Inflation, Interest Rates, and Secular Cycles

The month of March will mark the 13th anniversary of the secular bull market that began in March 2009.¹ Secular bull markets include interludes that refresh the journey higher, so multiple market and economic cycles can transpire over their duration. The challenge for investors is twofold:

1. when a bear cycle commences, assessing whether it is the start of a new secular bear market or merely a bear cycle that will rejuvenate the ongoing secular bull, and

2. if the latter, determining how much of a refresh the cyclical bear provided (i.e., where we are in the secular bull).

In our 2019 Capital Markets Forecast,² we wrote about the nature of the economic cycle and the characteristics of each phase. This structure remains generally intact as it relates to both the economic cycle and the resulting market cycle. But we would be remiss if we did not explore the possibility that increased central bank intervention over the past 12-plus years has distorted the cycle template. For example, was it a coincidence that the bull cycle that ended in February 2020 was the second-longest in the post-depression era? And for good measure, add in the ongoing, and unprecedented, multi-trillion-dollar fiscal stimulus: How does that impact the economic cycle and the secular bull market?

At this point, several important questions pose themselves:

1. How will the sudden, sharp inflation we’re now experiencing play into the remainder of the cycle?

2. What is the future of interest rates, both in the short term and the longer term?

3. As it relates to our asset-return projections, what do questions 1 and 2 mean for valuations over the next seven years?

¹Recall the distinction between secular markets and cyclical markets, about which we recently wrote here: https://balentine.com/insights/publications/market-update-may-04-2021/

Inflation

Inflation has reared its ugly head for the first time in a while, and to little surprise, the financial media is all over the story. However, the real story is a little more complicated than the headlines suggest.

Firstly let’s dig into what is being reported. The financial media have reported year-over-year price increases that are greater than any in the past 30 years. And while the facts presented may be technically accurate, we don’t believe they tell the whole truth. It is important to remember that not much more than a year ago, the coronavirus commenced, and a deflationary vortex on par with the one seen during the Global Financial Crisis was feared. Within that context, it makes sense to look at price increases over a two-year period and remove the denominator effect of the low Consumer Price Index levels of 2020. When viewed from this angle, the level of inflation we are experiencing was last seen all the way back in ... 2008! (Figure 1)
Figure 1. Although year-over-year inflation is running at its highest level in 30 years, accounting for the deflationary effects of the coronavirus paints a modestly different picture.

1-Year Inflation Rate

2-Year Inflation Rate

Source: St. Louis Federal Reserve and Balentine
Secondly it is important to distinguish between supply-driven inflation (i.e., price increases driven by reduced supply) and demand-driven inflation (i.e., price increases driven by increased demand). The former is more of a temporary phenomenon that eventually resolves itself, whereas the latter generally necessitates action by either the monetary authority (reducing the money supply) or the fiscal authority (reducing the velocity of money via tax increases and/or fiscal contraction). This is an important distinction because as supply-driven inflation resolves itself, it does not necessarily choke off an economic cycle, whereas the resolution of demand-driven inflation typically does.

**Inflation’s Relationship to Capital Markets**

Before we get into which is the more likely situation at present, let’s discuss why inflation is significant in relation to economic cycles and capital markets. We recently explored inflation’s impact on the economic cycle, so we would like to focus here on why it’s of concern to investors. This may seem obvious, but as we have mentioned in the past, the economic cycle and capital markets are not always tethered at the hip over the short term or the medium term.

To determine how inflation affects market returns, we analyzed annual data going back to 1928; we went farther back than 1950 in order to include the highly inflationary periods pre-Great Depression and post-World War II as well as the highly deflationary period during the Great Depression. We found, unsurprisingly, that stocks, bonds, and cash react differently to varying levels of inflation. In the analysis, we looked at both nominal and real returns.

The nominal data, in Figure 2, suggest the perfect spot for inflation has been 0% to 2%, which happens to be where we spent almost the entirety of the 2009–2020 cyclical bull. Importantly as it relates to today’s concerns, stocks have struggled in highly inflationary environments, which occurred mostly during the 1970s but also in the first few years after WWII. The most lucrative nominal period for bonds and cash was during the 4%–6% inflation regimes. Of course, that is somewhat misleading, since purchasing power was eroding quickly during said regimes. Thus it is crucial to look at real returns, which we show in Figure 3.
Figure 2. Nominal returns of stocks, bonds and cash under varying inflation scenarios suggest different optimal scenarios for each asset class. But this can be misleading ...

