# Stonehill FMA Exchange

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A Newsletter from the Stonehill College Chapter of the Financial Management Association



## *Inflation Hurts Everybody – What next?*

*By: Joseph LaFauci '23*)

U.S. inflation is at a 31 year high leaving many Americans feeling the pain of its implications. In fact, the reported December 2021 U.S. inflation rate was 7.04% year over year and federal government expectations have shifted to imply that a significant reversal is not likely in the near future. Last time inflation was anywhere near this high was in the 1980s. Then inflation was a result of the 1960s government spending on the Vietnam war colliding with President Lyndon B. Johnson's Great Society program which was ignited by a dramatic increase in energy prices led by oil embargos by the OPEC nations. The rise in federal spending enabled the money supply to grow rapidly. This resulted in a negative output gap, where demand far exceeded supply. Later in the 1960s, there was a trend towards oversupply, with this gap closing as the labor force grew with inflation and wages rising. Recently, aggressive government spending in response to the economic impact of the Covid Pandemic has once again led to a demand - supply gap not only in products but also in employment. In response, the Federal Reserve has quickly turned very hawkish and is likely to raise interest rates possibly 4 time in 2022 to help stem this tide. Will it be enough? That is not clear yet. Could it be too much and push the economy toward a recession undercutting a real recovery? Also, not clear. All this uncertainty is having a significant negative effect on stock markets, especially the high growth stocks that led the market gains over at least the past 3 years.

The Treasury market seems to already be out in front of the changes. On March 1, 2021, we saw the 5-year treasury note yield at 0.71% rising to 1.26% by December 31. At the time of this publication, (continued next page)

### Our Mission

The Stonehill College Financial Management Association's mission is to provide opportunities for professional interaction between and among students, practitioners, and academicians to promote the development and understanding of basic and applied research and of sound financial practices, and to enhance the quality of education in finance.

## *Inflation Hurts … Continued*

the January 25, 2021, 5-year treasury note yield had jumped to 1.56%. Bond trading pundits expect this rate to continue to climb over the rest of the year.

**5 Year Treasury Rate**


During the late 1970s and early 1980s cyclical stocks performed well yielding a greater return than defensive stocks and consumer staples. When inflation scares picked up late last March, ahead of Asia Ex- Japan Equity Research analyst James Sullivan from JP Morgan claimed it expected cyclical and defensive stocks to rally beyond the period of adjustment and lead the market higher. He also suggested that large financial institutions including banks and insurance could benefit from higher yields.

Veteran investor, Jack Ablin suggests investors should look for industries with pricing power such as materials, energy and an interest rate sensitive group, short term "REITs". A Real Estate Investment Trust, (REIT) is a publicly traded security that invests in real estate or loans secured by real estate. REITS typically benefit from rising interest rates, typically when the economy grows the real estate assets backing the REITs increase in value. Furthermore, as demand for financing, so do interest rates. There is strong positive correlation between 10-year treasury yields and total return for REITs. Below is a table containing data from S&P Dow Jones Indices LLC, Bloomberg, and The Federal Reserve. We can see that REITs outperform stocks during the late 1970s and early 1980s as well as during the dotcom bubble and the rise of the Real Estate bubble from 2003-2006 which lead to the great recession.

| TIME PERIOD | U.S. 10-YEAR TREASURY YIELD | | | CUMULATIVE TOTAL RETURN OVER PERIOD | | |
|---|---|---|---|---|---|---|
| | BEGINNING YIELD (%) | ENDING YIELD (%) | CHANGE (%) | REITS (%) | STOCKS (%) | DIFFERENCE (%) |
| December 1976-September 1981 | 6.9 | 15.3 | 8.5 | 137.4 | 46.0 | 91.4 |
| January 1983-June 1984 | 10.5 | 13.6 | 3.1 | 35.6 | 16.5 | 19.1 |
| August 1986-October 1987 | 7.2 | 9.5 | 2.4 | -10.1 | 10.9 | -21.0 |
| October 1993-November 1994 | 5.3 | 8.0 | 2.6 | -10.3 | 0.1 | -10.3 |
| October 1998-January 2001 | 4.5 | 6.7 | 2.1 | 27.4 | 27.8 | -0.4 |
| June 2003-June 2006 | 3.3 | 5.1 | 1.8 | 108.2 | 37.6 | 70.6 |

