CORNERSTONE
INVESTMENT PARTNERS, LLC

November 2020

"I'll Gladly Pay You Tuesday For A Hamburger Today"
The Cases For And Against Future Inflation During The COVID Economy

Executive Summary

Future Inflation Remains A Key Issue For The Market

Inflation has been weak since the global financial crisis (GFC), even though the Federal Reserve has maintained a highly accommodative stance. The government has taken aggressive actions in response to COVID-19, but it remains unclear how prices will respond going forward.

Scenario One: Government Actions Drive Higher Inflation

The combination of highly accommodative monetary and fiscal policy has increased the money supply almost five-fold, and chasing the same amount of goods and services, that may drive up price levels. Additionally, high levels of national debt may encourage policies to reduce its nominal cost. In that environment, value-oriented stocks have historically outperformed.

Scenario Two: Economic behavior that limits inflation potential

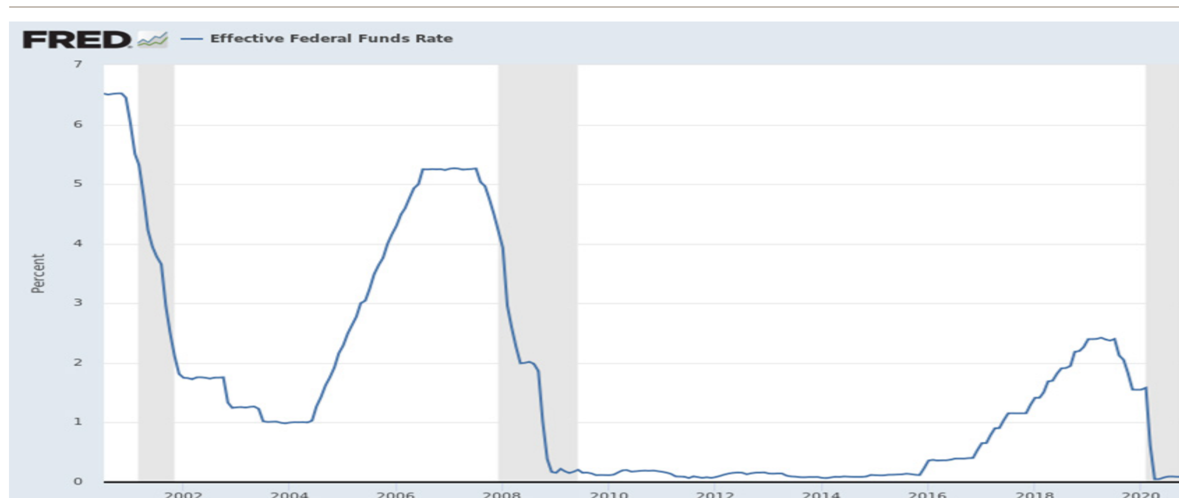
However, the reality of high unemployment, weak growth, and economic uncertainty have led private actors in the system to save more and drive down the velocity of money, which offsets the impact of desired policy actions. In that case, active management will be key, with a focus on identifying the right stocks that can both withstand weaker periods and thrive when the economy recovers.

The potential for inflation in the United States has been a popular topic of discussion since the Federal Reserve began its first quantitative easing program during the fourth quarter of 2008. Since then, the Federal Reserve has continued to pursue a largely accommodative stance toward monetary policy. In the ensuing years, however, classic measures of inflation such as the consumer price index ("CPI") have not moved meaningfully higher. If the Fed's actions over the past twelve years have not created an inflationary environment, it is fair to ask if the events of 2020 will lead to a different outcome.

Particularly for macroeconomic situations, where we do not forecast an outcome, the Cornerstone investment team strives to ensure that we understand both sides of the debate, and importantly, the impact on our portfolio in each outcome. We have explored the cases for both future inflation and disinflation, and what will likely happen to value-oriented stocks in either environment. We will leave the choice of possible outcomes to your judgement.

