seen lumber costs nearly double. Meanwhile, the reopening of the economy will most likely release pent-up demand for services, overwhelming supply, and companies will look for opportunities to charge higher prices. While at the same time, consumers may not mind paying higher prices to enjoy services that had been put off for so long. With the consumer wanting to spend and having the savings to do so, this dynamic may make it easier for companies to pass on higher prices, another potential source of inflationary pressure.

It has been a long time since investors had to think about positioning for higher inflation, from an equity standpoint. If inflation is expected to rise gradually, we believe high quality names with dividend growth will protect against rising inflation in the long run. High-dividend-yielding stocks can provide a good income stream but are not likely to protect against inflation if the dividend amount remains the same. We also favor companies with pricing power because of their ability to pass along increased costs to their customers. Historically, these companies have performed well through strong economic cycles, but also in more uncertain environments when inflation is rising or the bond yield curve is steepening.

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