INFLATION: RESILIENCY WITH HIGH-QUALITY STOCKS

In the wake of the COVID-19 economic and market shutdowns, both monetary and fiscal stimulus interventions appear to have successfully cushioned the world economy from the worst of the blow. As the impact of the virus wanes in many parts of the world, there are signs of an uptick in inflation, but will it last?

Reported Inflation

Inflation has been trending higher since January with the Consumer and Producer Price Indexes edging higher in May (5% and 6.6% year-over-year), the principal contributors being gasoline, airline tickets, hotels, and used cars. It's likely that pent-up demand fueled by savings accumulated during the pandemic as well as relief payments contributed to the reported increase in inflation. Historically, these one-time outlays, such as the COVID relief payments, do not result in lasting inflation without the perpetual, ongoing payments to sustain a persistent increase in spending.

Inflation: Does it finally return or stay low longer?

Inflation has generally been stable and range bound for many years. The current spike has been particularly strong – driven by the COVID-19 crash, an unprecedented $5 trillion in fiscal stimulus, and supply chain disruptions (factory shutdowns and a Suez Canal blockage). These events should have a transitory impact on long-term prices. How? Despite the unprecedented fiscal and monetary response, inflation expectations are still well anchored and little has occurred to increase the 30-year inflation expectation. Additionally, the record drop in money velocity suggests the credit process (commercial and industrial) is still contracting despite a surging M2 money supply (cash, savings, and money markets). These factors should have a limited impact on long-lasting inflation.

However, inflation could become a problem through a persistent and permanent increase in wages. The recent reported spike in average wage growth has had a distortionary effect since the pandemic because more low-income workers lost their jobs. This automatically lifted the reported average wage of anyone who still had a job. More importantly, the common view that tighter labor markets lead to higher wages, which in turn leads to higher inflation, held true until the early 1990s. Between 1974 and 1994, the correlation between wage growth and inflation was 92%; and subsequently it has dropped to just 8% from 1995 to 2021.[1] Additionally, 9.3 million people remain unemployed, which is well above the pre-pandemic level, providing slack in labor markets.[2]

What can investors do?

If an investor believes that long-term inflation will persist, what steps are necessary to protect your portfolio?

Primarily, own high-quality businesses. High-quality businesses are not immune to inflation, but companies that do possess durable competitive advantages can blunt the impact. Warren Buffet has stated that businesses with lower capital needs (such as Accenture, Intercontinental Exchange, or Visa)[3] should fare better than ones that are required to invest more capital just to maintain their current position. The ability to raise prices gradually is also critical in an inflationary environment, and we are beginning to see evidence for this in comments and actions by companies we hold. If a business can increase prices without losing customers to its competition, it's one to consider (think FedEx, Proctor & Gamble, or Sherwin-Williams).[3]

At Compass, we have found that a diversified portfolio composed exclusively of 25 mid- to large-sized and growing companies tends to outperform over long periods of time due to the companies' competitive advantages, pricing power, and consistent free cash flow. These attributes do not completely insulate high-quality companies from inflationary risks, but these companies can withstand the negative impact better than many others. While the investment landscape is continually changing – markets are going up and down daily, economic and political forces are always shifting – following certain time-tested investment disciplines is likely to produce desirable long-term results. Successful investing is NOT a matter of trying to determine the unknowable (such as the direction of the market, inflation, or interest rates). Rather, it IS a matter of establishing a sound long-term investment policy and following sensible investment disciplines in implementing this policy. Once these are in place, much anxiety and distraction disappear and we can move on to the fun of looking for mispriced, high-quality businesses to purchase.

[1] Piper Sandler Economic Brief, 5/10/21
[2] Bureau of Labor Statistics, May 2021
[3] Not a recommendation to either buy or sell

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AUM

$1.9 billion

INCEPTION

1988

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As an independently-owned firm, Compass provides customized investment services to individuals, foundations/endowments, trusts, and retirement plans. Our objective is to preserve and enhance the real purchasing power of our clients' wealth over time.

Our clients value working directly with a seasoned and experienced team of portfolio managers to help them navigate their investments relating to:

-Building a quality portfolio

-Retirement

-Sale of a business

-Divorce

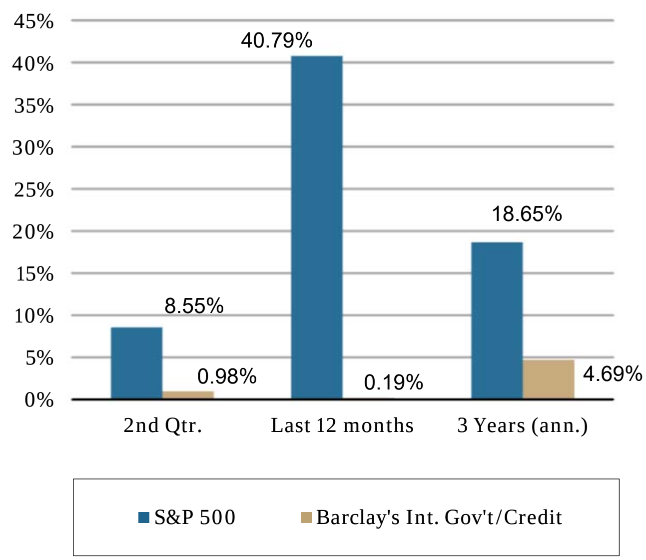
-Inheritance

-Trust distribution

Our experienced team is always available to provide financial advice and review your financial assets.

MARKET INDICES

Total Return as of 6/30/2021



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