## *Inflation Hurts … Continued*

Another sector that usually does well during times of inflation is Consumer Staples. Popular Consumer Staples companies include Procter & Gamble, Costco, and General Mills. During times of inflation, when prices increase, people are less likely to buy luxury items such as new cars, designer clothes, or Rolex watches, however, they still need toothpaste and soap. Since March 2020, when the stock market had its last major correction initiated by the global COVID-19 pandemic, the Consumer Staples sector of the S&P 500 has underperformed. This is because of the nature of Consumer Staples stocks viewed often as low Beta, defensive stocks, and are considered good to hold through recessions as they are less volatile to changes in the business cycle. Beta measures the sensitivity to market change when the market is falling, and lower Beta (less than 1.00) would mimic smaller price movements in the market. Since demand for Consumer Staples is inelastic, Consumer Staple companies have more pricing power as they are able to increase prices more easily during times of inflation. Similarly, Energy, Utilities and Healthcare stocks are generally relatively inelastic to demand as well. The same principles apply.

TIPS, Treasury Inflation-Protected Securities are issued and backed by the U.S. government, they are treasury bonds which are inflation protected. How it works is the principal portion of TIPS will rise with inflation to maintain its value, the president of Bone Fide Wealth, Douglas Boneparth recommends incorporating TIPS into your portfolio if you have inflation worries. Jimmy Lee, the CEO of Wealth Consulting Group in Las Vegas stated that they have used TIPS before as an allocation, but not as a full hedge, and that investors can do better by adding other tools such as commodities, high-yield bonds, and equities. (Continued on next page)

## *The Importance of Purchasing Power*

*By: Matthew Walsh '22*

Albert Einstein once proclaimed "Compound Interest is the eighth wonder of the world. He who understands it, earns it…he who doesn't, pays it". While Einstein alludes to the greatness of compound interest, he doesn't state how to use this phenomenal financial tool.

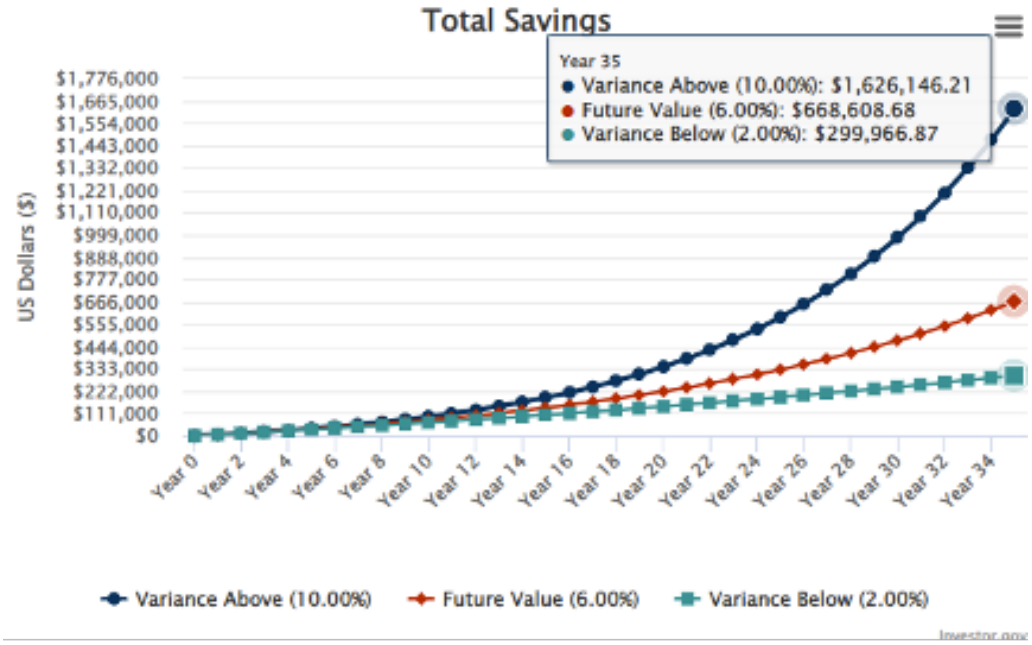
Some people believe that placing money into a savings account and waiting for compound interest to do its thing, is a wise decision and good money management. However, with the consumer price index rising over 7% YoY in December, you should question whether your money is growing at that rate, or a higher one. Many bank accounts offer a fraction of a percent interest, meaning your money is not growing slowly, but actually losing value significant purchasing power.

