Purchasing Power Losses Are Permanent

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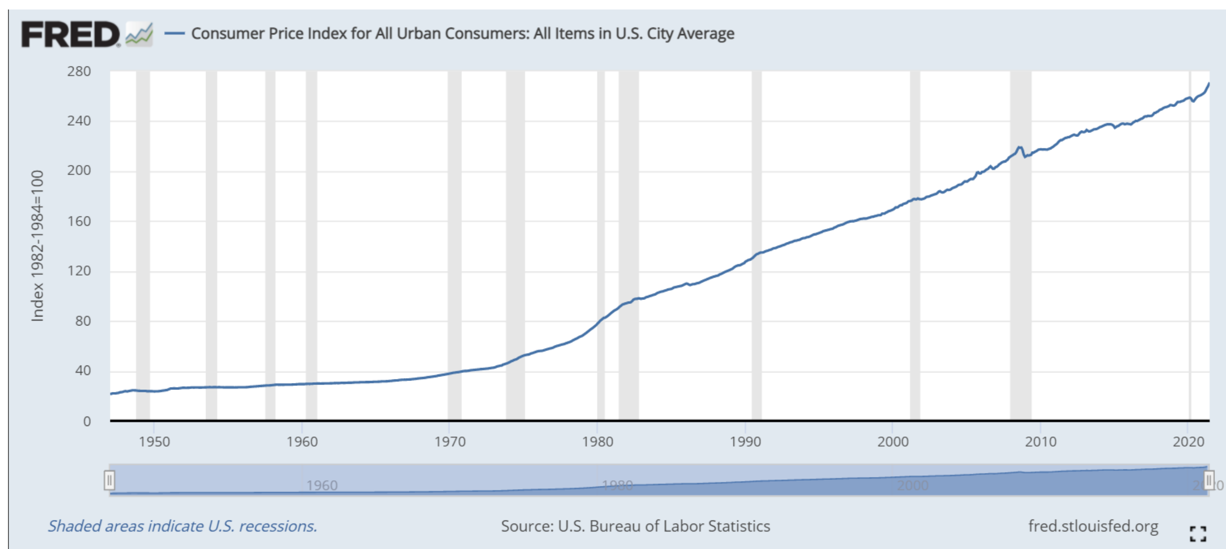
The unprecedented combination of artificially low, central bank manipulated treasury bond yields with elevated inflation presents investors with a serious challenge. When investors earn a rate of interest that is substantially below the rate of price increases in the economy, they lose purchasing power. The loss of purchasing power is very different than periodic corrections in equity prices. An investor with a diversified equity portfolio incurring a 10% portfolio loss often experiences a recovery when conditions improve and market confidence comes back. The net effect on an equity portfolio is that the annualized return, through the correction and recovery periods, will be positive and often in line with long term returns.

Let's look at the numbers to gain a better idea of the challenging current market environment. The total return of the Bloomberg Barclay's Aggregate Bond Index for the twelve-month period ending in June of 2021 was -0.33%. The yield-to-worst on the Index is 1.36% as of July 31, 2021. As the yield to worst has been a good predictor of forward returns, let's assume a forward return for the twelve-month period June 30, 2021 to June 30, 2022 of 1.36%. Combining both the trailing one-year return and projected one-year forward return generates a forecasted return for the two-year period of 1.03%.[1]

Now let's look at the effect of inflation. Periods of high inflation are not typically followed by deflation and broad decreases in prices. Periods of high inflation are instead commonly followed by disinflation, or periods in which the rate of price increases moderates but prices continue to rise:

Consumer Price Index for All Urban Consumers[2]



The twelve-month rate of inflation ending June 2021 was 5.39%. The future is unknown, but let's assume a quite plausible scenario in which consumer prices rise at a 5% annual rate for the June 30, 2021 through June 30, 2022 period. This generates a cumulative rate of price increases for the two-year period of 10.66%.[2]

1. Sources: SSI internal research, Bloomberg Barclay Research, accessed 8/2/2021. Bloomberg Barclay's Aggregate Bond Index performance as of 6/30/2021 and yield-to-worst as of 7/31/2021.
2. Sources: SSI internal research, Federal Reserve Economic Data, Federal Reserve of St. Louis, accessed 8/2/2021. Chart and Rate of inflation as of 6/30/2021.

Combining the actual and forecast bond returns with the actual and forecast rise in consumer prices for the two-year period generates a loss of purchasing power of 8.7% over the two-year period.[3] For the rest of 2022 and 2023 these purchasing power losses may moderate but will probably continue, as the rate of inflation continues to exceed treasury yields.

During the pandemic and the following years, current bond investors are facing the real risk of double digit losses in purchasing power without the potential for a recovery. This is an unprecedented situation that requires action. Portfolios hoping to moderate this risk must consider reducing exposure to investment grade bonds and find investment alternatives that can generate returns in excess of the inflation rate. Diversifying portfolios into investment alternatives will be needed to moderate the increase in portfolio risk from the reduced allocation to bonds. This in turn requires investors to cast a wide net for investment solutions, while still considering risks, such as duration, credit, and illiquidity.

3. Source: SSI Internal Research

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