Dodge & Cox®

Investment Perspectives

Weighing U.S. Inflation Risks and Investment Implications

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Key Takeaways

- After remaining at low levels for more than a decade, inflation measures have jumped recently, setting off a vigorous debate about whether higher U.S. inflation will persist.
- In our base case scenario, we expect U.S. inflation (as measured by personal consumption expenditures) to remain high over the short run, but ultimately settle back into a range of 2.0% to 2.5% over our investment horizon.
- The Dodge & Cox Funds are broadly diversified, feature a variety of investment drivers, and are well positioned across a range of economic environments.

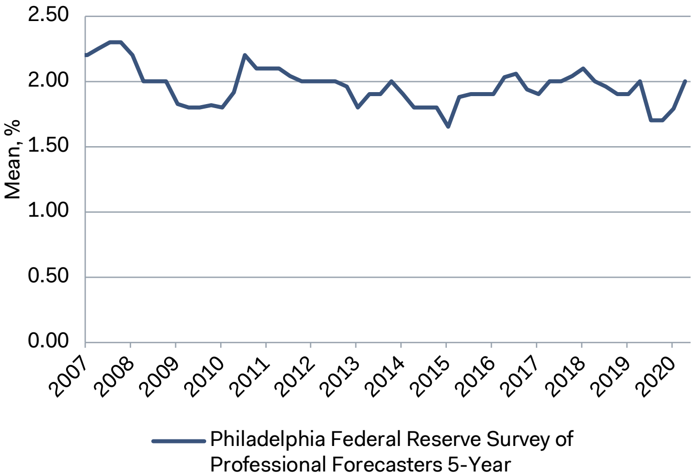
Introduction

In the United States, the strong economic rebound, large fiscal and monetary stimulus, and low base effects of 2020 have significantly increased expectations for higher inflation in 2021 (see Figure 1). The most recent readings indicated year-over-year headline personal consumption expenditures (PCE)[a] inflation of 3.6% and core PCE[b] of 3.1% (see Figure 2). Meanwhile, the ten-year breakeven inflation—a market gauge of consumer-price inflation expectations measured by the difference between nominal and real yields on Treasury bonds—is at approximately 2.4% (see Figure 3).

We believe the risk of inflation is important to consider because it erodes the real value of savings and investments, thus requiring a higher return to maintain the same purchasing power over time. While a modest amount of inflation is essential to a healthy economy, levels that are either too low or too high for extended periods can have serious consequences for economic growth and asset prices.

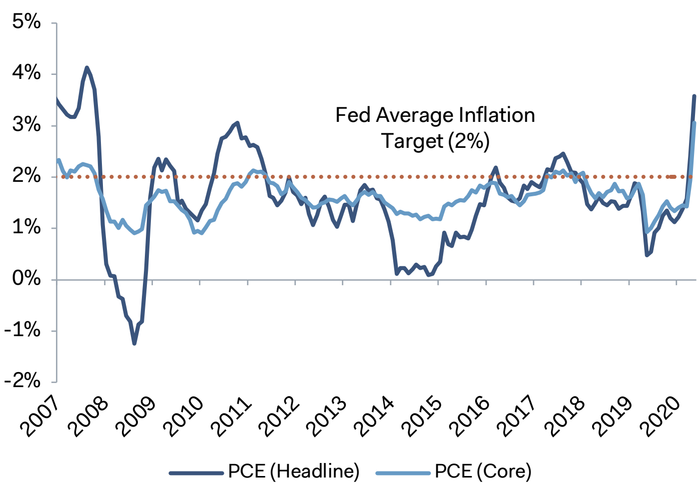
There is rigorous debate as to whether the higher levels of inflation we are experiencing will be transitory, as Federal Reserve officials have suggested, or more persistent, forcing the Fed to tighten monetary policy earlier than currently planned. In this paper, we outline the inflation debate, discuss our views, and walk through the implications for the Dodge & Cox Funds.

Figure 1: Survey Measures of Inflation—Professional Forecasters



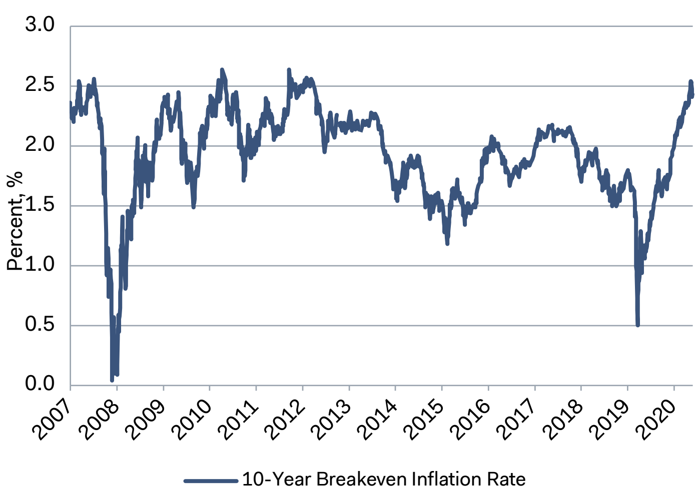
Source: Federal Reserve.

