

5 Key Questions for Inflationary Environments



INVESTMENTS

For many investors today, high inflation is for the history books.

But unlike the last 40 years, inflation has rapidly shifted. In 2022, the Federal Reserve has raised interest rates faster than any time in decades to combat inflation.

Change in Interest Rates

| | Federal Funds Rate (Beginning) | Federal Funds Rate (End) | Number of Months | Total Rate Change (bps) |
|---------------------|--------------------------------|--------------------------|------------------|-------------------------|
| Mar 2022 - Sep 2022 | 0.25-0.50% | 3.00-3.25% | 6 | +275 |
| Dec 2015 - Dec 2018 | 0.25-0.50% | 2.25-2.50% | 36 | +200 |
| Jun 2004 - Jun 2006 | 1.25% | 5.25% | 24 | +400 |
| Jun 1999 - May 2000 | 5.00% | 6.50% | 11 | +150 |
| Feb 1994 - Feb 1995 | 3.25% | 6.00% | 12 | +275 |
| Mar 1988 - Feb 1989 | 7.50% | 9.75% | 11 | +225 |

Source: Federal Reserve 09/21/22, Federal Reserve 08/29/19. Refers to periods with two or more interest rate hikes.



The Federal Reserve has raised interest rates **5X** in 2022 to date.

While there are no clear answers, we look at key questions about inflation and the potential implications for investors looking ahead.

1

What Are the Main Factors Driving Inflation?

Often, investors closely watch core inflation since it doesn't factor in volatile energy and food prices.

One-Month % Change (September 2022)



Core Inflation: 0.6%



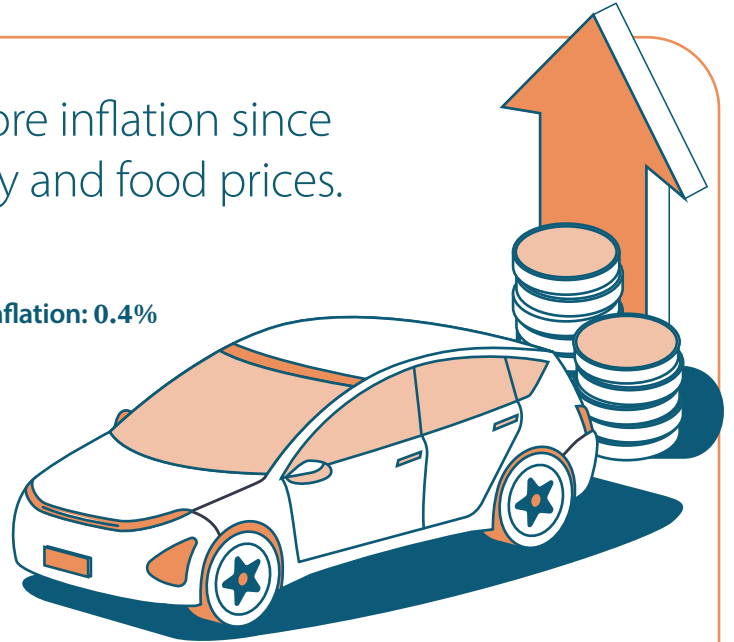
Headline inflation: 0.4%

Source: Bureau of Labor Statistics, 08/13/22.

Core inflation is represented by the Consumer Price Index: All items less food and energy. Headline inflation is represented by the Consumer Price Index.