Now I am not saying having a bank account is unwise. Rather it is a necessity. How much you keep in it is another story. Consider its best feature as an emergency fund. Too few people understand this merit. Ever hear of the "400 Dollar Problem". Professor Ciamarra's "Fundamentals of FinTech" course introduced this idea to me. This issue refers to a 2013 survey in which 48% of respondents could not cover a $400 expense without selling something or borrowing money. In the course, one of our assignments was to find workable solutions to this problem. Many groups came up with budgeting apps, new saving techniques, and ways fiscal and monetary policy can step in. While these ideas had merit, as college students, we need to start thinking about how we can prevent that problem from happening to ourselves and our peers. Learning to invest wisely may be an optimal solution.

## *Inflation Hurts … Continued*

An investment strategy that best allows utilization of compound interest includes two main investment methods: Taking advantage of the Roth IRA and Dollar-Cost Averaging. The Roth IRA is a retirement account in which a person's contributions and withdrawals are tax-free after age 59½. This is a great tool to maximize the eighth wonder of the world, as letting your money grow for 35+ years will be a game-changer. If you max out your Roth every year ($6000 a year for most people), with an average annual return of 6% (around the S&P 500 average return), your money will grow to $668,608, even though the money you contributed would only total $210,000. If the average return was 10%, that number skyrockets to $1.6 million, that could make for a comfortable retirement.

Dollar-Cost Averaging allows you to invest weekly or monthly instead of a lump-sum investment all up front. There is a popular investment saying, "Time in the market beats timing the market". One also can use a more hands-off approach. Numerous brokerages enable the use of automatic investing with many who Dollar-cost average using automatic investing, offered by many brokerages. Dollar-Cost Averaging also prevents large amounts of money from going into the market at once, allowing you to have cash on hand in case something like that pesky $400 problem pops comes up.