Scenario One: Why We Will Enter A Higher-Inflation Environment

In addition to the Federal Reserve's pursuit of accommodative monetary policy, the United States government has also shifted its stance on fiscal policy to one of extreme support. Earlier this year, the Federal Reserve took swift action in response to the outbreak of COVID-19 and reduced the upper limit of the Federal Funds Rate target range from 1.75% to 0.25% over the course of a two-week period. While clearly accommodative, this action is far from unprecedented, as the Effective Federal Funds Rate sat close to zero from the first quarter of 2009 until late 2015.

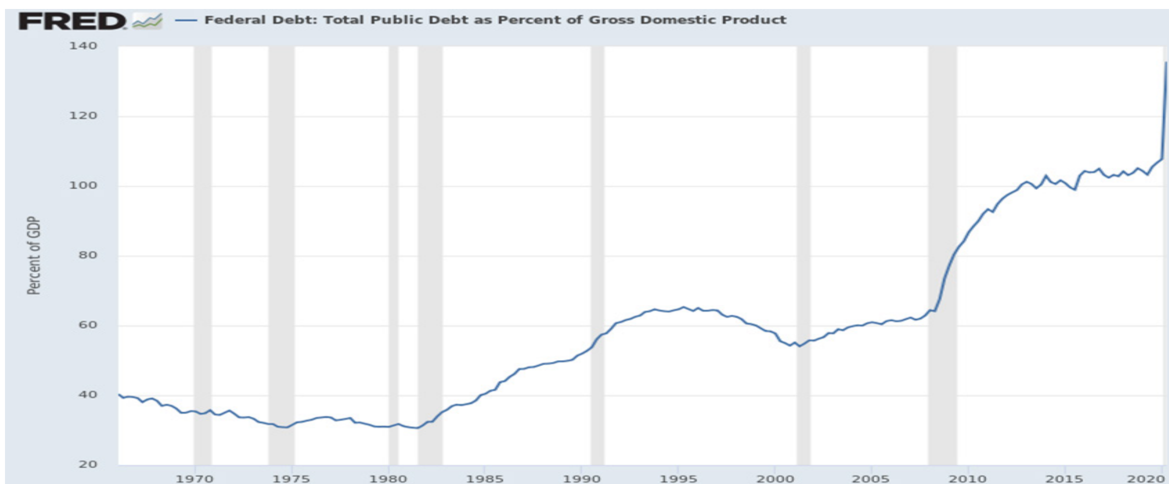


Source: St. Louis FRED, Federal Reserve Bank of New York

What may be different about 2020 is the intervention of the United States government in the commercial banking system. The Fed's quantitative easing programs generated substantial growth in non-bank debt, which allowed corporations to borrow inexpensively through debt issuance but did not result in significant broad money growth. In 2020, the US government has ordered commercial banks to lend money to corporations, and the government has agreed to guarantee and possibly forgive these loans. As a result, broad money growth, as measured by M2, has moved meaningfully higher, which represents a distinct change from the past 20 years.

Source: St. Louis FRED, Board of Governors of the Federal Reserve System (US)

The colloquial definition of inflation is "too much money chasing too few goods" and the government's recent actions have delivered significant growth in the amount of money in circulation. One could argue that the government has a strong incentive to create inflation as a response to the country's debt burden. The national debt to GDP ratio has risen well above 100% and inflation represents a path to resolution of this problem. We do not presume to understand the intentions of politicians. That being said, it appears that politicians may have some control over the money supply and may have incentives to continue increasing it. For example, given the amount of debt the government has taken on in recent years, an inflationary environment would make repaying that debt much easier, as the value of the dollar would decline.



