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Macro
Memo

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The New Inflation Reality

Part 2: When Permanent Truths Fail

Introduction

History is filled with wrongheaded ideas that were once considered beyond debate. Can you believe there was a time when doctors endorsed cigarettes? Advertisements featured physicians in white coats recommending specific brands. Smoking was thought to calm nerves, aid digestion, and even promote good health. What seems absurd today was once considered accepted wisdom. Wrong ideas can survive for years, sometimes for generations, because they appear to confirm experience. Then new evidence arrives, old assumptions are challenged, and another headstone is added to what might be called the Graveyard of Permanent Truths.

Investors are not immune to this tendency. Every era develops its own set of unquestioned beliefs, often built upon trends that have persisted for so long they begin to feel like laws of nature. In 2007 it was widely believed that real estate prices never decline on a national basis (even though that's exactly what happened in the 1930s). Then the Global Financial Crisis proved otherwise (again).

For much of the last four decades, another such belief has been portfolio diversification, and portfolio diversification meant owning an appropriate amount of bonds. The belief became widespread and accepted by investment industry regulators. So much so that investment companies began promoting products built around the idea, such as target-date mutual funds with asset allocations approximating the common performance benchmark of 60% stocks and 40% bonds.

“...sound as a bell”

Wise doctor.
Wise mother.
Fortunate youngster.
Regular physical examinations plus all the methods developed to prevent or inhibit even the once-causal diseases are now routine in American life.
The magnificent advance made in guarding health by fighting illness before it strikes is still another proud chapter in the history of the medical profession.

According to a recent Nationwide survey:

More Doctors Smoke Camels than any other Cigarette

The “T-Zone.” T for Taste and Throat

Your “T-Zone” is a most critical “laboratory” when it comes to cigarettes. Try the rich, full flavor of Camels’ choice tobaccos on your taste. See how your throat reacts to Camels’ cool mildness. Like millions of other smokers, you too may say, “Camels suit my ‘T-Zone’ in a ‘T!’”

• The makers of Camels take an understandable pride in the results of a nationwide survey among 113,597 doctors by three leading independent research organizations. When queried about the cigarette they themselves smoked, the cigarette named most by the doctors was... Camels. And these doctors represented every branch of medicine—general physicians, surgeons, diagnosticians, and specialists. Like you, doctors smoke for pleasure. The rich, full flavor and cool mildness of Camels’ superb blend of choice tobaccos are just as appealing to them as to you. Compare Camels—in your own “T-Zone.”

CAMELS Camel Tobaccos

However, we believe the multi-decade run of bonds offering stability to investment portfolios is not an unchanging principle of investing. Instead, it was an unusually long and favorable chapter in history. We further believe this chapter created a level of confidence in the ability of bonds to always act as a risk diversifier and portfolio performance enhancer that will prove unwarranted over the coming years.

The Evolution of Asset Allocation

The 60/40 portfolio did not become the industry standard because someone proved it was the “best” portfolio. Rather, it emerged from a combination of academic theory, historical performance, and practicality.

Its roots trace back to Harry Markowitz's work on Modern Portfolio Theory (MPT) in the 1950s. Markowitz demonstrated that investors should think about entire portfolios rather than individual securities. The key insight was that combining assets with different risk and return characteristics could improve the portfolio's risk-adjusted return.¹ This work eventually earned him the Nobel Prize and became the foundation of institutional portfolio construction.

Under MPT, stocks offered long-term growth while bonds provided income and stability. A portfolio combining the two often produced a better balance of risk and return than either asset class alone. The 60/40 mix happened to be a practical "middle ground."

As institutional investors applied MPT, many found that portfolios with roughly 50-70% equities and 30-50% bonds suited moderate-risk investors. Over time, 60/40 became the shorthand allocation for someone seeking growth but unwilling to tolerate the full volatility of an all-stock portfolio.

