**Portfolio Construction in a Challenging Market: Hedging Against Potential Inflation**

**The Gap**. The pandemic has not only caused incredible pain and death to hundreds of thousands of people, but it has also devastated the economy. Unemployment is coming off an all-time high as previously employed workers are not producing the amount of goods and services they were just a year ago. The result of this devastation is a gap between what the economy is capable of producing and what it is actually producing.

**Rescue Efforts**. In a bold effort to temporarily fill the production gap, the Government has passed a second round of spending: a $2.3 trillion pandemic aid and spending package that follows a previous $2 trillion package earlier in the year. President-elect Biden has stated he will introduce a third package early in his term. The purpose of all this money pouring into the economy is to fuel consumer spending that will, in turn, spur businesses to hire more workers. If it works as the Government believes, unemployment will decline, and the economy will recover within a shorter period of time.

T**he Big Question**. Where is all this money coming from? The Government does not have a rainy-day fund from which it can grab a fistful of dollars to throw at the economy. Instead, the US Treasury issues bonds (deficit financing) with the intent of selling them to the public both domestic and international. But this raises a second question: what if the public does not have sufficient funds to buy such an enormous amount of paper? What then? This is where the Federal Reserve Bank steps into the picture as the buyer of last resort. The Fed has an unlimited amount of money because it can print money. Sound magical? Yes, it is. Is it risky? Yes, it certainly is. But doing nothing would be even more risky.

**Inflation**. The risk of deficit financing is inflation. If the Government does not have the funds to repay all the borrowed funds in a timely manner down the road, one of two things happen: it either defaults and investors lose their investment, or it prints more money—default is not a real option. Such a cycle of injecting more and more money into the economy could lead to a situation where too much money is chasing too few goods—the classic definition of inflation. Since the end of WWII, the US has been caught in this cycle. Fortunately, the public has always bailed out the Government. Investors trust the American economy, which is a vote of confidence in capitalism and democracy. While I believe this is a good bet, it’s also prudent to hedge that bet. So how to do this?

**Hedging**. Traditional portfolio management theory says that hard assets such as real estate, commodities, and high-quality, short-duration bonds are the asset classes of choice as hedges against inflation. Unfortunately, the current environment is anything but traditional. A complicated picture of historically low interest rates combined with a thriving stock market befuddle economists at a time theory suggests exactly the opposite should be happening. Sky-high stock prices coming from a host of hot IPOs looking for growth capital and a red-hot technology sector have traditional theorists scratching their heads. The financial markets seem to see a “clear blue and 22” sky in the future.

**The Tilt**. While the stock market is sending a clear signal that the problem will go away, the landscape can be quite deceiving. Prudence calls for a diversification strategy tilted toward an asset class that has the potential of delivering yields that grow with inflation. Such an asset class is high-quality, dividend paying equities issued by companies that produce superior goods and services. This asset class should form part of a strategically diversified base of most portfolios aimed at weathering a potential inflationary storm.

**Final Thoughts**. Whether inflation takes off or not, dividend paying stocks should be included in most diversified portfolios especially those designed to provide income during retirement. I hope this essay helps you understand my thinking on this important issue. While I design every portfolio to address the unique needs of each investor, tilting the construction one way or the other is consistent within an overall diversification strategy. What I have presented here is the basic idea of how I approach portfolio construction in a challenging market. All the best…REC

Ps. Here is a link to another one of my most favorite songs. I dedicate this tune to all you movers and shakers, wherever you are. To help you move into the New Year, turn up the speakers, get off the couch, and get moving,☺.

Van McCoy – The Hustle (1975)

https://www.youtube.com/watch?v=wj23\_nDFSfE&list=RDwj23\_nDFSfE&start\_radio=1&t=0