Inflation is Returning but Equities Can Handle It This Time

There are many reasons to believe that inflation is likely to remain stubbornly high. Employment remains very strong, and wages have stayed high. Prices for goods have not gone lower, as they rarely do post an inflation spike. The cost of buying a home has gone through its own unusual cycle, whereby mortgage rates have gone up by so much that nobody can afford to move house. So, home prices have remained elevated, further exacerbated by a dearth of new home building over the last several years. But as ever with inflation, the base effects are important to consider, ie: what period are we comparing to? Looking back a couple of years, you see that the base effect for February 2024 CPI was 6.95%, yet the base effect for February 2025 is 4.59%. This 236bps lower starting point sets an easier comparison for inflation growth going forward.

Ask the average consumer and I'm pretty sure they'd say that inflation hasn't fallen at all for their monthly expenses, despite CPI going from a high of 9.1% in July 2022 to 3.1% in February 2024 and Wall Street celebrating inflation's demise.

Wall Street certainly did get very excited about the end of inflation; so much so that in December 2023 the expectation was for six interest rate cuts in 2024. This looks very unlikely now, with just one cut expected. The oil price is surging again, up 20% and the CRB Commodity Index up 11% from their December lows. Gold is also breaking out and the 10-year bond yield is up 52bps since its low on 27 December. So, the market also seems to be telling us that inflation is set to reaccelerate – the question is, will it be as bad for the stock market as it was when the Fed had to aggressively raise rates 2 years ago?

I believe the stock market can handle this reflation much better for three reasons. First, the growth outlook is much better this time around. The economic data in the US has bottomed and is beginning to inflect higher and equities can perform well in inflationary periods if there is economic growth. Equities have generally been good inflation hedges over time, when there has been growth and pricing power. Growth and inflation accelerating at the same time is our base case scenario for 2024, and this should suit the equity market.

Secondly, a feature that I think is somewhat overlooked is the wealth effect. There has been a huge amount of wealth created by the rise in the stock market. In the last 14 months alone, the value of the US Total Equity Market Index has risen from $41 Trillion to $54 Trillion. The housing market too has been strong. Since 2019, home prices have risen by approximately 50% and roughly $17 Trillion in wealth has been created. This wealth creation is far more distributed than equity wealth as the homeownership rate in the US stands at 65.7% as of YE2023. Although it has to be said that with mortgage rates still high, and housing transactions impaired, that wealth is harder to get at, but when rates do start to fall and housing transactions return to a more normalised level, it could unleash a lot of pent-up wealth to a lot of consumers, easing the cost-of-living impact.

But what if you don't own a home and don't invest in the stock market? That's what makes this cycle so interesting and unique. Young people have also benefitted, in terms of full employment but more significantly the recovery in Bitcoin and Crypto. Bitcoin is up 146% since the lows in October 2023 and that benefits young people much more than it does their parents.

Finally, there is the point that interest rates are already quite high by recent historical standards and there is a lagged effect on the real economy to higher rates. The Fed is of course aware of this and will want to see how the economy has responded before aggressively hiking again.

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Data sources: Hedgeye Risk Management, Cornerstone Macro & Bloomberg

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