Commentary

Why High Inflation May Lead to Lower Inflation

Trends caused by surging prices could slow future increases

Denise Chisholm
Director of Quantitative Market Strategy

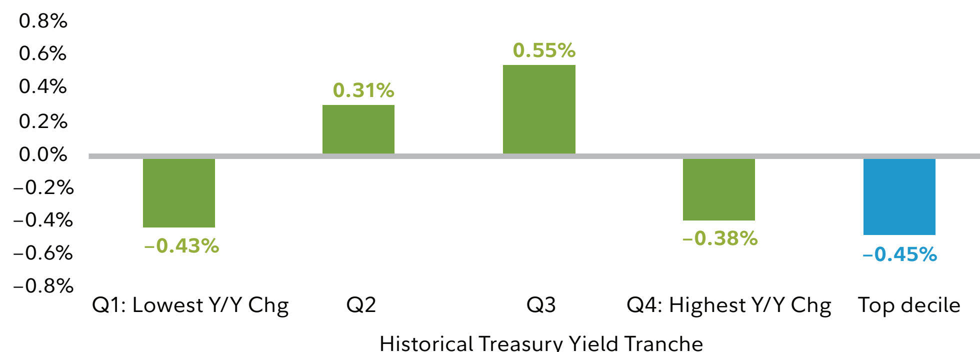
I approach my research by looking at market data through a historian's lens. I believe historical patterns, when considered in the appropriate context, can help investors build conviction about future trends. This month I'm focusing on some of the reasons I think inflation is likely to decelerate, and what that could mean for market leadership.

Inflation creates its own headwinds—including higher bond yields

Driven by surging demand, consumer prices rose 6.8% for the 12 months through November, the fastest pace in almost 40 years, while producer prices jumped 9.6%.[1] Those numbers brought back unwelcome memories of the 1970s for many observers. But my analysis shows that the runaway inflation of the 1970s was an exception, not the rule. High inflation historically tends to be self-limiting, because it kicks into gear dynamics that can slow future inflation. Several of those dynamics are occurring now, potentially restraining the pace of price increases over the coming months.

EXHIBIT 1: Jumps in long bond yields have held down future inflation, historically.

Average Inflation Acceleration (NTM) By Chg in 10-Year Treasury Yield Tranche, 1999–Present



NTM: next 12 months. Chg: change. Q: quartile. Past performance is no guarantee of future results. Inflation represented by CPI (consumer price index). Acceleration refers to the change in the 12-month inflation rate. Change in Treasury yield measured over 12-month rolling periods. Sources: Bloomberg Finance L.P., Haver Analytics, Fidelity Investments, as of Nov. 30, 2021.

One indicator suggesting inflation may decelerate is the recent rise in long-term bond yields. The yield on the 10-year Treasury rose about 70 basis points during the 12 months through November, a jump on par with some of the biggest year-over-year increases of the past two decades.[2] Increases in long bond yields push up rates on mortgages and other loans, which can curtail spending and take some air out of inflation (Exhibit 1, page 1).

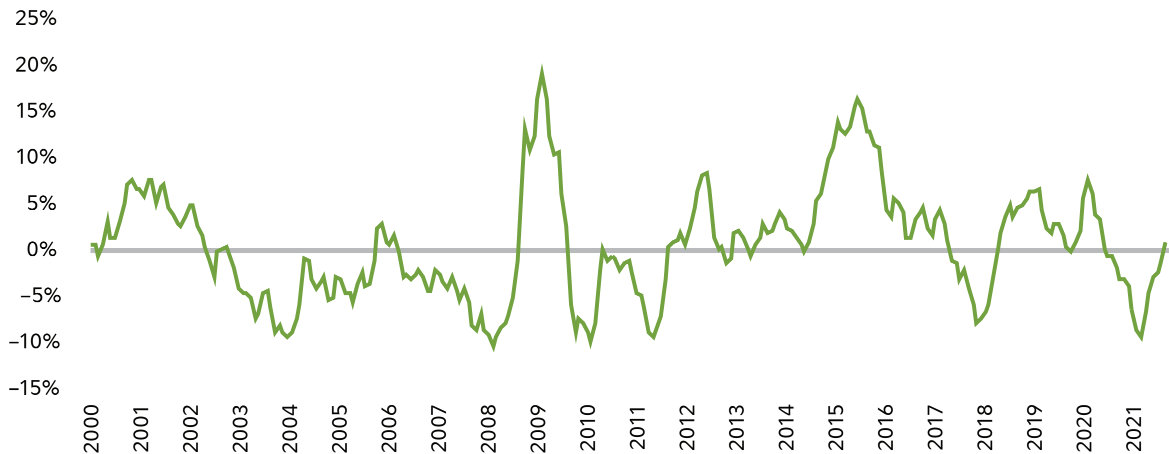
A strengthening dollar could restrain import prices

The strong demand that has driven up inflation in the United States also has contributed to higher economic growth and interest rates than in the rest of the developed world. The U.S. dollar has leaped against other global currencies as a result. (Exhibit 2 shows the dollar's appreciation in the second half of 2021.) Relatively high economic growth and interest rates appear likely to persist, so the dollar could keep appreciating.