<table>
<thead>
<tr>
<th>Inflation</th>
<th>% of Years</th>
<th>Stocks</th>
<th>Bonds</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;0%</td>
<td>11%</td>
<td>7.7%</td>
<td>1.3%</td>
<td>1.5%</td>
</tr>
<tr>
<td>0%–2%</td>
<td>24%</td>
<td>12.4%</td>
<td>5%</td>
<td>2.1%</td>
</tr>
<tr>
<td>2%–4%</td>
<td>34%</td>
<td>9.6%</td>
<td>5.6%</td>
<td>3.3%</td>
</tr>
<tr>
<td>4%–6%</td>
<td>13%</td>
<td>9.3%</td>
<td>8.8%</td>
<td>5.9%</td>
</tr>
<tr>
<td>&gt;6%</td>
<td>17%</td>
<td>7.4%</td>
<td>3.7%</td>
<td>5.4%</td>
</tr>
</tbody>
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Source: Aswath Damodaran

Figure 3. ... which is why we need to focus less on nominal returns and more on real returns.

<table>
<thead>
<tr>
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<tr>
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Source: Aswath Damodaran

Not surprisingly, real returns are far worse during the periods of higher inflation, and in the highest-inflation environments, the returns go negative. On the other hand, the real returns during periods with negative inflation (i.e., deflation) are better than they appear at first glance because deflation improves upon real returns. To summarize, some inflation (often dubbed “disinflation”) is good for financial assets, but excessive inflation is not. Additionally, while positive real returns can occur during periods of somewhat high inflation, it is clear that rising inflation does have a corrosive effect as the erosion of purchasing power outweighs inflation-related gains such as rising corporate revenues.
Determining the Cause of Inflation

So, back to the question at hand: Is the current inflation problem supply-driven (i.e., more than likely transitory) or demand-driven (i.e., more than likely non-transitory)? Current inflation readings are somewhat unique in that they include components of both reduced supply and increased demand. There are good reasons why inflation may be either transitory or non-transitory:

Reasons inflation may be non-transitory:

1. Unprecedented amounts of fiscal and monetary stimulus, including direct payments to employers (via the Paycheck Protection Program) and citizens. Consumer balance sheets are robust, owing to money saved during the pandemic. While they have begun to spend, consumers have as yet barely whittled down their cash balances.

2. A potential structural change in the labor market, with a structural deficit of labor.

Reasons inflation may be transitory:

1. Supply chain disruptions and shortages are likely to be ephemeral, albeit not as ephemeral as we all would want. That said, it is not reasonable to expect the global supply chains to simultaneously begin to function efficiently, so there would be fits and starts.

2. While consumers still have a lot of cash on their balance sheets, we would expect that the explosion we saw in consumer spending as the world has reopened over the past year is larger than the spending we will see going forward.

3. Unemployment benefits have been reduced, which should help lower the potential for the sort of structural change in the labor market referenced above.

4. As powerful as the economic rebound has been, we would expect the economic growth to revert to the mean. This would likely head off some of the inflationary pressures.

5. The structural technology gains made during the pandemic should continue to bring about deflationary pressures.

The Federal Reserve has championed the view that inflation is transitory, but of late it has ratcheted back that rhetoric. This is vitally important because transitory inflation would likely not lead to upward pressure on interest rates, whereas a more permanent inflation likely would. Although there is compelling reason to suggest that the inflation will abate, properly gauging the inflation’s permanence will dictate the proper interest rate policy moving forward, which is of vital significance. Alongside inflation, interest rates are an important determinant of both short-term and long-term equity valuation and price action.
Interest Rates

Why do interest rates matter to businesses? Most notably, higher interest rates increase companies’ cost of capital and discount rates. Thus, future cash flows are discounted back more heavily, leading to a lower present value of those cash flows. This affects asset classes differently, based most notably on the duration of cash flows: Shorter-duration assets are affected less than longer-duration assets. While this sounds a little bit like one of those theoretical business school concepts, the reality is that the excess return on capital over the cost of capital for a company (or for an individual project) matters tremendously when it comes to long-term valuations. Asset prices are very sensitive to disruptions in the cost of capital. And the cost of capital, in turn, is highly sensitive to perturbations in capital supply and demand. In fact, prices are often more sensitive to these factors than to changes in fundamentals.

