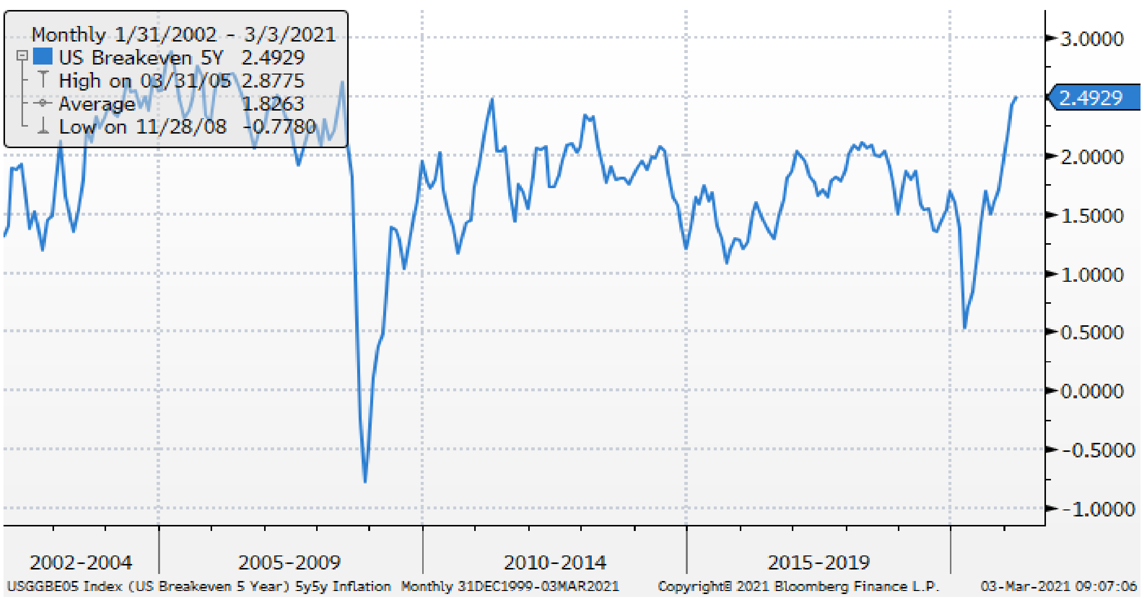
Deflating the Inflation Story

Craig Sullivan, CFA, CAIA®
Director of Fixed Income, External Managers & Alternatives

The dominant theme driving financial markets over the past several months has been inflation. The combination of easy monetary policy, additional fiscal stimulus, and the unleashing of pent-up demand as the economy reopens have resulted in a sharp increase in expectations for future inflation rates. Since early November, the market's expectations for inflation over the medium term has increased by nearly 90 basis points (bps), reaching the highest level since July 2008.