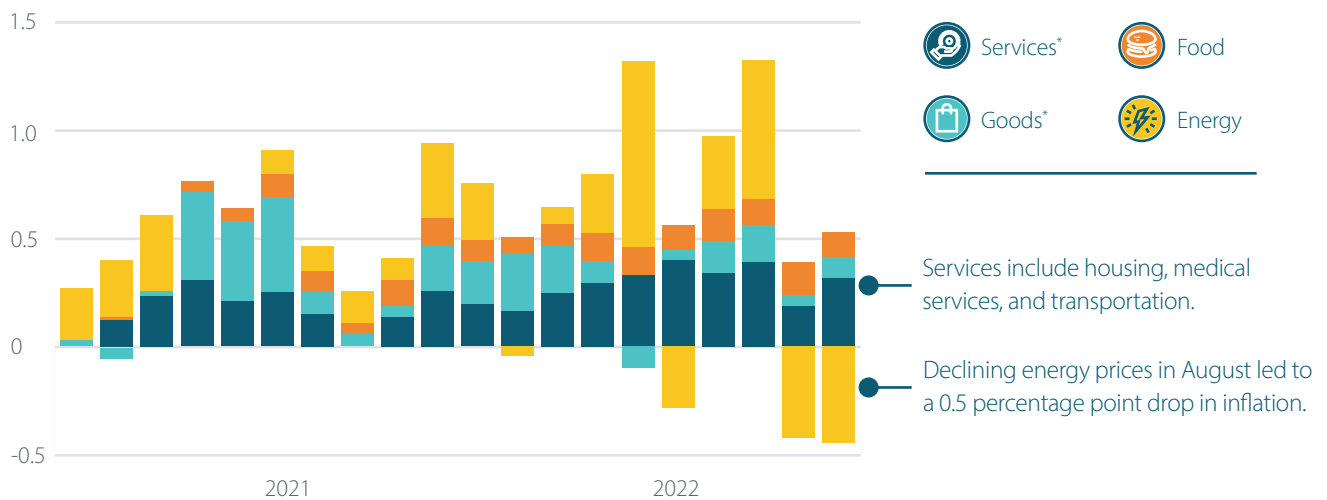
Earlier in the pandemic, surging second-hand car prices and supply-chain distortions were factors driving up inflation.

But as dynamics have shifted, rising services costs, including housing, have played a significant role.



Contributions to U.S. Inflation, by Month

Percentage Points



Source: Bureau of Labor Statistics, 08/13/22.

*Core prices, excludes food and energy.

Along with these factors, a strong labor market is adding to price pressures. Wages increased over **6% annually** in September, nearly the highest in two decades.

Source: Federal Reserve Bank of Atlanta, 10/19/22.



For this trend to reverse, unemployment levels may need to rise and interest rates may need to increase to cool an overheating economy.

2

What is the Effect of Fiscal Stimulus on Inflation?

Recent analysis suggests that the fiscal stimulus contributed to **2.5** percentage points in excess U.S. inflation.

Source: Federal Reserve, 07/15/22.

Given the complex nature of stimulus measures, let's take a look at some of the advantages and disadvantages of this response:



Fiscal Stimulus and the Economy

Pros



Economic Rebound



Employment Recovery



Boost in Consumption of Goods

Cons



Higher Inflation



Price Tensions



Higher Government Debt

Source: Federal Reserve, 07/15/22.

Supply disruptions and increasing demand contributed to 40-year inflation highs.

The U.S. government allocated over **\$5T** in fiscal stimulus in response to a historic crisis, elevating debt levels.

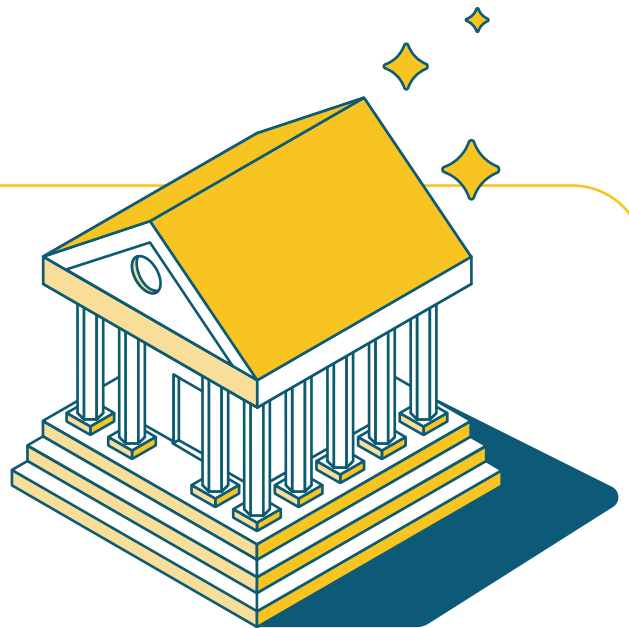
As the short-term implications begin to unfold, the longer-term structural effects of record stimulus remain far from clear.