A stronger dollar would further reduce the cost of imported goods, creating a headwind for inflation. Since 1999, inflation has decelerated 70% of the time in the next 12 months after the dollar switched from depreciating to appreciating.[3]

EXHIBIT 2: The U.S. dollar has jumped since May.

Nominal Broad U.S. Dollar Index, 2000–Present



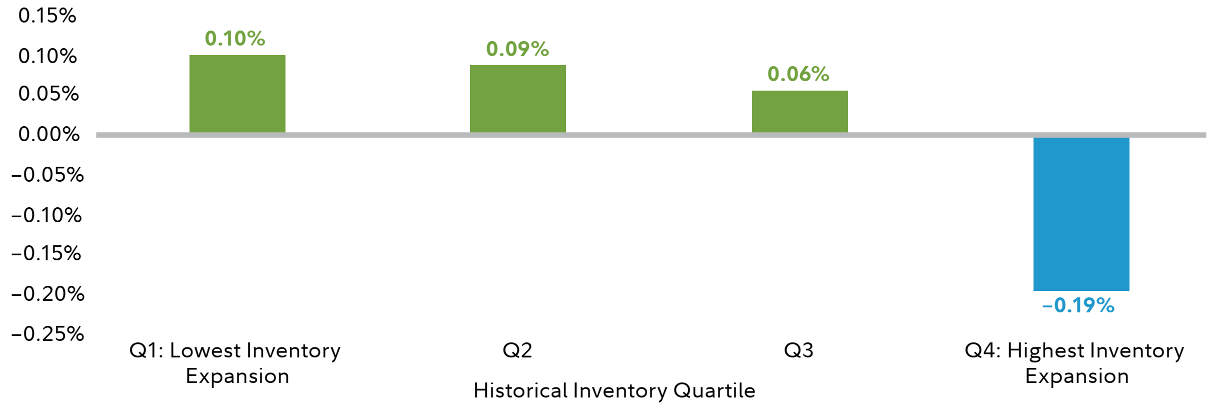
Past performance is no guarantee of future results. Sources: Federal Reserve, Haver Analytics, Fidelity Investments, as of Nov. 30, 2021.

Inventories have climbed despite snarled supply chains

Companies typically try to capitalize on strong demand and inflation by adding to their inventories, so they'll have more products to sell at high prices. Inventory builds eventually catch up with demand, helping to quell high inflation (Exhibit 3, page 3). The past year has been no different, despite the supply-chain bottlenecks that have gotten so much attention. According to the Institute for Supply Management (ISM) Manufacturing Inventories Index, inventories recently expanded as quickly as they have at any time in at least 20 years.[4]

EXHIBIT 3: Inflation tends to weaken after big inventory buildups.

Average Acceleration in Inflation (Next 12 Months) after Various Inventory Scenarios, 1999–Present



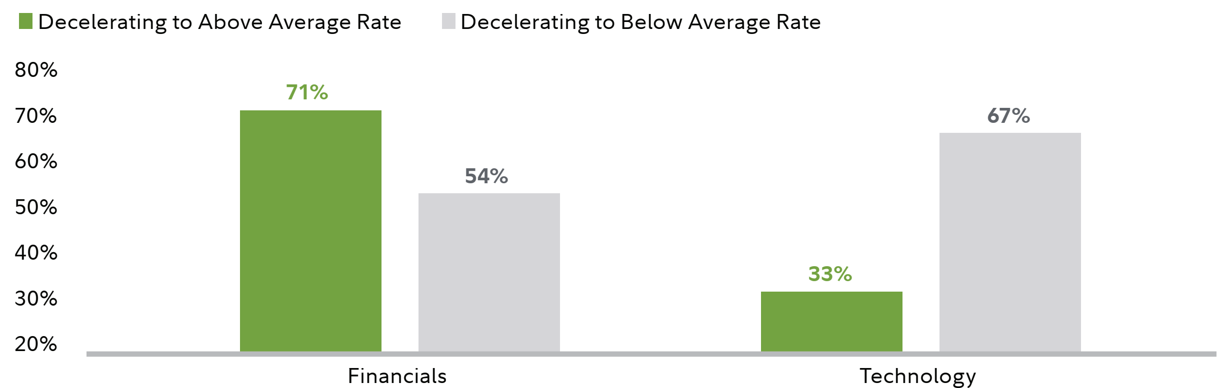
Past performance is no guarantee of future results. Inflation represented by CPI. Acceleration refers to the change in the 12-month inflation rate. Sources: Haver Analytics, Institute for Supply Management, as of Nov. 30, 2021.