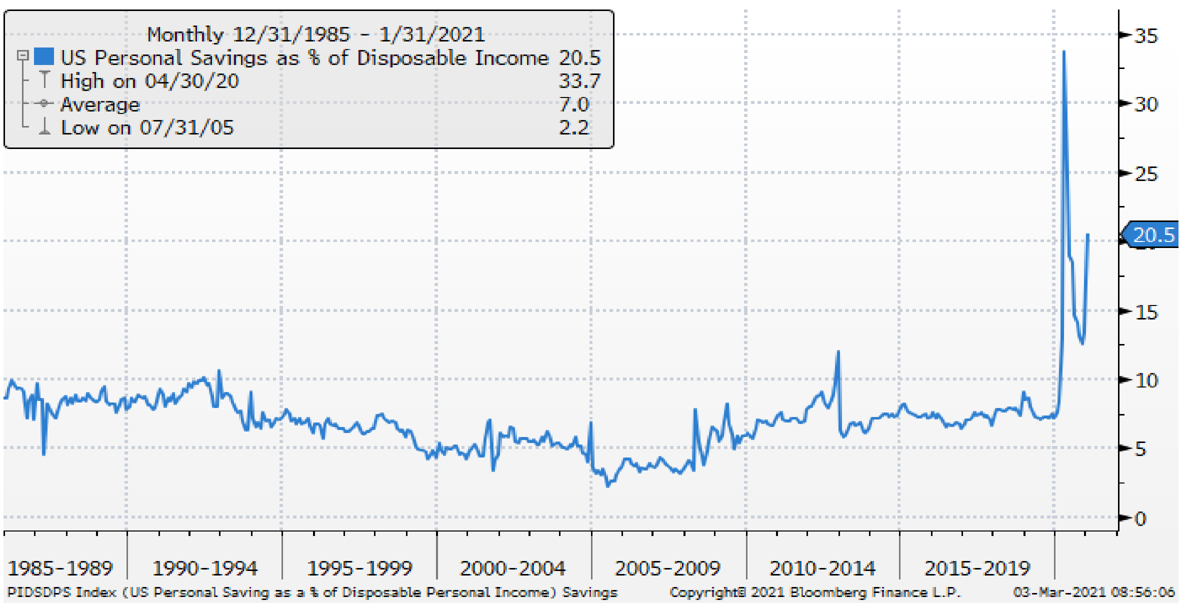


The rise in inflation expectations has been impactful on bonds markets, where yields on intermediate and longer-dated bonds have moved higher, resulting in price declines. While this move has garnered a lot of attention in the financial media, we think that it is important for investors to distinguish between a cyclical bounce in inflation readings over the near term and the structural forces which will drive inflation over a longer time horizon.

As we head into the spring and summer, two factors will drive inflation readings higher. First will be the impact of the 'base' effect. Inflation is measured on a year-over-year basis, meaning the price levels in a specific month of 2021 will be compared to the corresponding month of 2020 (the 'base'). In terms of economic activity, the worst of the pandemic occurred between late March and May of last year. During this period, many businesses were forced to close, and even businesses that remained open were often forced to cut prices as consumers reduced spending amid the severe levels of uncertainty. The economic shutdown resulted in price declines for a wide variety of items, particularly those associated with the service industry, such as airline fares (-30%) and hotel prices (-15%). The impact on mobility resulted in the price of oil – a major factor in headline inflation – declining by over 55% between February 28 and April 30 last year, including briefly trading at a negative price during mid-April.

With the easing of containment measures, economic activity – and the price levels of many goods and services – have at least partially recovered. Comparing current price levels to the depressed price levels from last year is going to result in a rise in inflation.

The second driver of inflation will be the uncorking of demand as economies continue to reopen. The combination of the fading restraint of the pandemic as more people are vaccinated, fiscal stimulus, and strong pent-up demand will likely lead to a surge in demand over the summer months. Supporting the robust demand is the strength of the consumer. The combination of uncertainty created by the pandemic, large amounts of fiscal stimulus, and having less entertainment outlets on which to spend money, have resulted in a sharp rise in the personal savings rate.



The surge in demand will also likely be concentrated both in terms of timing and focus. Most Americans are likely to be vaccinated over the coming months and will be anxious to 'escape' the house and once again go to bars, restaurants and travel. However, the lockdowns of the past 12 months have resulted in a decrease in supply for these activities as many bars ☹ and restaurants have gone out of business, hotels have closed, and aircraft have been stored. The combination of strong demand and more limited supply will result in a 'bottleneck' which will offer pricing power to many areas of the service sector.

The possibility for higher prices extends beyond the service sector. For example, as workers return to an office environment, the potential for an uptick in demand for business attire, replacing the jeans and tennis shoes of the work-from-home era, may result in higher prices if retailers have inadequate supply (inflation can occur in non-obvious ways, such as retailers who frequently have promotions, selling goods at full price).

However, the question for investors is the sustainability of the inflation impulse beyond this year. The Fed has expressed the view that higher inflation readings during 2021 will be transitory and, as such, they will look beyond them when setting monetary policy.