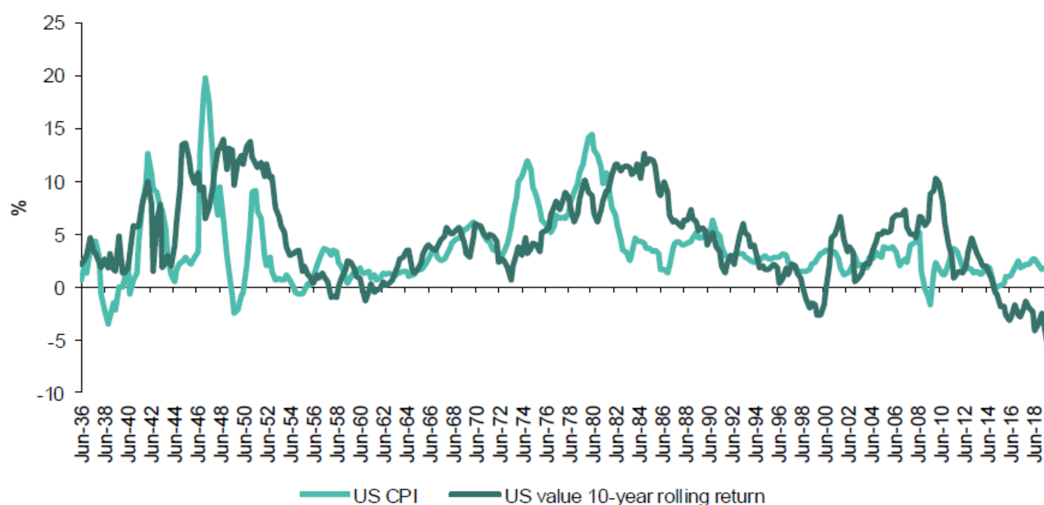
Source: St. Louis FRED, Federal Reserve Bank of St. Louis

The tariffs implemented by the current administration also contribute to the potential for inflation over time. At a minimum, it is generally more expensive to manufacture goods in the United States than it is to do so in foreign countries. If more manufacturing takes place in the United States, it follows that goods will likely become more expensive to purchase over time. To be clear, we make no prediction about how the trade war will play out. We simply argue that tariffs and more domestic manufacturing would drive higher prices over time.

What Will Likely Happen To Value-Oriented Stocks in a Higher-Inflation Environment?

We believe that there is a strong argument for the outperformance of value stocks, as a group, in an inflationary environment. In such an environment, long-term interest rates could rise, benefitting banks and potentially compressing the multiples of growth stocks. **Historically, inflationary environments have benefitted value stocks.**

EXHIBIT 1: **Inflation and value have moved together for 90 years...**



Source: Ken French data library, Datastream, Bernstein analysis

Fixed income investors tend to fear inflation, as it lowers the real value of the payments they expect to receive in the future. As a result, bonds have historically traded lower in inflationary environments, increasing the yields demanded by investors. Recent commentary from the Federal Reserve suggests a strong reticence to raise short-term interest rates anytime soon, so rising long-term interest rates would likely lead to a steeper yield curve. A steepening curve creates oppositional forces, as longer-duration bonds would trade down, but new investments can be reinvested at higher yields.

Banks, which appear attractively priced today relative to historical valuation levels, generally perform well during periods of yield curve steepening. The banking business model is to borrow at short-term interest rates (e.g. deposits) and lend at longer-term rates, capturing the spread between the two. **A rally in banks, relative to the rest of the market, would contribute positively to the potential relative outperformance of value stocks, as they make up a larger portion of value benchmarks.**

