The Crescent Group

RBC Wealth Management
The Crescent Group
Carsten Frederiksen, CFP®
Senior Vice President
Financial Advisor
Senior Portfolio Manager
Portfolio Focus
Direct: 214-775-6401
NMLS#: 1321563 City National Bank
The Crescent Group website

Paul Hendershot
Senior Vice President
Financial Advisor
Senior Portfolio Manager
Portfolio Focus
NMLS # 1370978 City National Bank

Nick Weege, CPFA
Financial Advisor
214-775-6408

Lindsey Vickers, MBA
Client Service Associate
214-775-6458

Andrew Ielmini
Investment Associate
214-775-6448

May 2021 Crescent Commentary

In last month's Commentary, we discussed one potential hurdle to investor wealth in the form of higher tax rates. This month, we discuss a second potential wealth hurdle which has recently surfaced in the form of accelerated inflation. We'll explain why this has caused some turbulence in stock prices recently, and what investors can do to protect themselves from the impact of inflation going forward.

During April and May, publicly-traded companies reported very strong earnings results for the first quarter of 2021. These earnings reports have provided a fundamental underpinning for the dramatic recovery in stock prices that we experienced over the past year. While this is obviously positive news for the economy and investment balances, it has also signaled a new challenge to wealth in the form of accelerated inflation. Because of the strength of the economic recovery, almost all companies have reported a strong increase in raw material and supply chain costs, with one long-time CFO calling the current period the strongest inflation he's seen in his career. Every company with pricing power plans to pass the higher costs to customers, with frequent discussion of 5-10% price increases for the year. The Consumer Price Index for April did in fact show a 4.2% increase over the prior year, well head of economist expectations of a 3.6% increase. There are two main takeaways for you as an investor[1][2].

Number one, you should expect to pay more for everything in your life. This should come as no surprise since that's the underlying trend since the government started recording inflation data, but current price increases emphasize this all the more. Inflation is no longer just an abstract idea — it's happening in a significant way in real time. If you pay attention, you'll see the price of almost everything you use is increasing: housing, food, consumer products and other daily essentials. As The Wall Street Journal put it, "Americans accustomed to years of low inflation are beginning to pay sharply higher prices for goods and services." During his May 1st annual meeting, Warren Buffett said "We're raising prices, people are raising prices to us, and it's being accepted…It's an economy really that's red hot, and we weren't expecting it[3]."

Number two, you must own assets with a proven track record of overcoming the impact of inflation. Our Group has talked before about

how this is a major focus of our financial planning approach. While clients living off their assets must own bonds and cash as a source of stable funds to draw on when markets are depressed, the remainder of assets must go into productive assets such as stocks and stock ETFs.

Many investors allow the fear of stock market corrections to limit their allocation to such productive assets. In May, stock prices did in fact experience turbulence as a result of April's increased inflation number and expectations of continued higher inflation going forward. The reason has to do with interest rates. During periods of higher inflation, the Federal Reserve has historically had to increase interest rates in order to reduce the impact of inflation. But interest rates act as gravity to reduce asset prices, so stock prices declined in May in response to expectations of higher future interest rates. Although the Fed has stated it won't raise interest rates any time soon, financial markets aren't waiting for the Fed to act – they're already adjusting asset prices to account for the fact that the Fed will have to raise interest rates at some point. But stock market reactions to expected higher future interest rates are nothing new. We experienced similar stock market reactions for several years, beginning with 2013. At that time, the Fed said it would start reducing Financial Crisis stimulus, and stocks declined similar to what happened this past month. This happened again in the following years as the Fed started to increase interest rates. Stocks continued to increase in value over that time period despite the increase in interest rates. That's because interest rates are only one factor in determining stock prices. Earnings are the single most important factor in stock prices and earnings kept rising due to a growing global economy. A similar phenomenon is playing out now as very strong economic growth will likely outweigh the impact of rising inflation and interest rates.

While we understand the emotions at play that cause investors to fear the turbulence of productive assets such as stocks, our Group works closely with each client to gauge your risk tolerance and create an allocation that generates the best return with the least volatility. Unfortunately, when an investor allows fear of temporary market setbacks to direct their allocation towards assets that don't overcome the hurdle of inflation – assets such as bonds and cash – they end up permanently losing money to inflation over the long term. At the historical 3% average annual rate of inflation in the U.S., your living standard gets cut in half every twenty-five years. This amounts to a permanent 50% impairment of your wealth that you never recoup. It's not like a bad market correction that resolves itself sooner or later. It's permanent. And yet there are no headlines about it. You'll never see a news article that says "Millionaire loses half of fortune to inflation – spends retirement living off rice and broth." And yet many investors do lose half their wealth and more to inflation over time, quietly and without fanfare or panic[4].

Among the major asset classes of stocks, bonds, and real estate, stocks have done the superior job of overcoming inflation over the decades. With an average annual return of about 7% over the past 120 years, stocks have handily provided a strong return in excess of the average inflation rate. Our Group takes inflation protection one step further by allocating portions of client assets to companies selling products cherished by consumers all over the world. In some cases consumers have enjoyed these beloved brands for nearly 800 years (monks first brewed Leffe beer in 1240). Because of the strength of these brands, these companies have the ability to increase prices to consumers almost every year to overcome the negative impact of rising raw material costs. Most of these companies already increase prices 10% or more annually in emerging markets with high inflation. Assets with such a strong and proven track record of price increases are exactly where you want to take shelter from inflation, and we saw that in the resilience of their stock prices in May relative to the entire stock market[1][5][6].

Our number one priority is the protection and intelligent growth of your wealth so that you can enjoy your desired standard of living now and far into the future. Our Group will continue to work closely with you to position your assets for protection and resilience against inflation and other wealth hurdles that surface in the future. Please contact us with any questions.

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Carsten Frederiksen, CFP® | Paul Hendershot | Nick Weege, CPFA | Andrew Ielmini | Lindsey Vickers, MBA

Sources:

(1) Company reports
(2) CNBC
(3) The Wall Street Journal
(4) Bureau of Labor Statistics
(5) S&P Dow Jones Indices LLC
(6) Robert Shiller

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