Inflation and Financial markets

In this blog, I would like to talk about how inflation plays out in the valuation of different financial assets and how investors should navigate through these so-called unusual times.

Let me set the stage for the discussion by stating that inflation should always be classified into – Actual inflation and Expected inflation and most importantly the difference between the two – Unexpected inflation. Why this categorisation is important we will see going ahead in this post.

Valuation of any financial asset that can be valued depends on it's cashflows and risk (represented by discount rate). So based on this framework let's see how inflation affect valuation of stocks and bonds.

1.The Discount rates,

Apart from the real risk-free rate, discount rates have two more components – Expected inflation premium and Risk premium, -

(A) **Expected inflation premium** – The required return on investments contains an inflation premium, this shows how much investors are expecting inflation to be over the maturity of the underlying security. When actual inflation number turns out to be higher than this expected number, expectations regarding future inflation go up resulting in a higher inflation premium which causes required returns to go up.

(B) **Risk premium** – Higher levels of inflation are often associated with more volatile levels of inflation giving rise to what is called inflation risk premium. So, in inflationary environment even the default spread as well as the equity risk premium goes up. High risk companies are more affected by the rise in risk premiums as these companies are more exposed to these factors.

So unexpected inflation causes required rate of return to rise as both inflation premium as well as risk premium goes up.

2.The Cashflows,

Even when actual inflation turns out to be higher than expected, cashflows from the bonds remain fixed as coupons are pre decided and they are not changing. With stocks, the impact of inflation on cashflows is more complicated. Companies with high pricing power are able to pass prices through to their customers which allows their revenues to grow at least at the rate of inflation, also companies with large gross margin and inputs which are in greater control and less exposed to macroeconomic factors are able to maintain their operating margins , with this if duration of investments made by companies is short and they are more flexible in nature then these kind of companies are able to maintain their earnings & cashflows growth even during the higher inflationary environment. As opposed to this, companies without any pricing power and higher input costs suffer from inflation – the worst part is that these companies constitute a major chunk of the market.

<u>Valuation –</u>

Fixed cashflows but increased required returns will cause bond prices to fall.

In stocks most companies will see their cashflows falling and at higher cost of equity, valuation of stocks will go down as well. But a few companies (as mentioned above firms with high pricing power etc.) may outperform the broader equity markets.

<u>Investor considerations –</u>

Once the inflation gets out of control it is not going to be easy or painless to control it again. And those who believe that central bankers have some magical button which they will press, and inflation will go away, may get disappointed.

We are in a very sensitive state right now where everything will be driven by the inflation numbers. And once inflation gets out of hand there is nothing which the central bankers can do about it without putting the economy into the risk of recession.

If we talk about different asset classes, then neither stocks nor bonds are a good inflation hedge. History suggests that in higher inflationary environment both stocks and bonds have performed pathetically. So, from asset allocation perspective more weightages could be given to assets like – Income producing real estate, Gold and other commodities. Securitized real estates like MBS or Even REITs do not provide any good protection against inflation as they have shown characteristics very similar to that of stocks and bonds.

Cryptos and NFTs could be presented as interesting choices but the kind of volatility that we have seen in these, make investors doubt whether these will be able to maintain their value in the bad times.

From a stock selection perspective, well established companies with positive free cash flow, high pricing power, less input costs, short duration & flexible reinvestment needs and relatively less exposure to rising risk premiums are good choice. But companies which has all these features are very few.

Apart from these there are few industries which benefit from rising energy prices like upstream oil companies.

<u>Conclusion –</u>

The inflation genie is out of the bottle, there is no doubt about that. We have had a low and stable inflation for the most part of the last decade, and this could be the reason why investors could be relaxed about it. But this is not a transient inflation, it is here to stay. So, we should not take it for granted. High inflation could be disastrous for any economy. And central bankers do not have an absolute control on it or even if they do have, costs of controlling the inflation are not small.

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