Figure 2: Highest U.S. Inflation Rates Since 2008



Source: Federal Reserve.

Figure 3: Market Expectations for Future Inflation Have Risen Sharply



Source: Federal Reserve.

The U.S. Inflation Debate

Case for Higher, More Sustained Inflation

The key argument supporting higher and more persistent inflation is a perfect storm of factors as the country emerges from the pandemic. These include:

- **Imbalance between aggregate supply and demand:** Driven by an extraordinary amount of fiscal stimulus, easy monetary policy, and pent-up savings, aggregate demand is expected to rise quickly and may outstrip supply as the pandemic subsides, particularly in sectors impacted by supply chain disruptions. This scenario of demand-pull inflation is commonly referred to as "too much money chasing too few goods."[c]
- **Potential for wage-price spiral:** The strong demand factors noted above can lead to near-term higher inflation and tighter labor markets. These, in turn, could raise inflation expectations and associated wage demands, leading to a wage-price spiral and, ultimately, higher inflation that persists longer term because price increases tend to be sticky.
- **Federal Reserve's new policy framework:** In adopting an *average* inflation target of 2.0% *over time,* the Fed has made it clear that it is less concerned about inflation running hot for periods after a prolonged period of lower inflation. Policymakers have also said they need to see evidence of sustained inflation before tightening policy, thereby increasing the risk they act too late to safely contain the inflationary impulse.

Case for More Contained Inflation

On the other side of the inflation debate, economists and academics argue that the structural factors that drove disinflation over the past three decades may continue to constrain inflationary forces. Frequently cited drivers include:

- **Globalization:** The ability to globally source labor and inputs enables producers to reduce costs throughout supply chains.
- **Technology:** By increasing labor productivity, technological improvements can lower the cost of production and services. In addition, the rise of online shopping, enabled by technological advances, empowers consumers to compare prices across producers. The result is greater transparency, more competition, and lower prices.
- **Less bargaining power on wages:** With the reduced role of labor unions, workers lack bargaining power to push up wages. At the same time, the "gig" economy, which tends to increase labor competition and drive down wages, is a powerful and growing force.

- **Income inequality:** Higher income households historically save more than lower income households. As a greater percentage of society's wealth resides with higher earners than in the past, a greater amount of funds flow into savings and investment versus demand for goods and services.
- **Anchoring effects:** After decades of low inflation, market participants may be less sensitive to data pointing toward a higher inflationary regime in the future. A greater degree of circumstantial evidence may be required to change expectations for higher prices going forward.

Our View

Our economic forecasts are long term in nature and are used to assess a range of possible outcomes stemming from our base, up, and down case scenarios. We build these models based on active debate within our team, considering a wide range of dynamics, including the inflation drivers mentioned above. In our base (most likely) case, we expect strong economic growth over the next couple of years, supported by vaccine deployment, ongoing policy stimulus, and additional fiscal measures aimed at infrastructure. We expect higher inflation to continue over the short run, but not persist, with inflation ultimately ranging from approximately 2.0% to 2.5% over our investment horizon. Our up case embeds a larger and more sustained overshoot of inflation (2.5% to 4.0%), while in our down case, inflation would remain subdued (1.0% to 2.0%). These two cases represent plausible alternatives, not tail-risk extreme outcomes. At this point in time, we would assess a somewhat higher likelihood of the up case transpiring than the down case.

Implications for the Dodge & Cox Funds

We build our fixed income and equity portfolios based on our assessment of fundamentals and valuation for individual issuers and securities. Through this bottom-up process, our Global Industry, Fixed Income, and Macro Analysts incorporate a number of macroeconomic factors, including inflation, into their models. These inputs are informed by our frequent conversations with company management teams, allowing us to benefit from their real time observations on pricing, among other factors. Meanwhile, our Investment Committees review similar factors along with economic scenarios as they evaluate individual investments, broad portfolio positioning, and overall portfolio risk. In each case, our investment team seeks to assess a range of outcomes, rather than single-point forecasts.

Below we highlight certain portfolio positions and sectors that historically have shown a greater sensitivity, both positive and negative, to inflationary environments.

Fixed Income

Defensive Duration[d] Positioning

Inflation expectations are incorporated into long-term U.S. Treasury yields so that, all else being equal, an increase in market expectations for inflation would result in a rise in Treasury yields. In terms of portfolio impact, a further jump in inflation expectations would likely result in negative near-term total returns for fixed income investments as we saw in early 2021. However, we believe the Dodge & Cox Income Fund and Global Bond Fund are well positioned from a relative return standpoint because they have less exposure to the long end of the yield curve, where inflation-driven rate increases are most likely to occur should the Fed remain on hold. Of course, if market expectations for inflation decline and Treasury yields return to the levels of late 2020, the reverse would be likely, benefiting total fixed income returns, but hampering the Funds' relative performance.

Though we have extended portfolio duration modestly over the last 15 months, we believe it is prudent to remain shorter than the benchmarks. We see a far greater chance of rates exceeding expectations reflected in current market pricing over our long-term horizon. Benchmarks have lengthened over the past decade due to lower rates and issuance patterns; in our opinion, the embedded interest rate risk does not represent a favorable risk-reward tradeoff given low levels of current income.