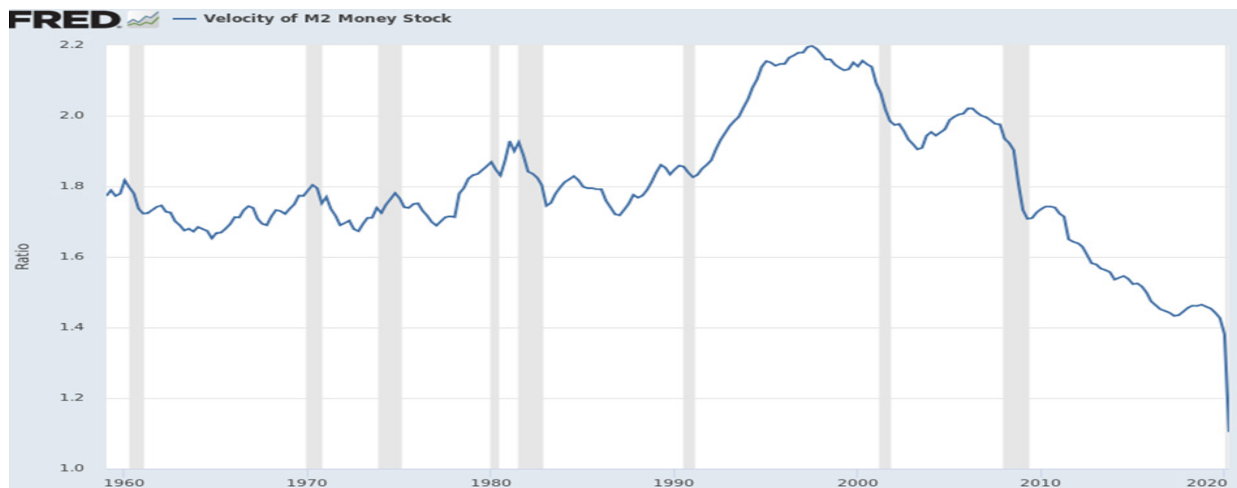
In an environment of higher long-term interest rates, it is also possible that growth stock multiples could compress meaningfully. Many growth-oriented companies currently generate meager profits relative to their sizable market capitalizations. To justify such potentially optimistic prices for these stocks, analysts often utilize discounted cash flow models to project free cash flow for decades going forward. The word discount is critical, because lower discount rates result in higher target prices. The opposite is also true, as higher discount rates lower the present value of future cash flows. **Near-term cash flows matter significantly more in an environment of rising interest rates.**

Past performance does not indicate future results. As with all investments, the possibility for profit is accompanied by the risk of loss.

Scenario Two:
Why We Will Remain In A Low-Inflation Environment

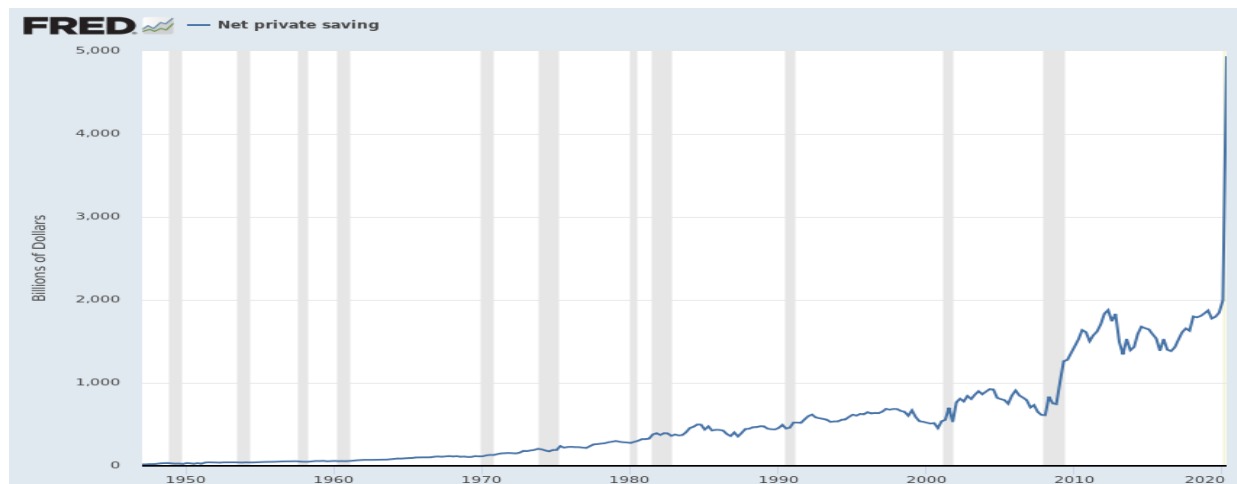
Inflation is defined as [Price Level = (Money Supply * Velocity of Money) / Real GDP]. The generally accepted notion among many market participants is that the increase in the money supply we have seen from a combination of very loose fiscal and monetary policies driven by government stimulus spending and quantitative easing to mitigate the economic impact of COVID-19 has to drive inflation.

However, that assumes people use that money. Instead, the velocity of money has gone in the opposite direction.