Comparing Current and Historical Interest Rates

So if we assume that at least some of today’s inflation is demand-driven, what are the implications for interest rates, and what is the corresponding impact on asset prices? As economies cycle through periods of inflation, disinflation and deflation, interest rates have historically adapted to the changing conditions. Conventional economics suggests that in the face of inflation, interest rates will rise, and this has generally been the case. Look no further than the period from the late 1960s into the early 1980s as inflation ramped up quickly (Figure 4).

Of course, no two periods are the same, and as a result, the trajectories of interest rates will vary. Case in point: during and in the aftermath of WWII, from 1941 to 1952 (Figure 5), inflation was arguably more rampant than during the period from 1968 to 1982, yet interest rates in the earlier period essentially did not rise.

This is a crucial point: Fundamentals often determine which specific asset is superior within an asset class (e.g., do I buy Apple, or do I buy Bank of America?). However, discount rates and the cost of capital are more important in determining the superiority of the overall asset class (e.g., do I buy more stocks, or do I buy more bonds?).
Figure 4. Interest rates rose during the strong inflation of the late 1960s to the early 1980s.

### Inflation vs. Interest Rates: 1968–1982

![Graph showing inflation vs. interest rates from 1968 to 1982.](image)

**Source:** FactSet and Balentine

Figure 5. ... yet rates did not rise throughout the even stronger inflation that occurred during and after World War II.

### Inflation vs. Interest Rates: 1941–1952

![Graph showing inflation vs. interest rates from 1941 to 1952.](image)

**Source:** FactSet and Balentine
We think the WWII period is a logical parallel for today, given that fighting the pandemic is in a sense a war. So what happened back then? Prior to the current period, the highest debt-to-GDP on record in the U.S. occurred around 1946, on the heels of robust spending for WWII — we recently surpassed that high, with a debt-to-GDP ratio currently over 120% (Figure 6). During that era, there were three independent episodes of inflation, and not one of them drove interest rates higher. Quite simply, the economy grew into the extra debt, which led the debt-to-GDP ratio to fall precipitously over the subsequent years — which in turn, allowed borrowing costs to remain low. That scenario certainly could recur this time around, given the pent-up demand for the economy to get going after all its fits and starts relating to the coronavirus. So, even if inflation does rear its ugly head in a less transitory fashion, it is by no means a given that rates will rise.

Conclusion

So, in summary, what does this all mean?

1. Inflation and the level of interest rates will factor heavily into how the secular bull market progresses from here.

2. Inflation does not preclude interest rates from remaining low.

3. Against the backdrop of low interest rates, asset values can continue to rise as the cost of capital and discount rates remain relatively low, providing reasonably low hurdle rates for corporations.

4. When the secular bull inevitably ends and the secular bear begins (again, the timing of this is uncertain; it could be any number of years away), the bear will likely be either longer or deeper than previous ones. But importantly, it does not mean that the underlying bull will meet its demise more quickly. Markets can defy longer-term trends for far longer than any investor can imagine, even if it means harsher consequences down the road when the bull ends.
**Figure 6.** After WWII spending drove the debt-to-GDP ratio to ~120%, a level breached only recently, strong economic growth brought the ratio down quickly.

Debt-to-GDP Ratio

Source: FactSet and Balentine

**Figure 7.** A change in direction for interest rates can take far longer than expected.

10-Year Treasury Rates

Source: FactSet and Balentine
The past 40 years of investing have provided investors with such a tailwind of returns in most asset classes that they did not have to think about the goals of their portfolios. As the capital markets continue to evolve, investors find themselves at a fork in the road. Given how low interest rates are today, leading to higher equity valuations than in the past, investors who do not make conscious decisions on their portfolio diversification and asset allocation strategies could find themselves in twenty years wishing they had.

This article extracted from Balentine’s 2022 Capital Markets Forecast.
2022 CAPITAL MARKETS FORECAST

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