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Investing during high inflation

Making sense of the new inflation regime

Principal®

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The Federal Reserve (Fed) was caught behind the curve, and will need aggressive rate hikes to slow demand, and thus, inflation. Maintain neutral risk, but seek high quality, defensive assets.

The Fed is playing catch up

With inflation seemingly reaching new 40-year highs each month, the Fed finds itself woefully behind the rate hiking curve. Though price pressures were initially attributed to "transitory" supply/demand imbalances, repeated negative supply shocks and strong demand have allowed price pressures to broaden and accelerate.

Policy tightening is needed to regain price stability

Some price pressure will ease naturally without Fed intervention. As time and inflation deteriorate household savings and sentiment, especially for the lowest income demographic, consumer demand may soften, and labor supply may expand—limiting both price and wage inflation. However, geopolitical conflict may still weigh on energy, food, and goods supply, causing CPI (consumer price index) inflation to still be elevated above 6% by end-2022, before a recession could reset prices to target by end-2023.

Long term inflation expectations are still anchored around the Fed's inflation target, which means the inflation fight is not yet lost. However, the Fed will need to be aggressive with its tightening process, continuing to hike at an aggressive pace and carrying interest rate increases into 2023.

Investment implications:

Slower growth: As the Fed fights inflation by dampening demand, seek out high quality firms that can still deliver solid earnings during tighter financial conditions.

Inverted yield curve: Aggressive near-term tightening raises short rates, and as slower growth caps long rates, bank stocks may come under pressure.

Less pricing power: As consumers become more deliberate with purchases, firms with lower pricing power, like small-caps, may struggle passing on higher costs. Mid-cap firms may have better pricing power, and their exposure to the domestic U.S. economy, which is likely to outperform other global markets, presents a sweet spot.

Elevated inflation: Inflation's eventual descent to the Fed's 2% target may take many quarters. In the meantime, both equities and fixed income could be challenged, setting up real assets for potential outperformance.

A Fed caught behind the curve

With inflation reaching fresh 40-year highs, and the fed funds rate still accommodative, it is apparent that the Fed has been caught behind the curve. However, the Fed has finally recognized its erroneous read of the inflation situation and is now desperately playing catch-up.

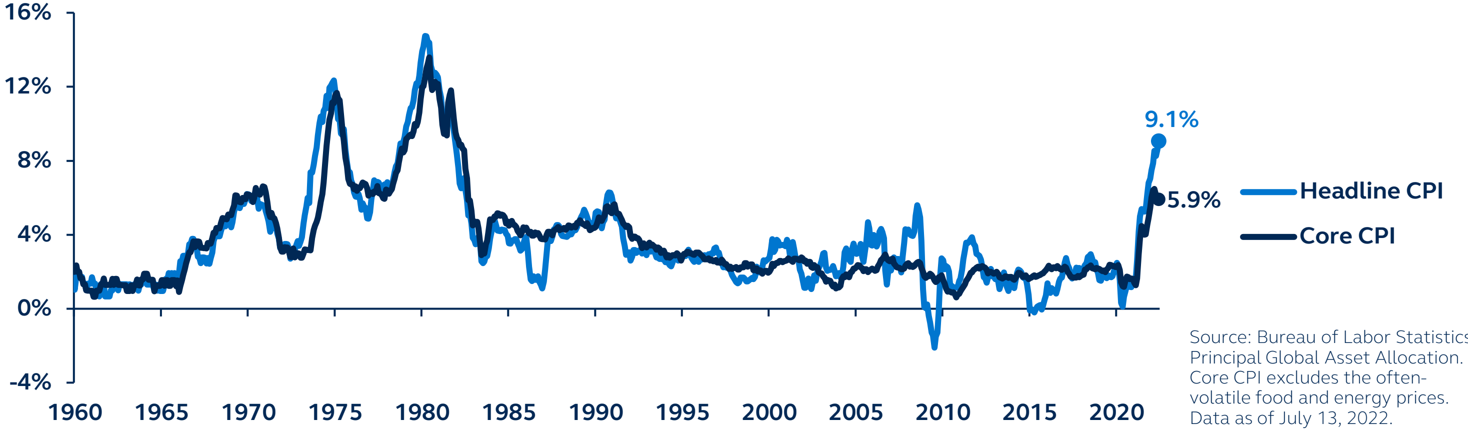
Spooked by sizzling CPI reports and rising consumer inflation expectations, coupled with signs of continued strength in the labor market, the Fed raised policy rates by 75 bps in June and by 75 bps in July.

In the space of five months, market expectations for policy rate tightening in 2022 moved from 200 bps as of March 2022 to 330 bps as of early August 2022. Furthermore, the Federal Reserve itself expects further tightening next year.