Source: St. Louis FRED, Federal Reserve Bank of St. Louis

This has been caused by increasingly risk-averse actions by both businesses and individuals. With significant economic uncertainty and higher unemployment rates, savings and savings rates have skyrocketed. In a 3-month period from March to June of this year, more dollars have been saved ($4.9 trillion) than in almost the entire financial crisis period ($5.2 trillion from 1Q08 to 2Q09).



Source: St. Louis FRED, U.S. Bureau of Economic Analysis

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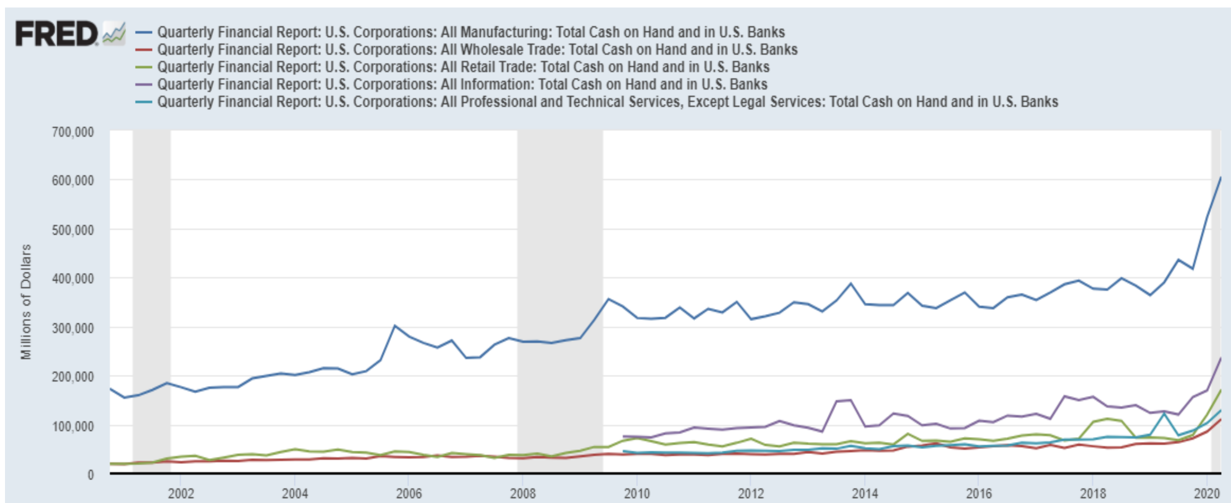
With much of the United States in lockdown and their revenues falling significantly (in some cases to zero), businesses began to focused on liquidity at the expense of all else to preserve cash flow. They called on all the credit lines available to them, raised debt, and also cut spending and dividends. But instead of all that money pouring into the economy, it is just sitting on corporate balance sheets.



Source: St. Louis FRED, U.S. Bureau

Consumers are similarly saving. On one side, they are (over)reacting responsibly to an increasingly uncertain labor environment and volatile stock market. But also there are fewer opportunities to spend money, with much of the leisure, restaurant, and travel markets closed. Additionally, the wealthy have taken an increasing share of national income levels, and they save relatively more money than less affluent people.

Source: St. Louis FRED, U.S. Bureau of Economic Analysis

Going forward, what will happen? Savings rates remained high for four years after the last recession. While each recession was caused by very different factors, the sharp downturn experienced by the COVID-19 period could drive fears and impact behavior well into the future.

Also pressuring the velocity of money is that banks are not lending as much as they have historically, which is typically a driver of the money multiplier effect. This is driven by the insidious combination of higher credit risk and lower compensation for that risk.