Market leadership may ride on how much inflation falls

If inflation decelerates, will it fall to a relatively high or low rate? The answer has important investment implications. I think inflation is likely to level off at an above-average rate, in part because earnings have improved dramatically in 2021, and inflation tends to have a strong correlation with the previous year's profit growth. A scenario in which inflation decelerates but stays higher than average historically has favored value stocks, especially financials. It hasn't been good for technology, which tends to fare well when inflation drops to low levels (Exhibit 4).

EXHIBIT 4: Financials vs. technology in scenarios with slowing inflation.

Historical Odds of Outperformance (NTM) When Inflation Falls to Above-Average or Below-Average Rate, 1999–Present



NTM: next 12 months. Sector returns are based on the top 3,000 stocks by market capitalization relative to the Russell 3000 Index. Past performance is no guarantee of future results. Inflation represented by CPI. Sources: Haver Analytics, FactSet, Fidelity Investments, as of Nov. 30, 2021.

Author

Denise Chisholm

Director of Quantitative Market Strategy

Denise Chisholm is a market strategist in the Quantitative Research and Investments (QRI) division at Fidelity Investments. In this role, she is focused on historical analysis, its application in diversified portfolio strategies, and ways to combine investment building blocks, such as factors, sectors, and themes. In addition to her research responsibilities, Ms. Chisholm is a popular contributor at various Fidelity client forums, is a LinkedIn 2020 Top Voice, and frequently appears in the media.

Prior to assuming her current responsibilities in September 2020, Ms. Chisholm held multiple roles within Fidelity, including sector strategist, research analyst on the megacap research team, research analyst on the international team, and sector specialist.

Fidelity Thought Leadership Vice President Christie Myers provided editorial direction for this article.

Endnotes

[1] Inflation represented by CPI. Sources: Bureau of Labor Statistics, Haver Analytics, Fidelity Investments, as of Nov. 30, 2021.

[2] Sources: Bloomberg Finance L.P., Fidelity Investments, as of Nov. 30, 2021.

[3] See endnote 1.

[4] Sources: Haver Analytics, Fidelity Investments, as of Nov. 30, 2021.

Information provided in this document is for informational and educational purposes only. To the extent any investment information in this material is deemed to be a recommendation, it is not meant to be impartial investment advice or advice in a fiduciary capacity and is not intended to be used as a primary basis for you or your client's investment decisions. Fidelity and its representatives may have a conflict of interest in the products or services mentioned in this material because they have a financial interest in them, and receive compensation, directly or indirectly, in connection with the management, distribution, and/or servicing of these products or services, including Fidelity funds, certain third-party funds and products, and certain investment services.

Information presented herein is for discussion and illustrative purposes only and is not a recommendation or an offer or a solicitation to buy or sell any securities. Views expressed are as of December 2021, based on the information available at that time, and may change based on market and other conditions. Unless otherwise noted, the opinions provided are those of the author and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information.

Third parties mentioned are independent entities and not affiliated with Fidelity Investments.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Nothing in this content should be considered to be legal or tax advice, and you are encouraged to consult your own lawyer, accountant, or other advisor before making any financial decision.

The technology industries can be significantly affected by obsolescence of existing technology, short product cycles, falling prices and profits, competition from new market entrants, and general economic conditions.

Stock markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market, or economic developments, all of which are magnified in emerging markets. These risks are particularly significant for investments that focus on a single country or region.

Investing involves risk, including risk of loss.

Past performance and dividend rates are historical and do not guarantee future results.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

All indices are unmanaged. You cannot invest directly in an index.

Index definition

Consumer Price Index (CPI) is a monthly inflation indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food, and transportation. Core CPI excludes food and energy prices due to their volatility.

The Institute for Supply Management (ISM) Manufacturing Inventories Index is an economic indicator derived from monthly surveys of private sector companies focused on manufacturing inventory levels. An Inventories Index greater than 44.5 percent, over time, is generally consistent with expansion in overall manufacturing inventories.

The Nominal Broad U.S. Dollar Index is a measure of the value of the United States dollar relative to other world currencies. It is a trade-weighted index that improves on the older U.S. Dollar Index by using more currencies and updating the weights annually.

The Russell 3000® Index is a market capitalization-weighted index designed to measure the performance of the 3,000 largest companies in the U.S. equity market.

Third-party marks are the property of their respective owners; all other marks are the property of FMR LLC.

This material may be distributed through the following businesses: Fidelity Institutional® provides investment products through Fidelity Distributors Company LLC; clearing, custody, or other brokerage services through National Financial Services LLC or Fidelity Brokerage Services LLC (Members NYSE, SIPC); and institutional advisory services through Fidelity Institutional Wealth Adviser LLC.

Personal and workplace investment products are provided by Fidelity Brokerage Services LLC, Member NYSE, SIPC.

Institutional asset management is provided by FIAM LLC and Fidelity Institutional Asset Management Trust Company.

© 2022 FMR LLC. All rights reserved.

1009995.1.0 1.9904795.100