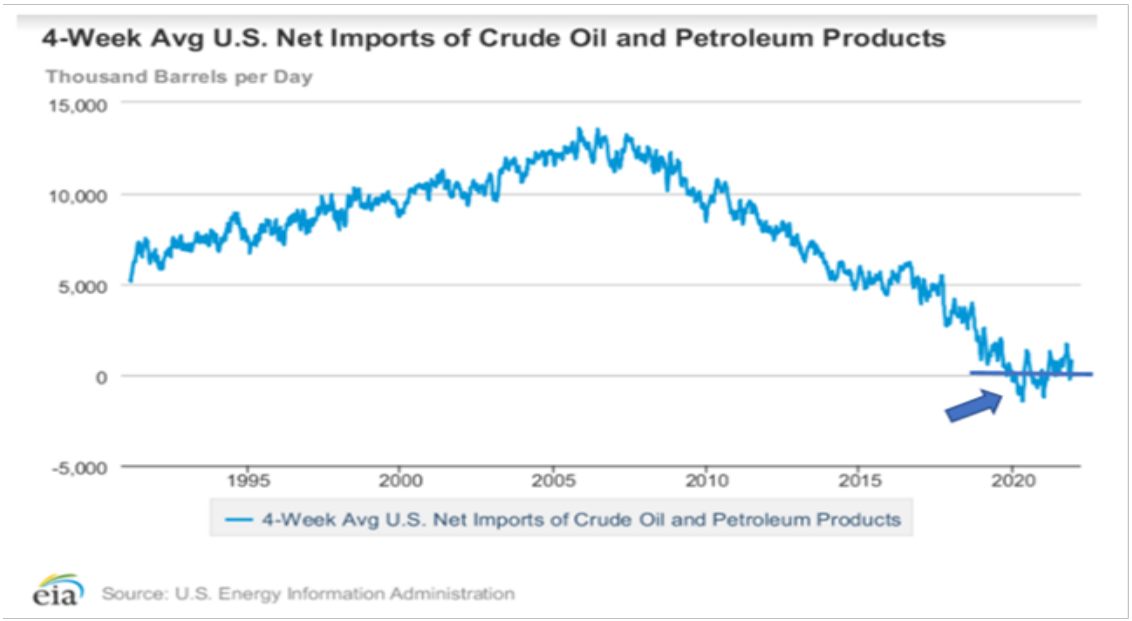



Overall, saving money is a wiser move than spending. But it is investing that creates real wealth. A Roth IRA and Dollar-Cost Averaging are just two approaches to allow your money to take full advantage of compounding returns. So, when you are 59½, you could attain financial freedom for the rest of your life. But when you get there, give Einstein and yourself a pat on the back for doing the smart thing.