The Fed is embarking on a brisk and aggressive hiking cycle to combat 40-year high inflation.

Consumer price index

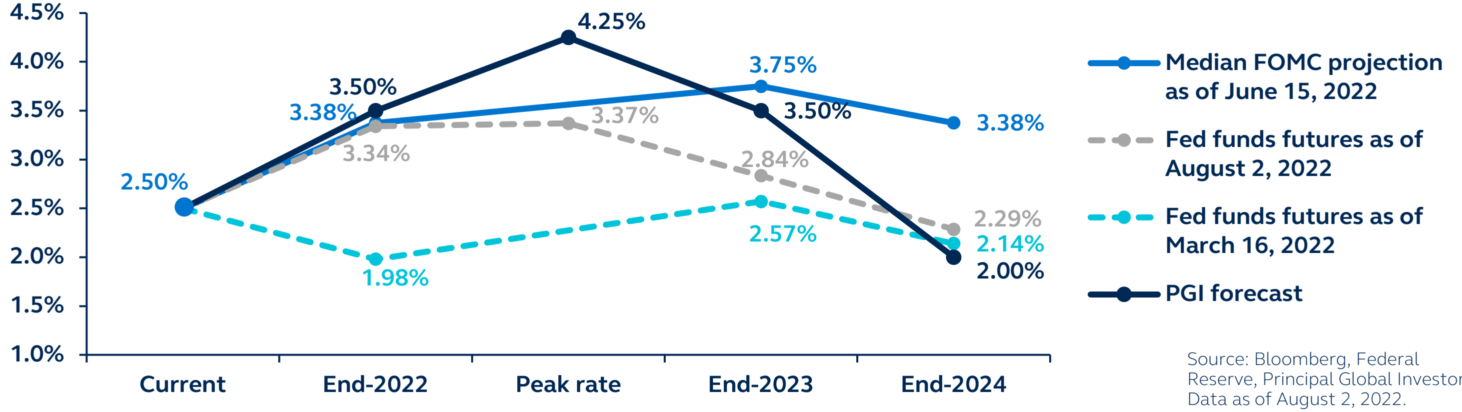
Year-over-year, 1960–present



Source: Bureau of Labor Statistics, Principal Global Asset Allocation. Core CPI excludes the often-volatile food and energy prices. Data as of July 13, 2022.

Implied fed funds target rate and market expectations

FOMC member projections & fed funds futures



Source: Bloomberg, Federal Reserve, Principal Global Investors. Data as of August 2, 2022.

How transitory became persistent

Scarred by two decades of uncomfortably low inflation and even deflation concerns, the Fed initially didn't believe inflation would rise meaningfully and sustainably above its 2% target. This erroneous read of the inflation situation is resulting in a more aggressive pace of monetary tightening today.

In the Fed's defense, when inflation started to surge in the first half of 2021, it was concentrated in categories that had seen supply/demand imbalances arise out of the pandemic. However, multiple COVID shocks hindered full healing in goods and labor supply. Indeed, it wasn't until late fall 2021 that freight rates showed tentative signs of topping. As a result, supply remained tight, and goods prices elevated.

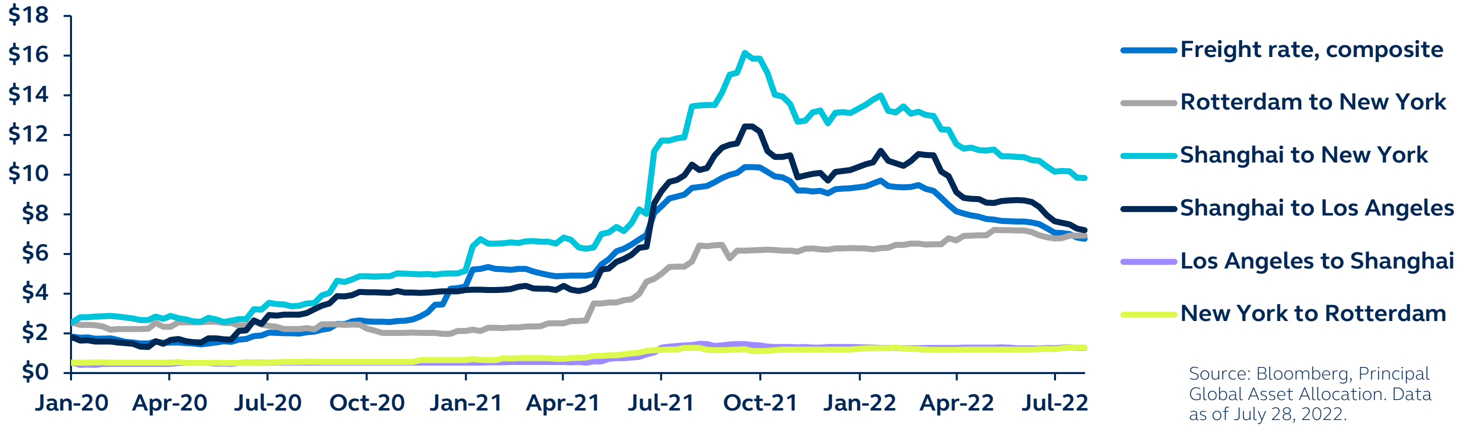
The global economy faced another inflation shock in early 2022 as a result of the Russia/Ukraine conflict, which disrupted exports of oil, natural gas, coal, grains, oilseeds, and fertilizer—sending energy and food prices soaring.