The disinflationary era made it look brilliant

The real reason 60/40 became dominant was its remarkable performance during the roughly 40-year period from the early 1980s through 2021. During that era:

- Inflation generally declined.
- Interest rates trended lower.
- Falling rates boosted bond prices.
- Lower rates supported higher stock valuations.
- Stocks and bonds often moved in opposite directions during market stress.

This created a period in which both asset classes performed well and bonds frequently cushioned stock market declines. As a result, balanced portfolios delivered attractive returns with less volatility than equities alone.

The financial industry standardized around it

Once the 60/40 framework demonstrated decades of success, it became widely accepted and

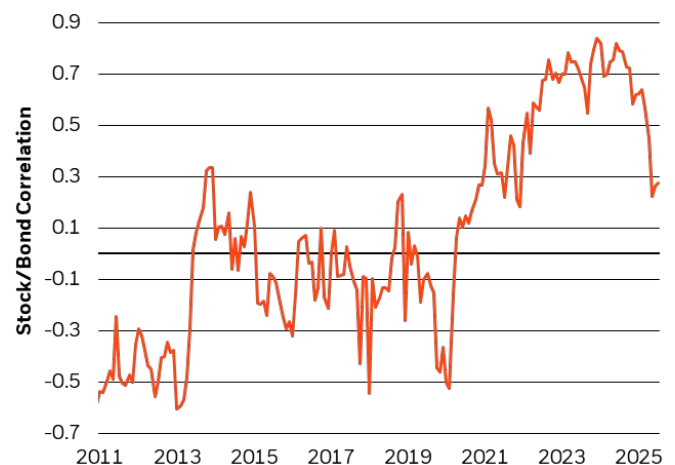
pervasively used across the industry:

- Pension funds frequently use it as a policy benchmark.
- Balanced mutual funds have adopted it.
- Target-risk funds are often designed around it.
- Financial planning software uses it as a default moderate-risk allocation.
- Advisors find it easy to explain to clients.

Its simplicity became one of its greatest strengths. Investors could understand it, regulators were comfortable with it, and advisors could scale it across large client bases.

So, What Changed?

The challenge is that the environment which helped create the 60/40 success story is changing. Tailwinds will turn into headwinds.



Source: BlackRock, Bloomberg. 12-month rolling correlation between the S&P 500 Index and the Bloomberg U.S. Aggregate Bond Index. As of July 31, 2025.

The chart above shows that stock-bond correlations² have not been consistently negative over history. The diversification benefit varies across economic regimes. When inflation rises and interest rates increase, stocks and bonds can decline simultaneously, as investors experienced in 2022.

In last month's Macro Memo, The New Inflation Reality, Part-1, we argued that the era of disinflation is over, and we should expect higher inflation in the immediate years ahead.



interest rates made the combination of stocks and bonds work exceptionally well in practice. The industry adopted it because it was simple, scalable, and historically successful. The debate today is not whether diversification still works, we believe it does. The debate is whether the specific 60% stocks/40% bonds mix remains as well suited to a more inflationary world as it was during the disinflationary era.

We will conclude this three-part series with our next Macro Memo addressing the concept of “duration”, and the role it plays in allocation decisions.

If you would like to discuss the potential implications a more inflationary environment could have upon your investments and overall financial plan, we would welcome the conversation.

¹ *Raw returns can be misleading because a high-performing investment might have experienced wild price swings or severe volatility to get there. Risk-adjusted metrics put those profits into context by revealing whether the reward truly justified the risk. When comparing two investments with identical gains, the one that achieved them with lower risk or less volatility has the superior risk-adjusted return.*

² *Asset return correlation measures how the percentage gains or losses of two different investments move in relation to each other over a specific time frame.*

In a higher-inflation environment:

- Bonds may no longer provide the same cushion.
- Both stocks and bonds can be pressured by rising discount rates.
- Real assets, commodities, infrastructure, and other alternatives may play a larger diversification role than they did during the disinflationary era.

Conclusion

The 60/40 portfolio became the investment industry’s standard because Modern Portfolio Theory showed the benefits of diversification. Then a 40-year period of falling inflation and

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