3

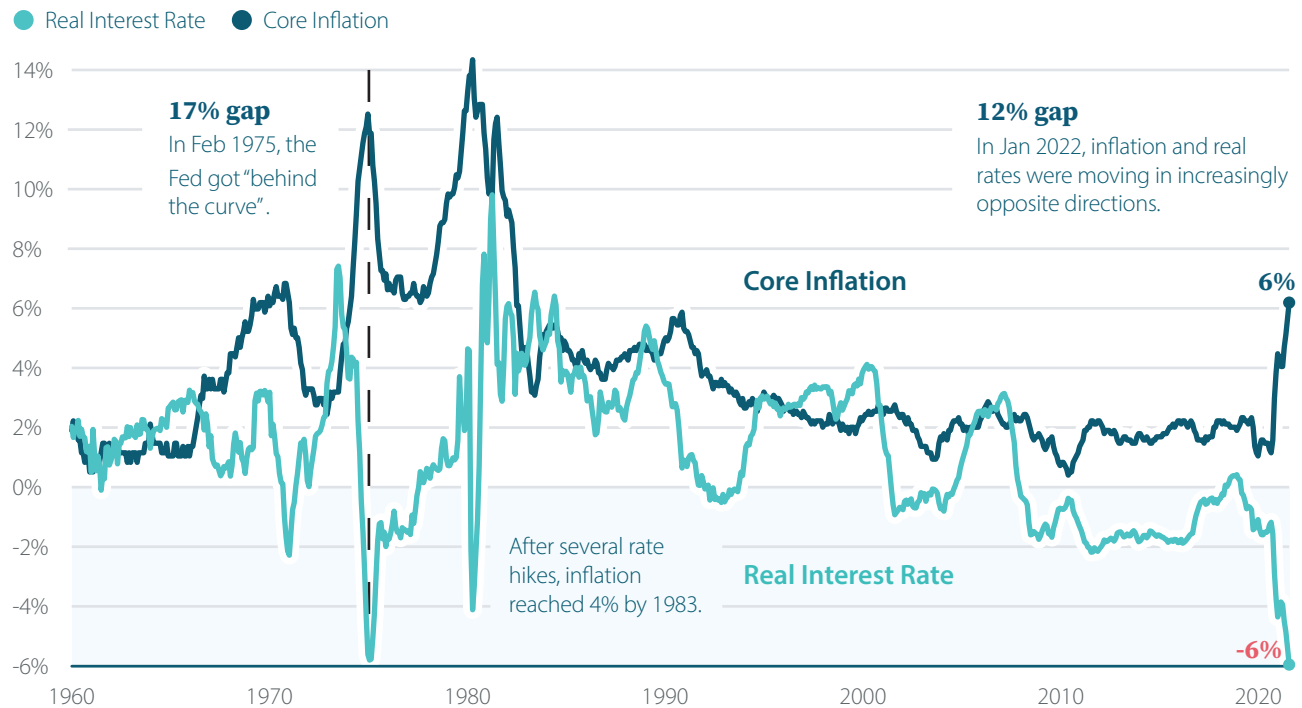
How Do Interest Rates Impact Inflation?

Interest rates are a key tool that the central bank uses to influence demand across an economy.

As the cost of capital increases, it can lower business lending and consumer spending on items like houses and cars, causing demand to slow.



Core Inflation vs. Real Policy Interest Rates



Source: Peterson Institute of International Economics, Federal Reserve Bank of St. Louis, 03/14/22. Core inflation is measured by the Consumer Price Index minus food and energy. The real policy interest rate is the Federal Funds rate minus core inflation over 12 months.