With goods inflation more persistent than anticipated, plus the addition of food and energy inflation, price pressures have broadened out and become sticky.

Repeated negative supply shocks and strong demand exacerbated supply/demand imbalances, causing inflation pressures to become persistent.

Global freight rates

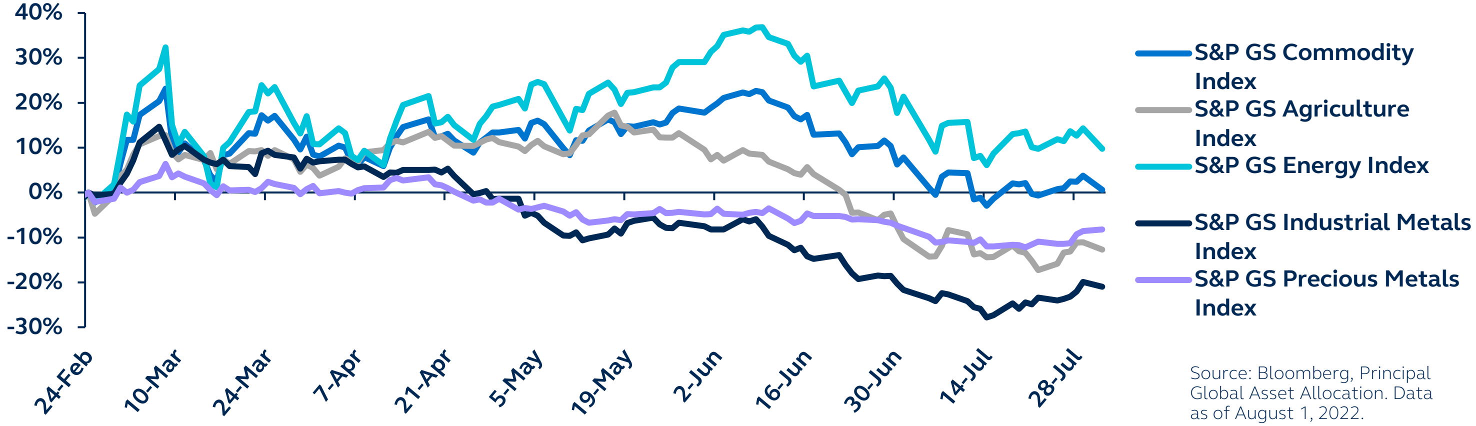
Rates per 40-foot box, thousands, January 2020–present



Source: Bloomberg, Principal Global Asset Allocation. Data as of July 28, 2022.

Commodity price movement

Rebased to 1 at invasion of Ukraine on February 24, 2022



Source: Bloomberg, Principal Global Asset Allocation. Data as of August 1, 2022.

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Some price pressures will ease naturally

While fiscal stimulus during the pandemic increased consumer demand, and both generous unemployment benefits and rising asset prices reduced labor supply, these wealth impacts have faded. Higher prices are now eating into household budgets, forcing sidelined workers back into the work force, and should help to cap wage inflation.

