INVESTOR NEWSLETTER

HELPING YOU MAKE INFORMED INVESTING DECISIONS

Russell Investments

INVESTING IN INFLATIONARY TIMES

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We all know the feeling of going to the grocery or hardware store and realizing our paycheck isn't stretching as far as it used to. When we feel the impact of inflation in our pocketbooks, we may buy less or choose items of lower quality. And we may have less available for saving and investing.

Inflation also impacts the value of our investments. It reduces the returns we obtain from investing in the markets. If our portfolio rises by 7%, but inflation is 4%, then the real return of our portfolio is only 3%. And if there's a bad year in the markets and returns are negative, inflation will take a bite out of your portfolio anyway, increasing the magnitude of the loss.

Moderate inflation isn't necessarily a bad thing. When an economy is growing in a healthy way, prices can rise steadily but in an orderly fashion. And generally, wages on average rise in an orderly fashion as well (even if it personally doesn't feel that way).

In an ideal inflation regime – such as what we have enjoyed for most of the previous four decades – prices of products and services go up because there is rising demand for them. That in turn prompts manufacturers and providers to increase supply, which can lead to more jobs, higher wages and then even more demand. It's a virtuous cycle.

But sudden and elevated inflation is worrisome. That's a sign of an imbalance in an economy. When an economy is not growing in an orderly fashion, it causes uncertainty. When companies are uncertain about the economic outlook, they may slow their spending and hiring decisions. And when ordinary people are uncertain about the economic outlook – and their jobs – they may slow their spending as well. Slower retail spending – a large contributor to Canada's gross domestic product – can lead to lower economic growth and an even greater slowdown in spending. It's a vicious cycle.

The 3 main sources of inflation are:

Demand-pull inflation – this is generally caused by a strong economy

Cost-push inflation – this may come from rising wages, or the increased cost of energy or materials

Easy-money policies – when central banks try to boost the economy by lowering borrowing costs or increasing the money supply

The oil crisis in the early 1970s, which sparked double-digit inflationary regimes and strict monetary policies, led to a recession later that decade. This is one of the best-known examples of **cost-push** inflation. The surge in inflationary pressures in 2022 is mainly attributed to the **easy-money policies** that the world's biggest central banks adopted when Covid-19 first appeared in early 2020. In both the U.S. and Canada, the central banks increased the money supply through asset purchases as well as huge fiscal stimulus to keep the economy afloat as pandemic-related restrictions hampered normal business activity.

While **demand-pull inflation** may seem the more benign option, it isn't always. When inflation is due to an overheating economy, then central banks are forced to raise interest rates to cool it down. And that in turn has an impact on our pocketbooks: the cost of borrowing money can rise sharply, which can cause the sales of key big-ticket items, such as homes or vehicles, to fall. That then can cause the manufacturing and construction industries to slow – which can have a domino effect across the economy.

In fact, an overheated economy has been one of the most common recession triggers in the U.S. since World War II.[1]

[1] Forbes https://www.forbes.com/advisor/investing/inflation-and-stock-market/

What does inflation mean for investors?

For investors, inflation is both good and bad. The bad is easy enough to see:

- inflation reduces the real value of your portfolio
- inflation cuts into your purchasing power, potentially leaving you with less available to invest
- inflation, if it persists long enough, generally pushes the price of stocks down as many companies find their profit margins are squeezed by higher input costs and reduced demand
- inflation causes central banks to hike interest rates – raising borrowing costs that could reduce corporate spending on growth opportunities
- inflation that leads to recession generally causes investors to switch to "risk-off" mode, which can hurt the more dynamic sectors of the financial markets

But inflation doesn't hit every part of the financial system the same way. In fact, some sectors actually benefit from inflation. For example, **energy stocks** often rise in inflationary environments, mainly because energy prices are a component of inflation indexes and therefore the stocks rise in tandem with prices. **Real assets**, such as real estate and infrastructure, often have their long-term contracts or concessions tied to the Consumer Price Index (CPI), a key measure of inflation. **Defensive stocks** such as consumer goods can often withstand inflationary pressures. People will always buy toilet paper, shampoo and toothpaste, for example. **Utilities** also fare relatively well in inflationary regimes.

