ECONOMIC FINDING • MARCH 2023

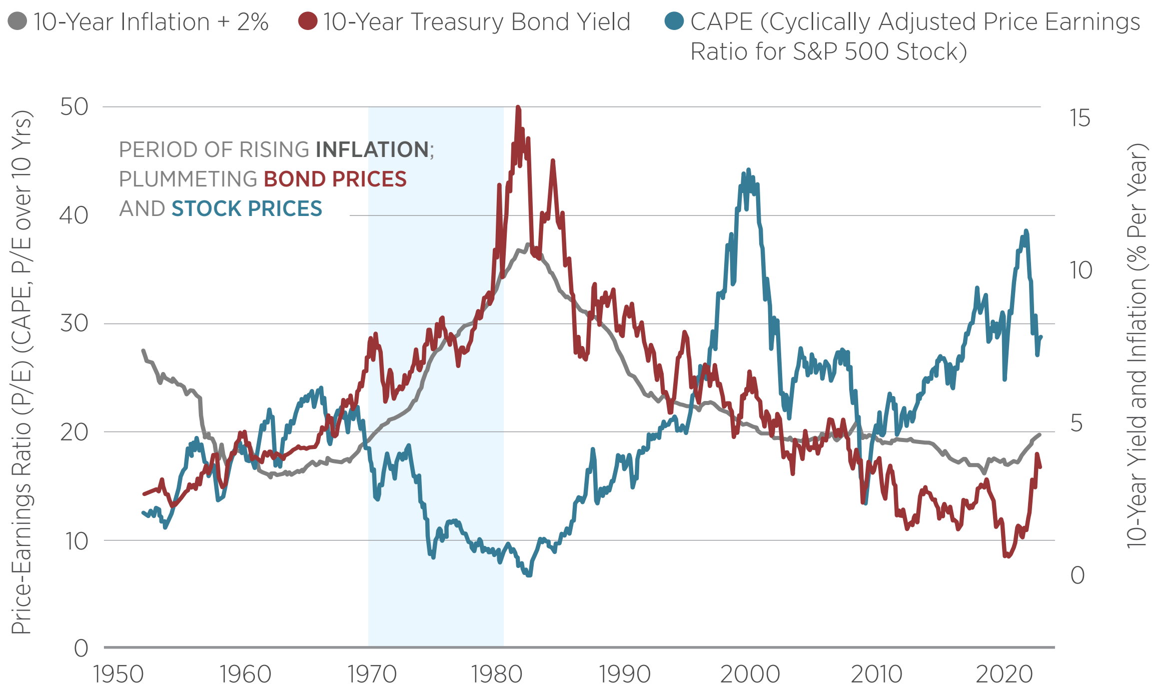
Inflation and Asset Returns

Based on BFI Working Paper 2023-34, "Inflation and Asset Returns," by Anna Cieslak, Duke University; and Carolin Pflueger, University of Chicago

During a period of "bad" inflation, stock and bond prices fall together; during "good" inflation, stock prices rise while bonds fall. The former is owed to supply shocks and often persistent, while the latter is owed to demand shocks and typically transitory.

Not all inflation is created equal. While the high inflationary period of the 1970s and 1980s was marked by stock market lows not seen since the Great Depression, recent upticks in inflation have been met by rising stock values. How stocks comove with Treasury bonds has shifted over time as well. These inconsistencies present a challenge to investors seeking to safeguard their portfolios against risk, as well as for policymakers aiming to understand how financial markets respond to shocks. Motivated by this, this paper offers a framework for understanding the implications of inflation.

Figure 1 • Levels of Stock and Bond Valuations and Long-Term Inflation



Note: This figure shows stock market valuation (measured as Robert Shiller's price-earnings ratio), the 10-year Treasury bond yield (which is inversely related to prices), and the 10-year annualized CPI inflation from January 1952 through January 2023. The line representing inflation is constructed by adding 2% to the 10-year annualized rate of inflation. As you can see, the 1970s and 1980s were characterized by rising inflation and plummeting bond prices (indicated by rising yields) and stock prices.

The authors distinguish between inflation that is "good" and that which is "bad," using prior research to show how the two have different sources and implications for markets. They establish the following concerning "good" vs. "bad" inflation:

GOOD INFLATION

- Good inflation occurs during periods of strong economic growth and is owed to increased demand.
- As a result, stock prices tend to rise at the same time that prices for long-term nominal bonds fall.
- Such conditions were observed during the 2000s, when the correlation between stocks and bonds shifted to negative.
- Bond risk premia are negative and good inflation is typically transitory.

BAD INFLATION

- Bad inflation occurs during periods of low growth and is due to supply shocks.
- Stock prices fall along with bond prices, and long-term bond risk premia are positive.
- Such conditions were observed during the 1970s and 1980s.
- Bad inflation is typically persistent and costly.

This framework can help policymakers and investors draw more accurate conclusions about the sources and consequences of future bouts of inflation. While it is still too early to predict the impacts of the post-COVID pandemic surge, evidence from surveys and inflation swap markets suggest that inflation risk premia are narrow. The authors conclude by offering two interpretations of these early indicators: that of the optimist, who may be relieved that inflation risk remains small, and that of the pessimist, who may worry that markets outpace beliefs, often slow to update.

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