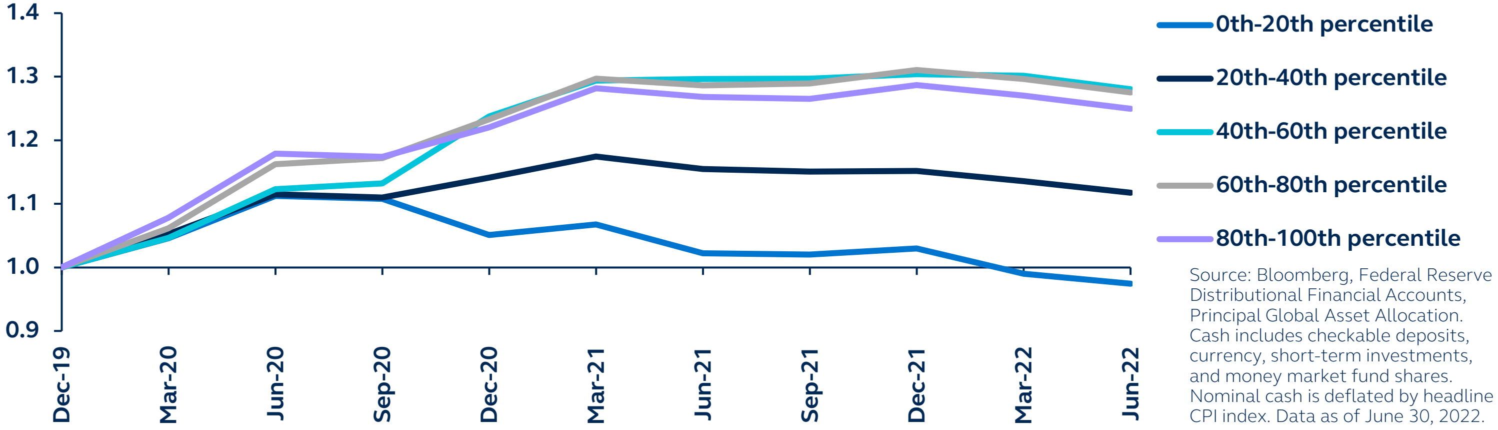
Already, high prices are weighing on consumer sentiment. The University of Michigan consumer survey suggests intentions to purchase vehicles and household durable goods are at the lowest in history. Anecdotes from corporate earnings calls confirm that the U.S. consumer has become more discerning with their purchases, a tentative sign that softer demand may soon outweigh limited supply, easing price pressures.

Commodity price inflation may also ease in coming months as recession fears grow. With this, headline inflation should soon peak and start its downward trend.

As high prices weigh on savings and sentiment, consumer demand may soften, and labor supply may expand—limiting both price and wage inflation.

Real cash holdings by household net worth

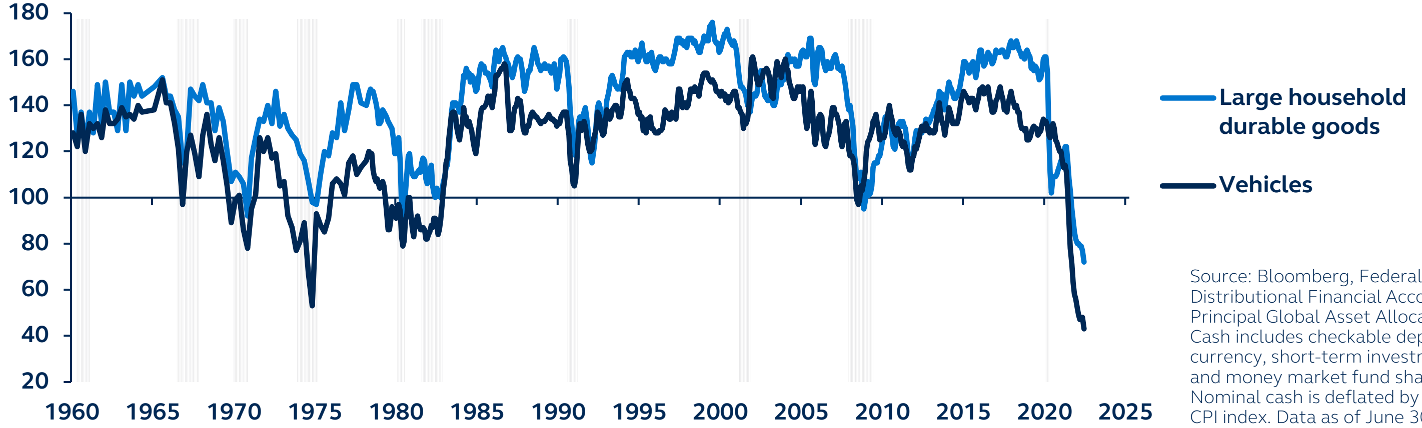
Level, rebased to 1 at December 31, 2019



Source: Bloomberg, Federal Reserve Distributional Financial Accounts, Principal Global Asset Allocation. Cash includes checkable deposits, currency, short-term investments, and money market fund shares. Nominal cash is deflated by headline CPI index. Data as of June 30, 2022.

Buying conditions

Level, 100 = neutral sentiment, University of Michigan consumer sentiment survey, recessions are shaded, 1960–present



Source: Bloomberg, Federal Reserve Distributional Financial Accounts, Principal Global Asset Allocation. Cash includes checkable deposits, currency, short-term investments, and money market fund shares. Nominal cash is deflated by headline CPI index. Data as of June 30, 2022.