Significant Credit Sector Weighting

The Funds also feature a substantial weighting in credit securities, and credit spreads are generally negatively correlated with rate increases during economic expansions. While far from a guarantee, excess returns from credit tend to be positive in rising-rate environments, which could benefit the portfolio if inflation proves to be more persistent and pushes rates higher. Moreover, within credit, the Funds currently hold issuers exposed to commodity prices, in particular oil and natural gas, which are likely to benefit from an inflation overshoot. The Funds do not hold these issuers specifically as an inflation hedge, although it is a helpful secondary benefit.

However, inflation at the high end of our up case does present some risks to the portfolios' credit holdings. If inflation remains stubbornly high and the Fed realizes it is behind the curve, policymakers will have to move quickly to adjust policy. If this plays out, we expect short-term rates to move significantly higher, which when combined with tightening-induced recession fears, may weigh on risk assets, including credit securities.

Yield Advantage

The Funds also have a higher yield than their benchmarks. This is a byproduct of favoring non-Treasury sectors, particularly Agency MBS and Credit. A higher yield can be helpful in rising-rate environments as it mitigates price losses and allows for reinvestment of more income at higher rates. Across all environments, income, and the compounding of that income over time, is an important component of total return.

Equity

Financials and Energy

The Dodge & Cox Stock Fund, Global Stock Fund, and Balanced Fund have significant exposure to U.S. Financials and the Energy sector. Conventional wisdom suggests financial services and energy companies are strong beneficiaries of an inflationary environment. Key drivers of bank profitability—such as a steeper yield curve, higher loan growth, and lower loan losses—stand to benefit from higher levels of inflation, interest rates, and economic growth. In addition, higher energy prices and increased energy demand driven by stronger economic activity have clearly benefited energy producers and servicers in past commodity cycles.

However, we acknowledge that conventional wisdom may not reflect a full range of outcomes. For instance, bank net interest margins also exhibit sensitivity to short-term rates, which may remain depressed for some time. The Fed may raise rates in an attempt to combat higher than desired inflation, which could hurt credit costs and growth. While our outlook for energy prices is constructive over our investment horizon, efforts to decarbonize the global economy have intensified alongside technological innovations in alternative energy sources.

At the company level, our analysts work with a range of interest rate and oil price assumptions in order to weigh investment opportunities and risks against current valuations. For example, within the Energy sector, current company valuations imply oil prices of around $50 per barrel despite oil currently trading in the high $60s. We remain comfortably overweight both sectors as we believe the outlook for the Funds' financial and energy holdings more than adequately compensates investors for bearing these risks.

High Valuation Technology and Bond Substitutes

Companies thought to have stable, recurring cash flows and higher dividend yields—such as Utilities, Real Estate, and Consumer Staples (also known as the "Bond Substitutes")—have generally benefited from a declining interest rate environment over the past decade. Higher valuation technology companies, which are commonly expected to generate a higher percentage of cash flows further out into the future, were also considered beneficiaries as the discount rate used to value expected future cash flows declined.

All else being equal, companies that have benefited from a falling interest rate environment are unlikely to benefit from such a tailwind again given the historically low level of current rates. Conversely, higher-than-expected inflation and interest rates may disproportionally impact companies with high valuations driven by high expectations for stable or fast growing cash flows. Given what we believe to be full valuations at many of these companies, the Funds remain underweight the Information Technology and Bond Substitute sectors.

Conclusion

Our goal at Dodge & Cox is to preserve and enhance the purchasing power of our clients' investment dollars. With this in mind, we carefully consider the impact of all factors, including inflation, on an investment or portfolio. While we see drivers for higher near-term inflation, we believe that sustained inflation is unlikely over our three- to five-year investment horizon. The Dodge & Cox Funds have exposure to areas of the market that are poised to benefit from higher inflation, but ultimately they are well positioned across a range of economic environments given their diversified portfolios and various investment drivers.

Before investing in any Dodge & Cox Fund, you should carefully consider the Fund's investment objectives, risks, and charges and expenses. To obtain a Fund's prospectus and summary prospectus, which contain this and other important information, visit dodgeandcox.com or call 800-621-3979. Please read the prospectus and summary prospectus carefully before investing.

Investment prices may increase or decrease, sometimes suddenly and unpredictably, due to general market conditions. Local, regional, or global events such as war, acts of terrorism, the spread of infectious illness or other public health issues, recessions, or other events could also have a significant impact on a Fund and its investments. In addition, investing in non- U.S. securities may entail risk due to foreign economic and political developments; this risk may be higher when investing in emerging markets.

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a Personal consumption expenditures (PCE) measure how much consumers spend on durable and non-durable goods and services.

b Core PCE prices exclude food and energy prices.

c Barth, James R., and James T. Bennett. "Cost-push versus demand-pull Inflation: Some empirical evidence: comment." *Journal of Money, Credit and Banking 7*, no. 3 (1975): 391-397.

d Duration is a measure of a bond's (or a bond portfolio's) price sensitivity to changes in interest rates.