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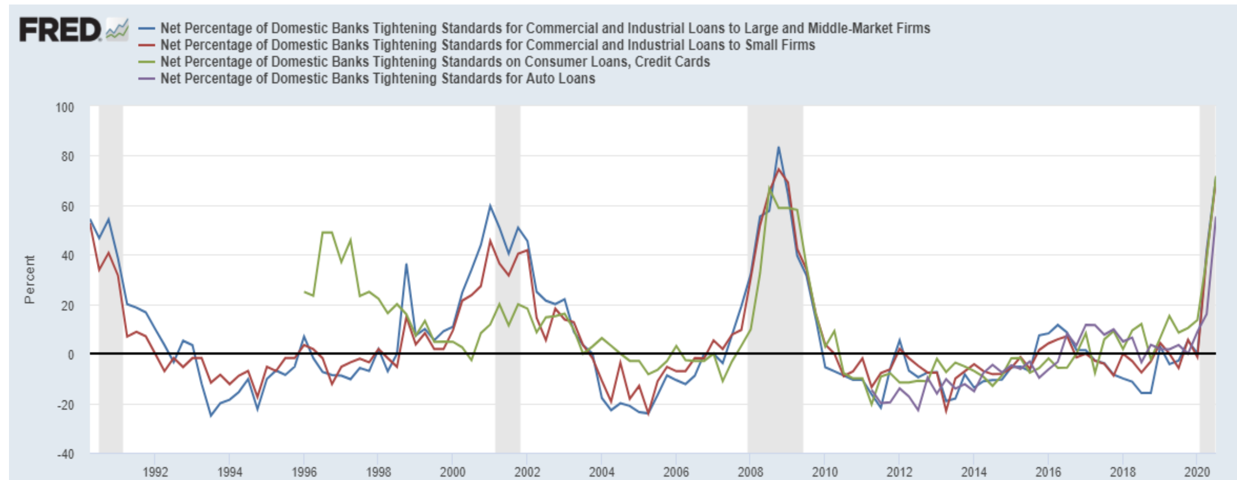
With low interest rates, banks have generally seen net interest margins compress significantly. Additionally, with many business closures and ballooning forbearance programs, credit risk has risen and CECL accounting standards amplify the impact of near-term concerns on long-term credits. This has led to the tightening of standards to levels only seen once before in the last 30 years.



Source: St. Louis FRED, Board of Governors of the Federal Reserve System (US)

Similarly, there is an excess supply of labor and lower demand for it. Remember, unemployment caused this recession, instead of being a result of it. As of February 2020, only 5.8 million people were classified as unemployed in the United States. While down from the 20 million-plus peak in April during more stringent lockdowns, as of the end of September 12.6 million are unemployed, and there are also an additional 1.9 million who are now only marginally attached to the labor force.

Source: St. Louis FRED, U.S. Bureau of Economic Analysis

That is a large portion of the population not getting paid.

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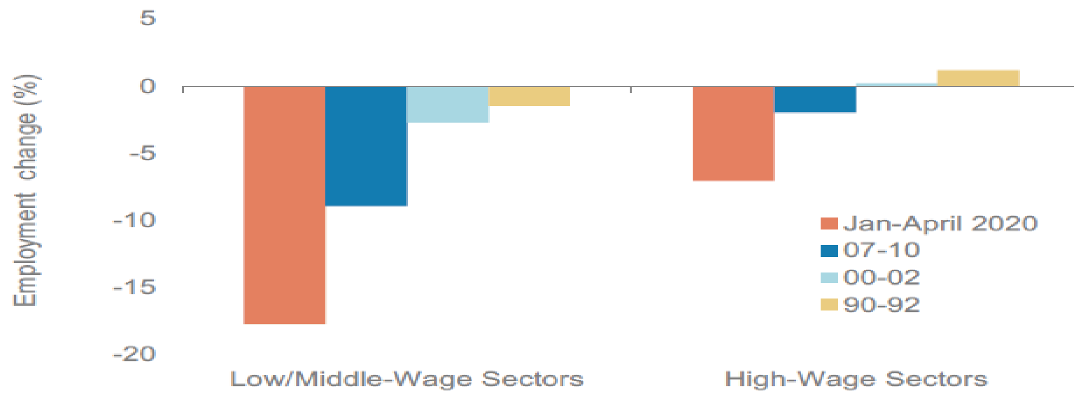
Additionally, many of these jobs may not return for a long time, if ever. Corporations have espoused how much of their recent cost savings will be permanent, and over 100,000 restaurants (representing 3 million employees) have closed in the last six months.