Nonetheless, quick and steady rate hikes are needed

Even with inflation close to its peak, the Fed needs steady rate hikes to tighten exceptionally accommodative financial conditions, and thus rein in inflation by dampening demand.

More importantly, it remains crucial that the Fed clamps down on inflation expectations before they rise too far and become unanchored.

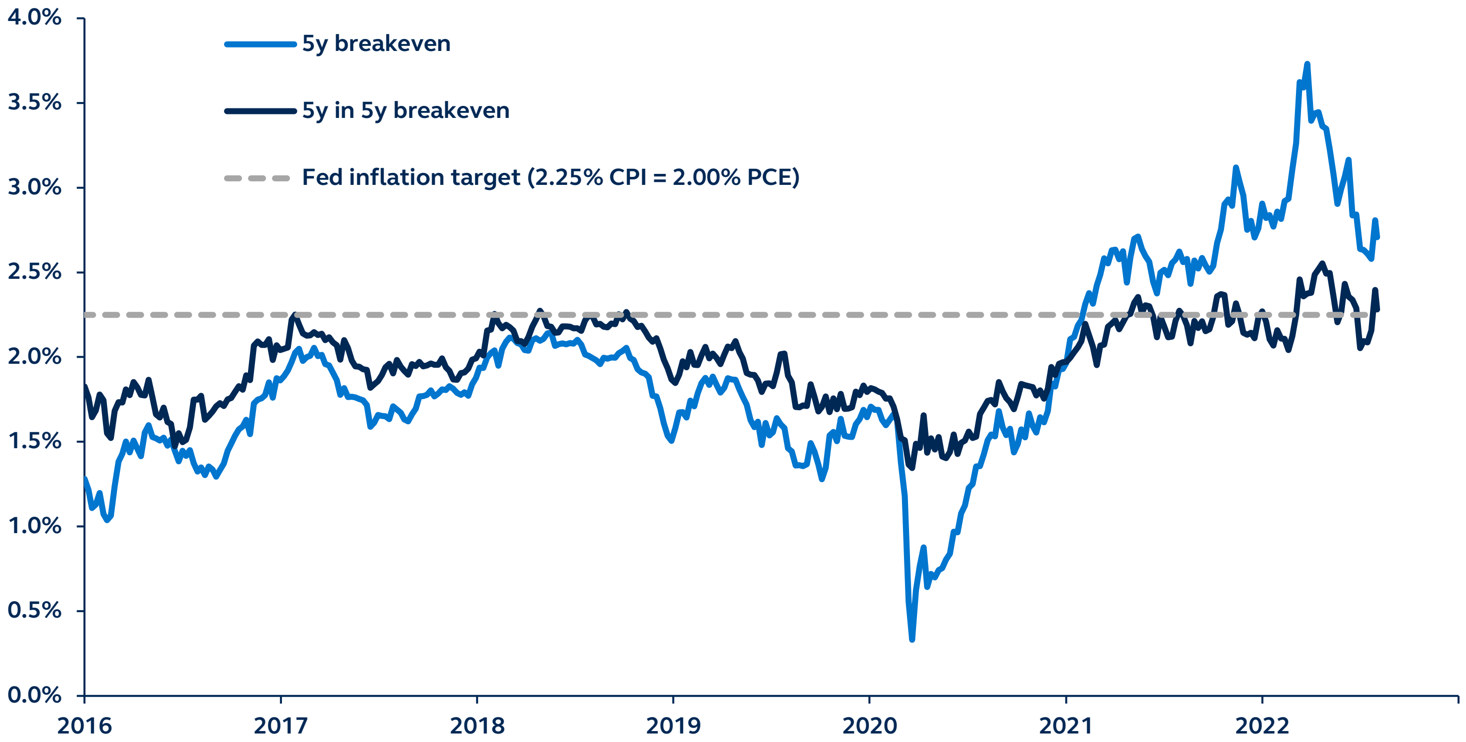
Currently, inflation breakevens imply that longer-term expectations are still anchored, with the spike in expectations contained to the near-term. However, without continued action from the Federal Reserve, inflation expectations could drift higher, threatening long-term price stability.

Although the Fed hasn't lost the inflation fight, it must continue to tighten policy.

While long-term inflation expectations are still anchored, the Fed needs to regain credibility with brisk policy normalization.

U.S. breakeven inflation

2016–present



Source: Bloomberg, Principal Global Asset Allocation. Data as of August 2, 2022.

…and stubborn prices mean an aggressive Fed

While recent easing in food and energy prices should provide some relief for the next few CPI readings, inflation may remain uncomfortably high.