Over the last 11 tightening cycles since 1965, six resulted in soft landings and **three resulted in hard landings.**

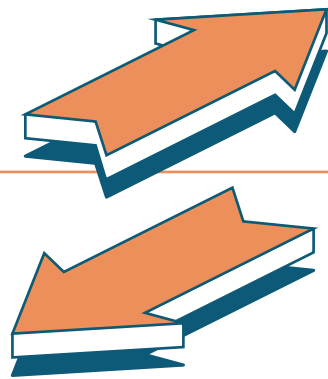
Source: Blinder, A. 02/11/22. Excluding the Global Financial Crisis and COVID-19. A soft landing is defined as a tightening period of the Federal Funds rate that is followed by no decline or a moderate decline in real GDP. A hard landing occurs when there is a steeper decline in real GDP.



Whether or not the recent tightening cycle will result in a hard landing remains an open question.

4

How Long Will Inflation Last?

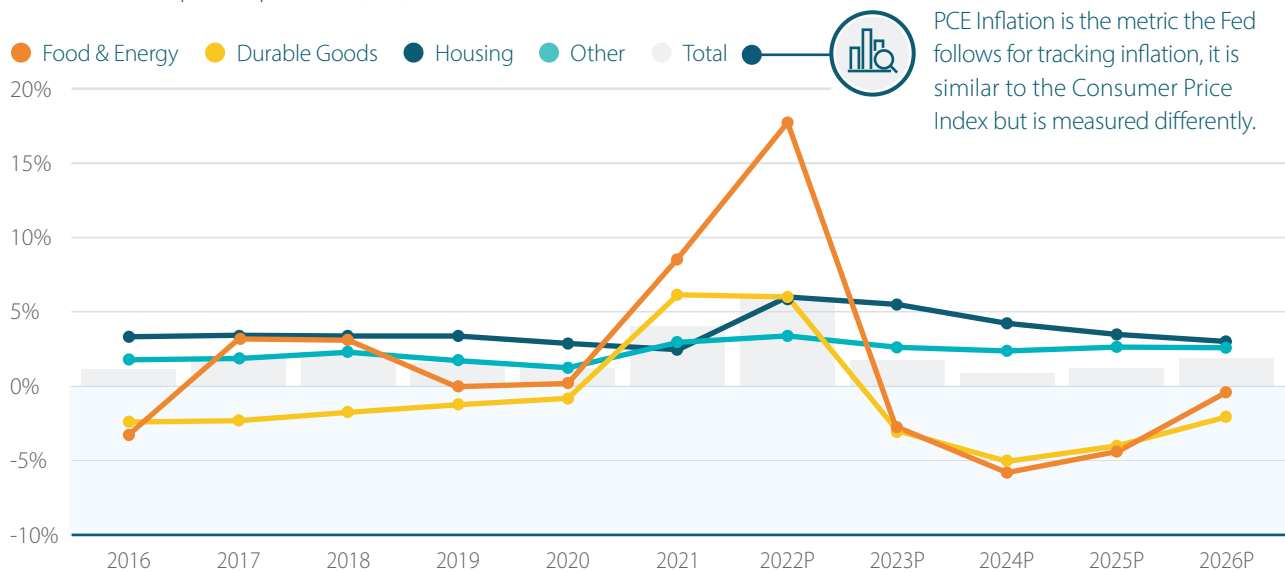


From the vantage point of 2022, the direction of inflation is as complex as it is uncertain.

Below, we show two separate scenarios for where inflation may be headed in the near future.