## *This Is Not The 1970's - A Contrarian Take on Today's Inflation Scare*

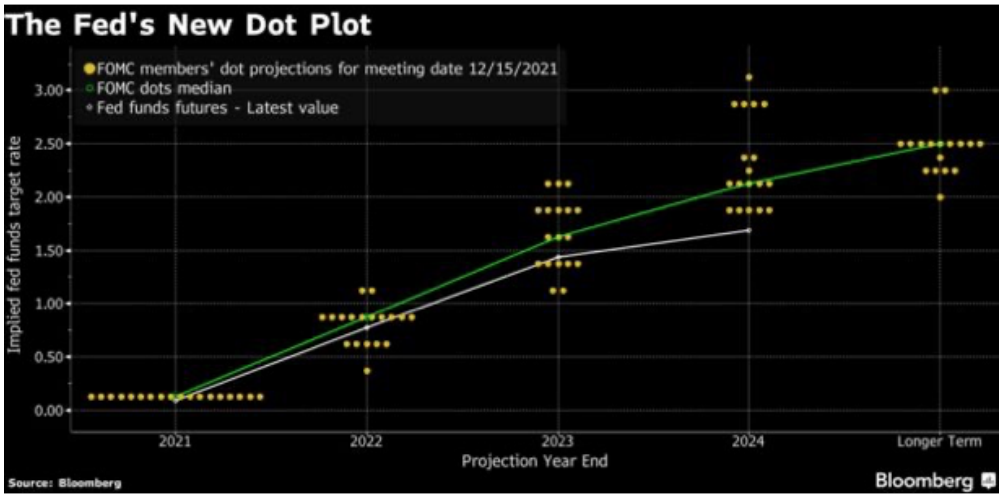
*By: Michael Holtz '23*

If you have had the opportunity to study Economic History with Professor Motomura you would have gained some important insights about the cause and impact of the high inflation rates in the U.S. during the 1970s. You would also have learned about the Bretton Woods agreement and how the U.S dollar was pegged to the price of gold at $35/oz after WWII. Had that peg not been put in place in 1946 the price of gold would have steadily increased to $105/oz by 1971. When President Nixon took the U.S. off the gold standard, the dollar absorbed over 25 years of inflation and markets drove the price of gold to $183/oz by 1974. The secondary effect of the weakening U.S. dollar was impact from rising oil prices. Since oil is priced and traded in dollars, OPEC took the opportunity to use its near monopolistic power to increase oil prices. Oil prices continued to increase as a consequence of the 1973 Arab/Israeli war, the 1974 oil embargo and the 1979 oil embargo by Iran. Since then, major world currencies have freely floated in the FOREX market for over 50 years and inflation adjustments have been more gradual. Secondly, domestic oil production has increased, and imports have declined since 2007. The chart below from the Energy Information Administration shows that the United States has become a net exporter of oil as of 2020. High oil prices are now a U.S. policy choice and less dependent on OPEC. The sudden turnaround in net imports is a direct result of the Biden Administration reversing federal support and liberal licensing for exploration in the oil and gas industry shifting its favor toward "green energy" sources.



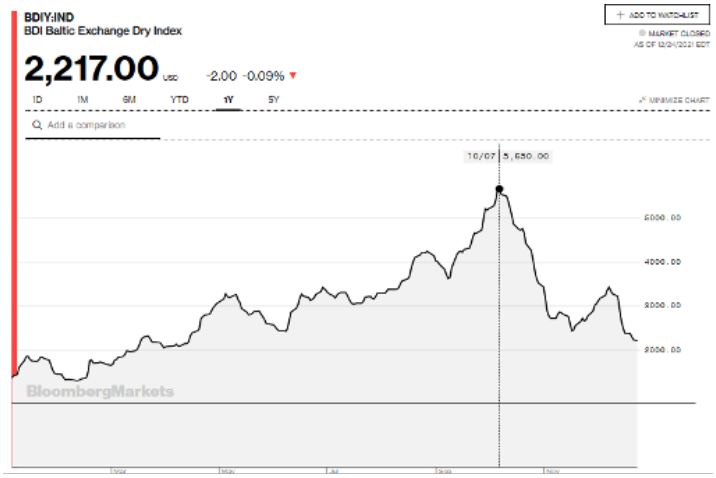

**Interest Rates Will Rise**

The Federal Reserve has indicated after its December meeting that interest rates will increase in 2022. A new dot plot shows potentially four rate increases with an exit interest rate close to one percent by the end of the upcoming year. The Fed has already begun to taper purchases of 10-year Treasuries and Mortgage-Backed Securities and will most likely end these purchases this spring. This should cause mortgage rates to rise, which will have an effect of slowing demand for housing and price increases next year.




**Trucking and Shipping Supply Chain Issues May Ease**

Like the magazine cover indicator, the popular Sunday night show "60 Minutes" serves as a similar indicator as well. On November 14th, 2021 "60 Minutes" highlighted the Supply Chain Crisis by reporting from the port of Los Angeles to discuss shipping delays and the truck driver shortage. The head of the Harbor Trucking Association, Matt Schrap, told 60 Minutes there is no driver shortage and blamed the bottlenecks on the port of Los Angeles and Long Beach's antiquated booking system. The rule is that empty containers must be returned by a trucker before they can take away a full container out of the port. Truckers must wait in long lines while until there is a place for their empty container before they can haul away the full containers. So, it is the rules at the port that are causing delays in trucking, not a lack of truck drivers. Additionally, shipping rates, as measured by the Baltic Dry Index, have dropped significantly since peaking in early October. Rates were $5,647 on October 6th and now dropped to $2,217 by December 24th.