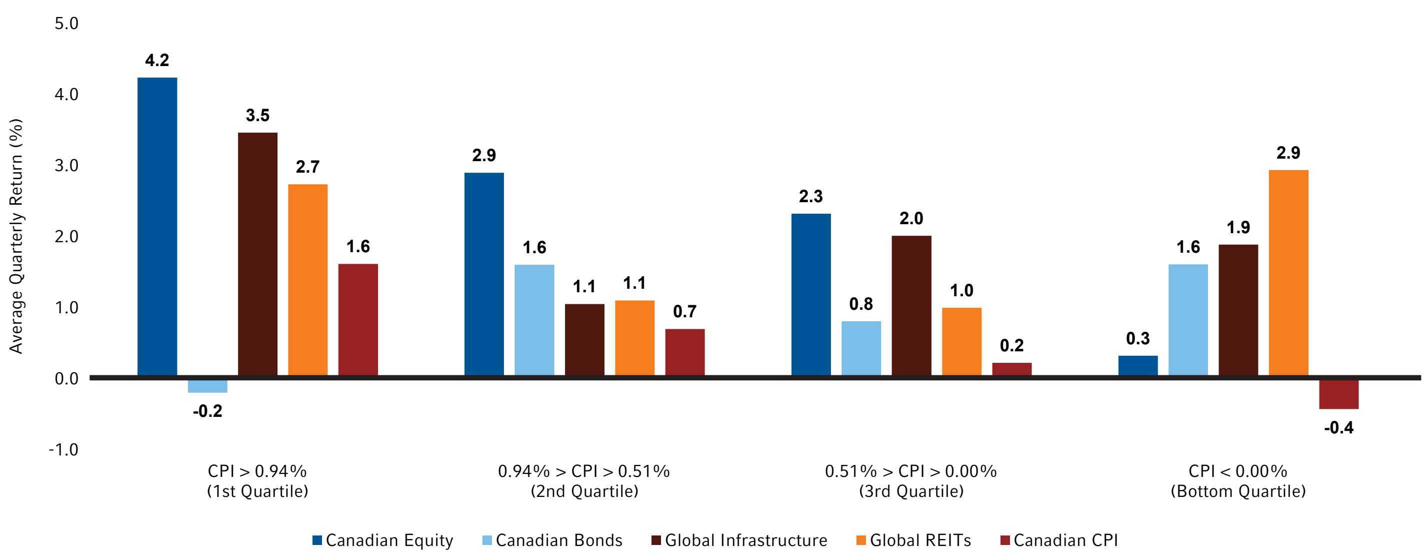
Growth stocks are most sensitive to rising interest rates resulting from inflation. That's because they're generally valued on their future earnings using discounted cash flow models. High current interest rates tend to lower the value of future cash flows. **Value stocks** may be a better bet in a high-inflation, high-interest-rate environment. It can be less expensive and less risky to buy undervalued stocks of companies with strong business fundamentals.

Rising inflation has a significant impact on **fixed-income assets**, such as government treasury bills and corporate bonds, which pay fixed interest rates. This is because inflation lowers the real level of income from bonds (yield minus inflation).

The chart below shows how different asset classes react to various inflation environments.

Average quarterly asset class returns by inflation environment

(January 1, 2003 to March 31, 2023)



Source: Russell Investments and Morningstar Direct, as of 3/31/2023. In CAD. The average asset class returns were calculated by segmenting corresponding Canadian Consumer Price Index (CPI) observations from 1/1/2003 to 3/31/2023 into quartiles. Canadian Equity: S&P/TSX Composite Index, Canadian Bonds: FTSE Canada Universe Overall Bond Index, Global Infrastructure: S&P Global Infrastructure (Net) Index, Global Real Estate Investment Trusts (REITs): FTSE EPRA/NAREIT Developed Index Net TRI (USD), Canadian CPI: Canadian Consumer Price Index. Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

High inflation may increase uncertainty and hurt your pocketbook but you can still pursue your financial goals. Here are some tips to keep on track:

Don't act on your emotions

As tempting as it is to flee a volatile market, letting fear guide your investing decisions is a mistake. You could end up missing out on gains when markets rebound. You can't time the market without a crystal ball so it's generally a better strategy to remain invested over the long term.

Use different strategies to remain on track

Dollar-cost averaging can help take some of the emotion out of investing and reduce the effect of volatility. As you will purchase shares on a regular basis, you will buy more shares when prices are low and fewer when prices are high. If you are enrolled in a company-sponsored defined contribution plan, you will be automatically participating in dollar-cost averaging.

Diversification across stocks, bonds and alternatives can help smooth your returns. As discussed, different assets will react differently to the effects of inflation and to rising interest rates. But it's not necessarily a good idea to avoid those assets that are most impacted by inflation because they will eventually rebound. A well-diversified portfolio is one of the best ways to weather the market's ups and down.

One way to ensure you are diversified and remain within your risk tolerance is to do regular **rebalancing**. If your original target allocations of stocks, bonds and cash have shifted so that they no longer match your risk tolerance and investment objectives, it may be time to rebalance.

Work with a financial advisor

Inflation can lead to volatile markets. Markets can be hard to navigate in the best of times, let alone when the outlook is uncertain. For investments you may hold outside your employer-sponsored retirement plan, a financial advisor can help guide you and keep you on track to pursue your financial goals.

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