Inflation Scenarios, by Component

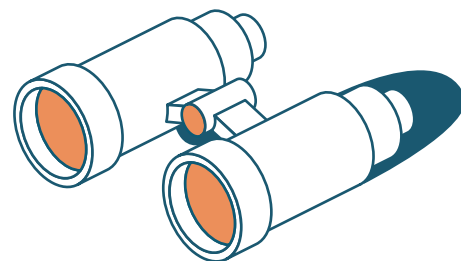
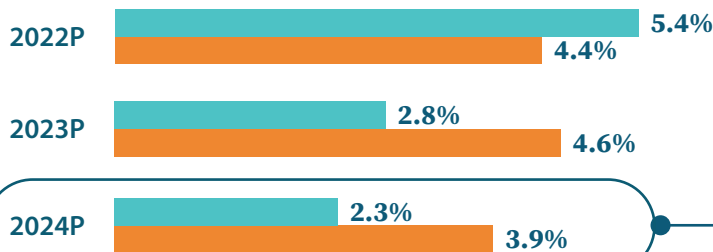
Personal Consumption Expenditure (PCE) Inflation



Source: Morningstar, Bureau of Economic Analysis, 08/07/22.

Inflation vs. Interest Rate Scenarios

Federal Funds Rate PCE Inflation

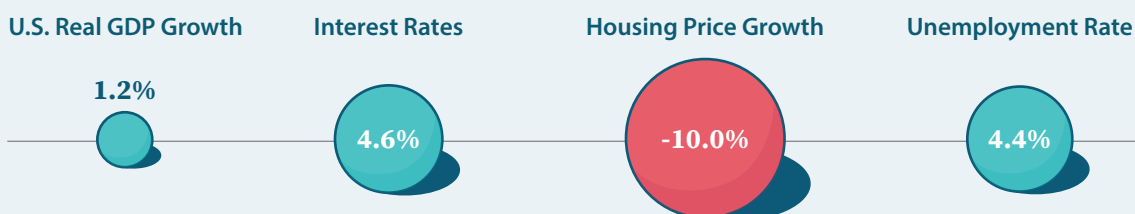


By 2024, inflation is expected to fall closer to the 2.0% target.

Source: Federal Reserve Board, 09/21/22. Reflects median projection for PCE Inflation.

What other key factors could influence inflation going forward?

2023 Projections



Source: Federal Reserve Board 09/21/22, Morningstar 08/07/22. Interest rates represented by the Federal Funds rate. Housing Price Growth represented by median U.S. home prices. For information purposes only. There is no guarantee that these projections will come to pass.

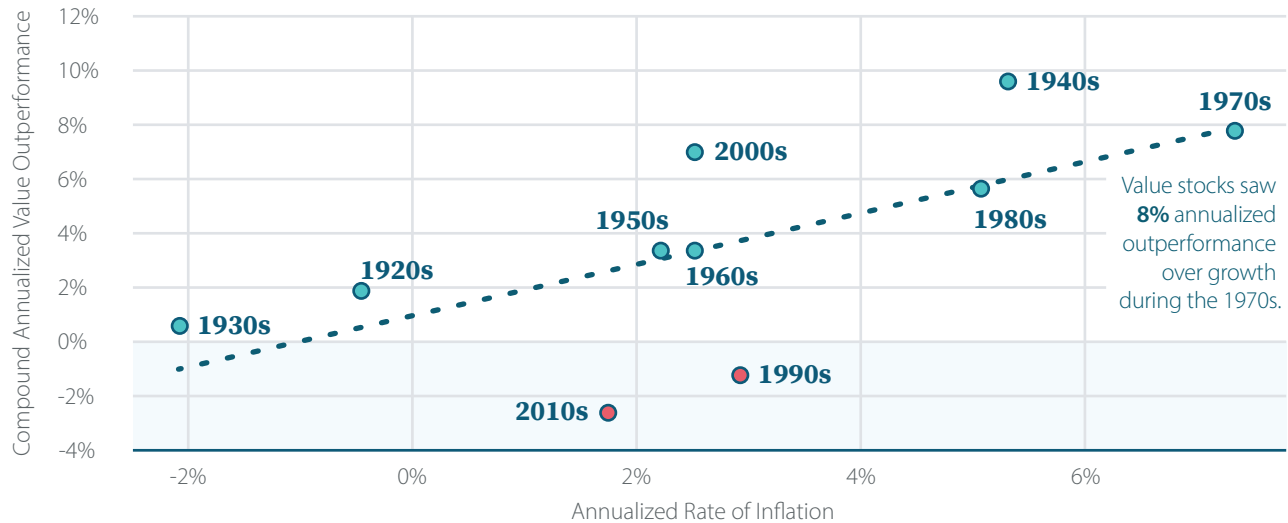
5

What May Lessen the Impact of Inflation On My Portfolio?