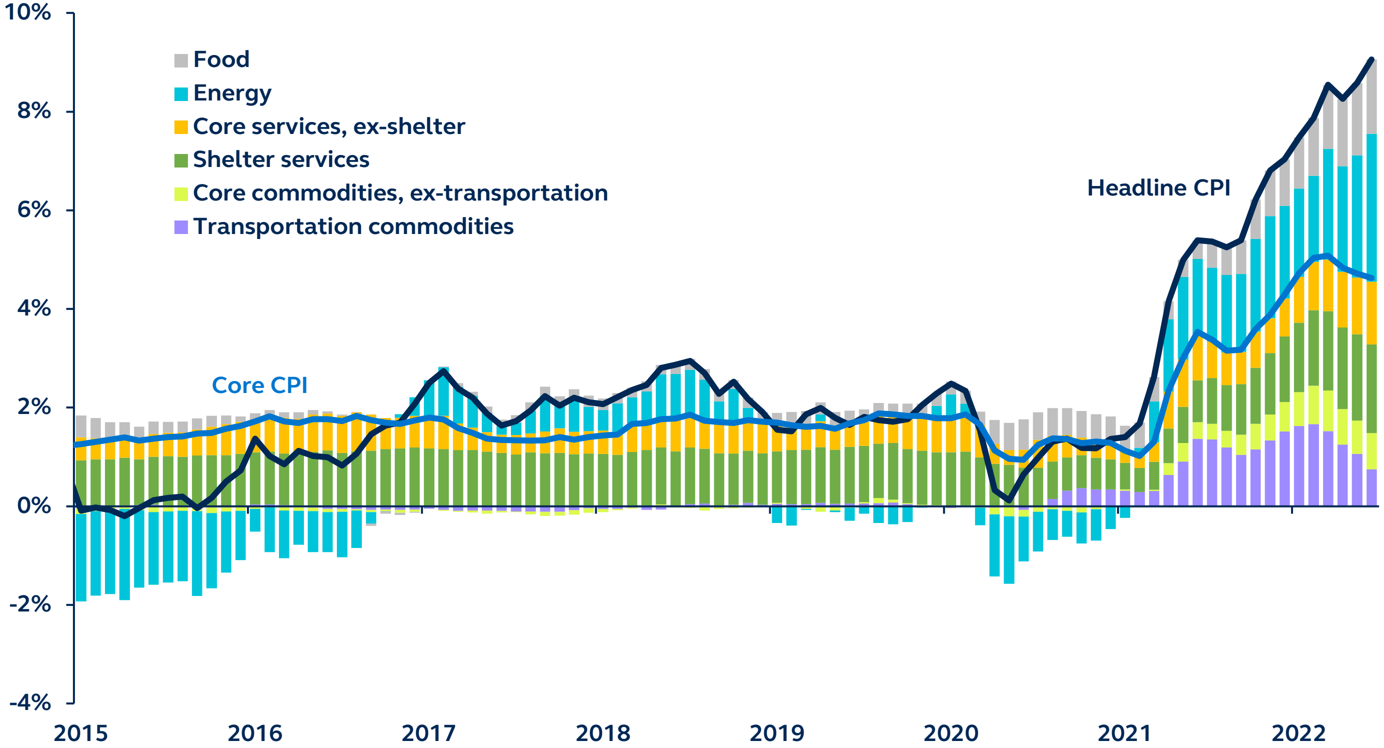
- House price appreciation has yet to peak and typically takes 18 months to flow into shelter inflation (worth around 1/3 of the CPI basket). This component of CPI will likely be elevated for some time.
- Excluding shelter, core services is currently being bolstered by summer vacation spending. While pressures may reduce in the autumn, a spending shift from goods to services is also characteristic of the post-COVID lifting of restrictions.
- Durable goods (like transportation commodities) have shown surprising resilience to weakening growth. However, as recession approaches and households cut discretionary spending, this category is most vulnerable to deflationary pressures.

Shelter and non-essential goods/services have traditionally been more responsive to monetary policy. As rate hikes have generated slow progress thus far, the Fed must continue hiking aggressively if it wants to get a handle on the inflation problem.

Inflation is expected to fall, but slowly. Stubborn prices means the Fed will need to hike even more aggressively.

Contribution to headline inflation

Year-over-year, 2015–present



Source: Bureau of Labor Statistics, Principal Global Investors. Data as of July 13, 2022.
* Core measures excludes the oft-volatile food and energy prices.

Neutral risk, but with a defensive tilt

The Fed is committed to controlling prices, even at the risk of speeding up a recession. The front-loaded hiking path puts upward pressure on the short-end of the curve, whereas slower growth significantly limits any upside potential for 10-year U.S. Treasury yields. As such, the 10-year/3-month yield curve—an important recession indicator—is likely to invert by the end of 2022. Rate hikes during early 2023 will drive the front-end higher but, by end-2023, with the Fed embarking on rate cuts to support the economy, the front-end will likely dip back.