Source: St. Louis FRED, U.S. Bureau of Labor Statistics

Interestingly, while wages have actually gone up in recent months, that could be driven by mix (lower wage sectors have been disproportionally impacted than higher-wage earners).

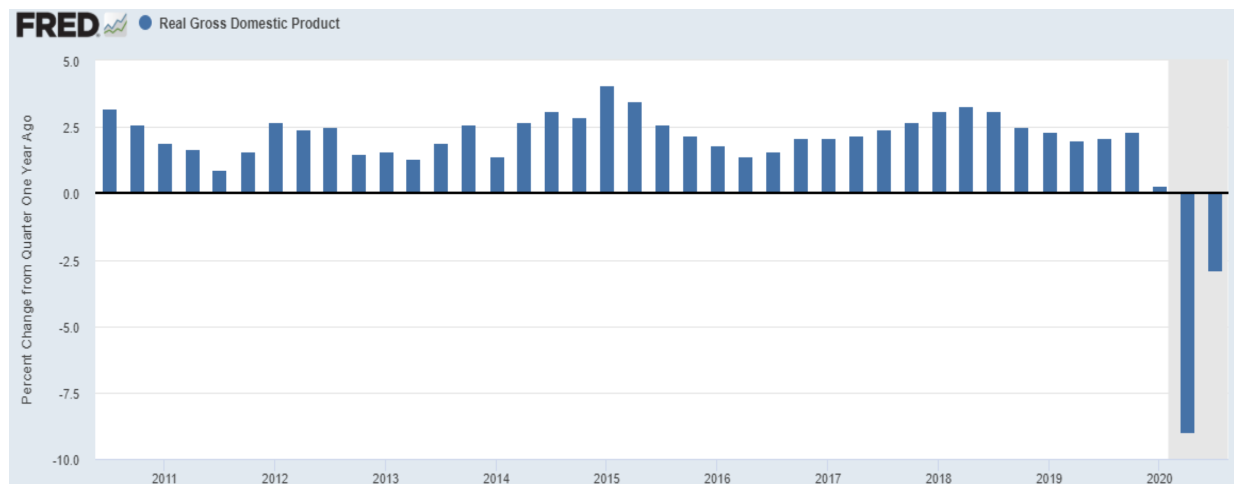
Exhibit 19: US job losses during this recession concentrated in lower wage sectors



Source: BLS, Census Bureau, Haver Analytics, Morgan Stanley Research

With an unknown outcome of additional direct stimulus payments and expiring housing protections, the unemployed and marginally employed may well accept lower wages in the future, even if they do get hired, and work-from-home arrangements could also pressure wages by reducing labor friction.

Not surprisingly, world and US GDP have fallen significantly this year. This lack of global demand is also driving deflation in some commodity prices, particularly oil.



Source: St. Louis FRED, U.S. Bureau of Economic Analysis

Given central banks' desire to drive growth at any cost and recent statements, we expect to see the Federal Reserve (as well as central banks across the world) continue its policy of quantitative easing as an attempt to buy their way out of this environment. A recent comment by the Bank of England asking whether British banks were ready for negative interest rates is unlikely to disabuse investors of that notion. However, this period shows that there are limits to centralized policies, as while they incentive certain behaviors, they cannot force it. With the eventual opening of the economy and increasing growth rates, inflation may rise from current levels, but it is quite possible that the negative effects of 2020 will have a dampening effect on overall inflation for years to come and ensure it remains below central bank target levels.

What Will Happen To Value-Oriented Stocks in a Low-Inflation Environment?

Over time, rising inflation and performance in value stocks have been correlated, and we will not pretend that a low-inflation period has historically been good for value stocks. However, investors do not need to own the entire value space unless they rely upon passive management for their value exposure.