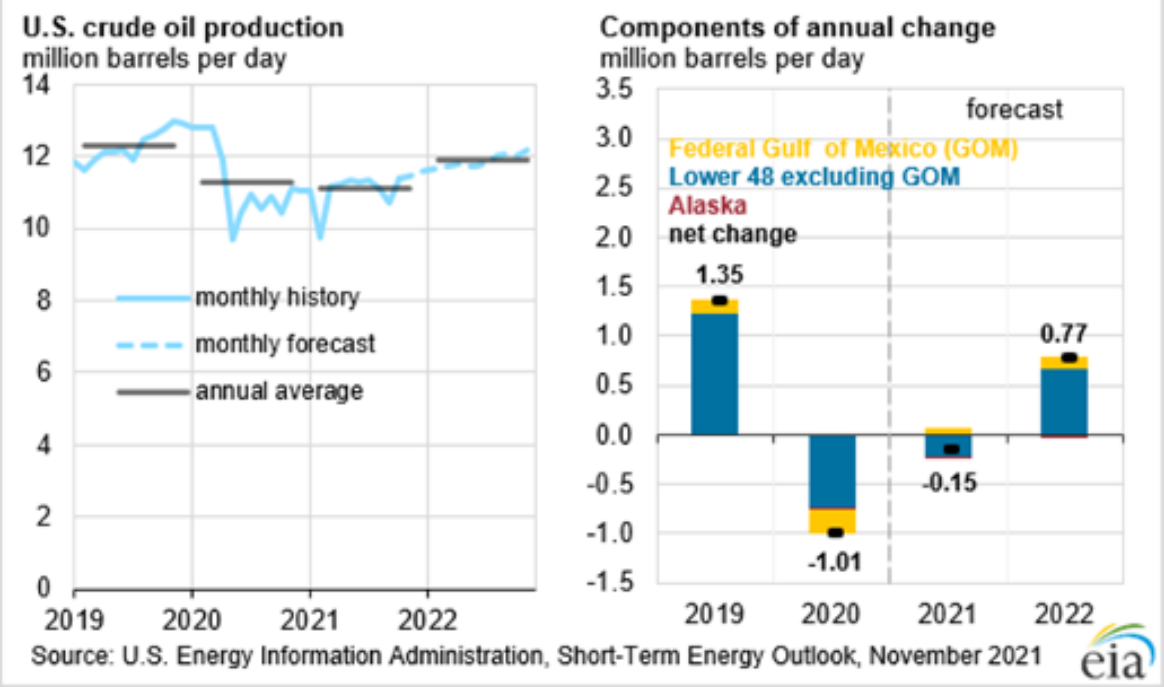

**Semiconductor Shortages May Ease**

There is a large investment being made so that production capacity can meet demand in the next few years. Samsung announced on November 22, that it will build a $17 Billion dollar plant in Tyler, TX as part of a three-year plan to spend $205 billion on new semiconductor manufacturing. Taiwan Semiconductor and Intel have announced they each will spend $100 billion over the next three years to build factories in the U.S. and Europe. There are also recent indications that demand

has leveled off slightly. In October Apple told suppliers that it will cut production of the iPhone 13 by 10 million due to the semiconductor shortage. On December 2nd, Apple announced that holiday demand was lower than expected and it would not meet the previously reduced sales expectations of 90 million. Reduced demand for iPhones and an increase in supply from producers should ease semiconductor shortages.

**Oil Prices are Coming Down**

A tip in the oil prices may have come during an interview with the U.S. Energy Secretary Jennifer Granholm by Bloomberg's Tom Keene. When asked about high oil prices she laughed and said, "Would that I had a magic wand". Shortly afterward WTI crude prices rose to almost $85/barrel. As American's traveled for the Thanksgiving Holiday high gas prices became the topic of conversation on many news programs and articles. In response, President Biden announced that he would release oil from the strategic oil reserve. This was a clear signal that the Democrats are worried about taking the blame for high oil prices and how it may affect the mid-term elections in 2022. The EIA reports that the U.S. is expected to increase production by 770,000 barrels per day, the first increase in two years. If history repeats itself the Biden administration will publicly condemn the energy industry for climate change while allowing increased domestic oil production. Under the Obama/Biden administration domestic oil production increased 88% from 5 million barrels/day in 2009 to 9.4 million barrels/day by 2015.




While we begin 2022 with high expectations for Inflation, we could very well be having a conversation about overproduction and supply glut predictions for January 2023. The invisible hand may once again show that markets correct themselves and inflation worries may recede as we come out of the COVID19 pandemic.

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