Slowing growth and Fed policy inverting the yield curve are challenging the current investment environment. However, opportunities for investors still exist.

Equities: The U.S. economy is slowing rapidly. However, the outlook is far worse for Europe and large parts of emerging markets. U.S. mid-caps are in the size sweet spot—more domestically focused than large-caps, yet better pricing power than small-caps.

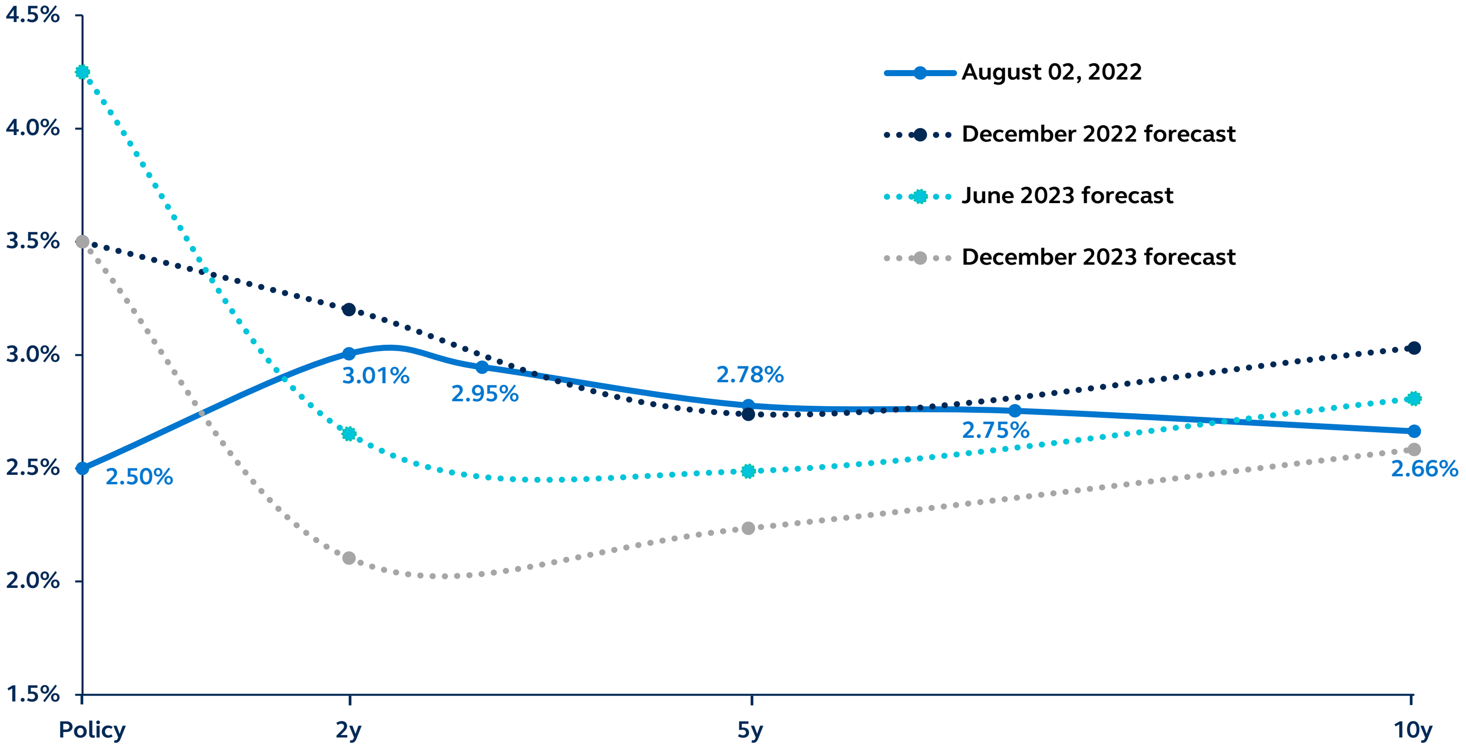
Fixed income: 10-year rates, and therefore duration risk, have likely peaked. As such, U.S. Treasurys and securitized debt are likely better positioned for the oncoming recession.

Alternatives: Real assets remain an attractive inflation hedge.

Against the challenging backdrop, it is important to diversify portfolios with high-quality assets.

U.S. 10-year Treasury yield curve

Current yield curve vs. forecasts



Source: Bloomberg, Principal Global Asset Allocation. Yield curve forecasts are PGAA forecasts. Data as August 2, 2022.