A lower nominal-growth environment, particularly in the near-term, should reduce out-year cash flows even if long-term growth remains high. Compounding off a lower base impacts faster-growing companies more than slower-growing companies. Value-oriented stocks, particularly those with lower growth rates, have a greater portion of their intrinsic value driven by nearer-term cash flows which are likely more certain to be received than those from the distant future. **All else equal, a short-term period of macro-driven weakness, as long as it is followed by a coherent recovery, could advantage many value stocks relative to growth stocks in the long run. But it is important to ensure that the companies in a portfolio are likely to participate in that recovery, are not permanently impaired by this environment, and do not have balance sheet concerns.**

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Separately, on a fundamental basis, one needs to explore why the Federal Reserve is keeping rates low. There appears to be more pressure placed on the Fed to increase economic growth compared to its historical mission to stabilize it. Maintaining sustained low rates is an active decision to support investment in capital and labor, and thus grow GDP (itself a function of the change in capital, labor, and productivity). **Particularly combined with loose fiscal policies and deregulation, if this monetary policy is successful and drives real (not just nominal) growth in GDP, then value-oriented companies, which often have a greater sensitivity to changes in GDP, could be relatively advantaged. But this could result in inflation quickly once the economy stabilizes, so it is important to recognize both that a portfolio needs to be positioned in advance of that future inflection and ensure that the companies currently in a portfolio will be able to fundamentally handle both environments and not be disproportionally disadvantaged in the future.**

There is no doubt that many companies and industries will be weak in a low-inflation environment. Commodity-linked companies may see both margins and absolute profits flatten or even decline. Firms with significant operating leverage may see decelerating growth. And those businesses in highly competitive markets may have less ability to raise prices as customers have more power and less nominal cash. **Portfolio managers do not need to buy every company. Instead, we argue that the opportunity for concentrated active managers like Cornerstone, who can pick among value-oriented stocks to build the best portfolio for clients, is stronger when there is a lower-correlation market that allows for differentiated performance.**

Conclusion

The one thing we know is that we cannot predict what is going to happen in the future. For starters, the situations we have laid out can change, and there are several key variables to keep an eye on.

- Healthcare response: While it is highly likely that we will eventually solve the COVID-19 crisis, the timing of a vaccine or therapeutics is unknown. Until we see a path through the pandemic, global demand will likely remain weak and uncertainty high, but when we see a path through the pandemic, then things could change quickly.

- Government response: It appears obvious that governments will continue to provide fiscal and monetary policy stimulus. However, the timing, magnitude, and model of those actions will have a significant impact on whether they are successful or not and could be critical to whether we experience a low-inflation or high-inflation outcome.

- Private response: Regardless of government actions, decisions made by firms and individuals, whether by banks choosing to lend, firms choosing to invest in capital, labor, or productivity, or individuals choosing to spend, will influence whether or not government responses will be successful in driving the desired outcome.

However, the potential impact on portfolios of the future path of inflation is high enough that positioning yourself on one side or another carries significant risk, and actions taken to increase exposure to that decision can materially impact results. Looking forward, it is important to remain nimble.

Due to their generationally-attractive valuations, higher level of dividend payouts, and values driven more by shorter-duration forward earnings, value stocks may provide a lower-risk alternative to the broader market, regardless of the inflationary outcome.

Cornerstone's portfolios are actively-managed, valuation-oriented, and fundamentally-driven, and our experienced team has been through a range of different market environments. The portfolio management team shares over 100 years of investment analysis and portfolio management experience. Please contact us (reach out) if you have any questions about this topic, any of our other thought papers, or Cornerstone's strategies across the large-cap and small-cap space.

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Mark Spatt, CFA

Investments

Mark is a Partner for Cornerstone and is responsible for research and portfolio management. Prior to joining the firm full time, he interned at Cornerstone during the summer of 2012. Previously, Mark was an Associate at Centerview Capital, an operationally-oriented private equity firm investing in consumer-focused businesses, where he took an active role in sourcing, evaluating and monitoring the firm's investments. Mark began his career as an investment banker at J.P. Morgan's Mergers and Acquisitions Group in New York, where he advised large-cap clients on complex domestic and cross-border transactions. Mark earned an MBA, with honors, from the Wharton School at the University of Pennsylvania, double majoring in Operations and Management and holds a Bachelor of Arts from Princeton University.

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