During inflationary periods, value stocks have tended to perform well, as seen in the 1970s and 1940s.

Inflation and Value Performance



Source: Robert Shiller and Kenneth French, Euclidean Technologies 10/21. Inflation is represented by the Consumer Price Index. Value stocks are represented by companies with the 30% highest book-equity-to-market value across the NYSE, AMEX, and the NASDAQ. Index definitions can be found at the bottom of this piece. An investment cannot be made directly in an index. Past performance is not indicative of future results.

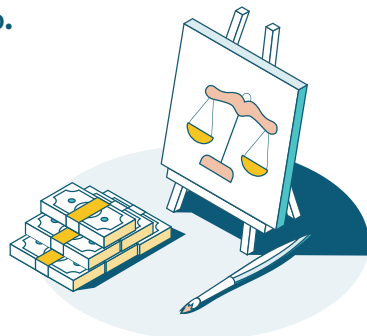
Similarly, tangible assets like **commodities** and **real estate** have tended to weather these periods thanks to their diversification and portfolio stability across economic cycles.

Source: IPE, 03/22.

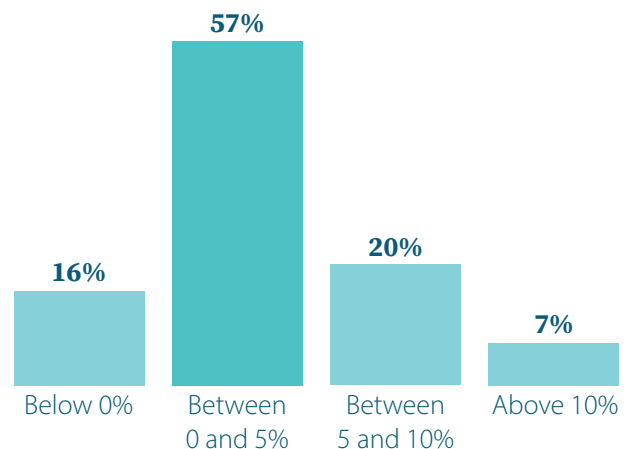
The Big Canvas

Generally speaking, periods of high inflation over history are quite rare.

Since 1947, the average U.S. inflation rate has been **3.4%**.



Where Has Inflation Resided Most Often? 1947–2021



Source: CFA Institute, 07/19/21.

Against a changing environment, investors may consider balancing their portfolios with more defensive strategies that have been historically more resistant to inflation.

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The **Federal Funds Rate** is a target interest rate determined by the Federal Reserve. It is the interest rate at which banks and credit unions lend reserve balances to each other, most often overnight.

The **Consumer Price Index** measures the average level of prices in the U.S. based on a basket of goods and services over a given time period. The **Consumer Price Index: All Items Less Food and Energy** is the average level of prices for a basket of goods and services in the U.S. less food and energy, often used to measure core inflation. The **Personal Consumption Expenditures Price Index** is a primary measure used by the Federal Reserve to track the price of a broad range of goods and services in the U.S., reported by the Bureau of Economic Analysis. **Median Home Price Growth** is measured by the U.S. Census Bureau and is estimated by sample surveys. **Value outperformance**, also referred to as 'High Minus Low (HML)' is measured by companies in the New York Stock Exchange (formerly AMEX), and the NASDAQ that fall within the top 30% of firms with the highest book-equity-to-market value and are represented as compound annualized returns.

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