Hedging for inflation

Though food and energy prices remain a wildcard, inflation is likely near the peak. However, it may take multiple quarters (and a recession) for prices to normalize near the Fed's inflation target.

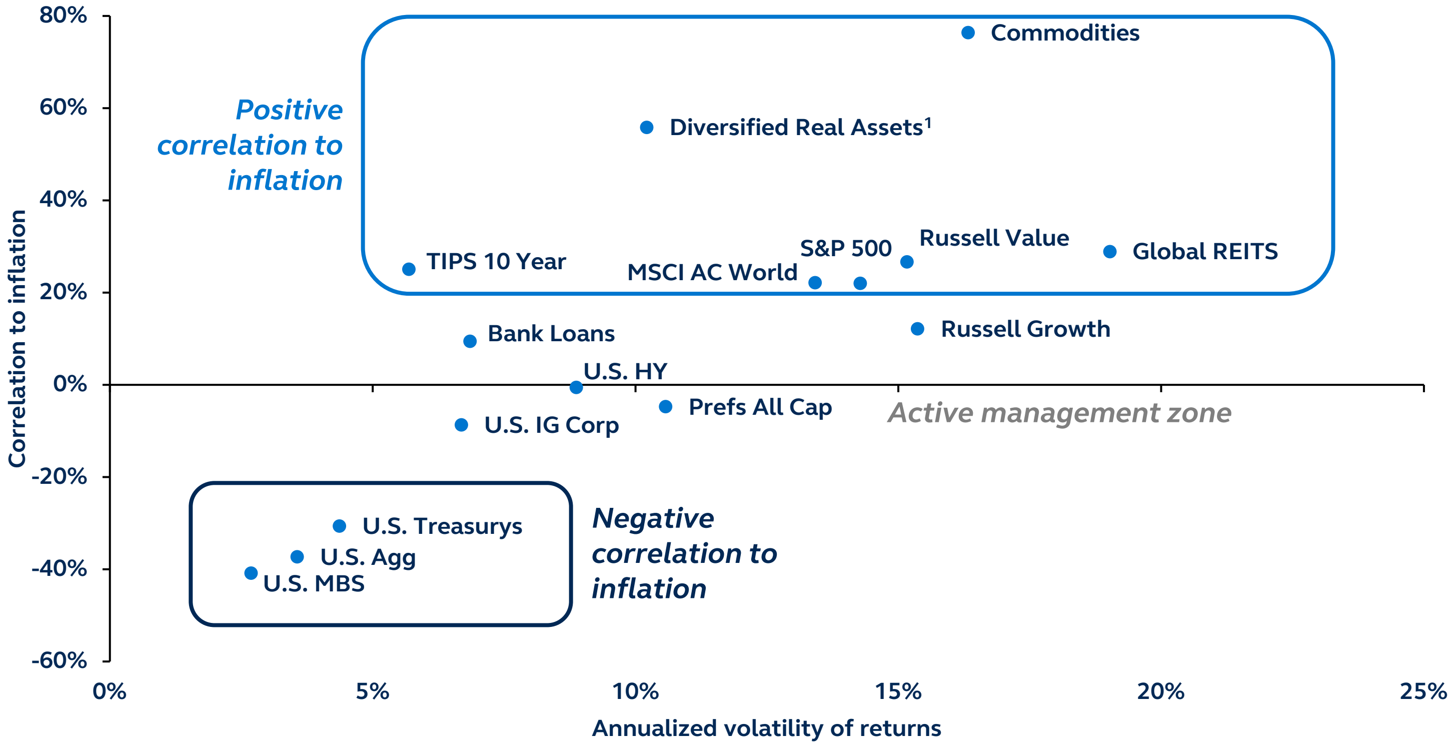
In the meantime, real assets may provide a hedge against elevated inflation. Though returns from commodities and infrastructure may be volatile, they historically outperform in inflationary environments, and help diversify equity exposure. Treasury inflation protected securities (TIPS) also work as an inflation-resilient diversifier.

Ultimately, holding a diversified basket of real assets can provide inflation mitigation with lower volatility than holding commodities or infrastructure alone.

Though inflation is likely near the peak, investors may want to preserve portfolios against still-elevated inflation.

Major asset class inflation sensitivity

Correlation to 12-month rolling CPI, volatility is annualized, January 2003–present



[1]Represented by the Principal Diversified Real Asset fund.

Source: Bloomberg, Principal Global Asset Allocation. Inflation sensitivity is the correlation of the 12-month rolling CPI-U non-seasonally adjusted and the particular asset class. Volatility is annualized monthly returns. Data is for the time period of January 1, 2003 to May 31, 2022, except Diversified Real Assets which started in January 2010.

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