Similarly, we expect higher inflation readings during 2021 to be temporary due to several structural forces, some of which have been in place for a number of years, which will keep inflation muted. These include:

- Aging Demographics. The aging of the U.S. (and global) population reduces aggregate demand as older individuals tend to save more and spend in a different way compared to younger people.

  The impact of aging demographics has been a clear and powerful deflationary factor in Japan over the past two decades.

- Government Debt. Classic economic theory suggests that increasing government debt levels will result in higher inflation levels. However, in practice, an increase in government debt in developed economies (e.g., Japan) has actually led to slower subsequent growth, and with it, muted inflation.

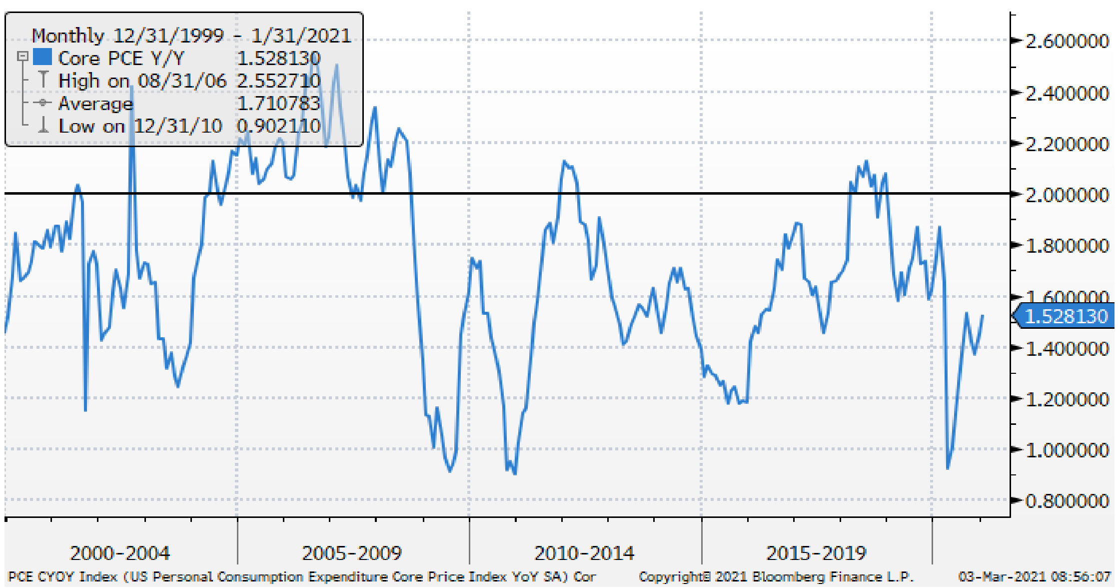
- Technology and Automation. Companies are constantly utilizing technology and automation to reduce price. This trend restrains labor costs as workers are replaced by machines. The pandemic has actually resulted in an acceleration of many of the automation trends.

- Slack in the Labor Market. The sudden and deep decline in economic activity as a result of Covid-19 has left considerable slack in the labor market. Relative to 12 months ago, the *reported* U.S. unemployment rate is 2.8% higher, and the labor force participation rate is 2% lower. Unfortunately, these numbers probably also underestimate the actual unemployment figure. The Fed estimates that correcting for a reduction in those looking for work due to the pandemic (due to health concerns or home schooling) would lift the unemployment rate from the 6.3% reported rate in January to a total closer to 10%, which would be a ~6.5% increase relative to last February. Another measure – the employment-to-population ratio – is near the lowest level since the early 1980s.

  The considerable slack in the labor market means wage growth is unlikely in many segments of the economy. Thus, a key ingredient for a sustainable increase in inflation – wage growth – is absent.

- Clearing the Bottleneck. Essentially, the rate of change in demand for goods and services as consumers exit from hibernation may, for a period of time, outpace the rate of change in supply (output). However, this 'bottleneck' will dissipate over time as it did following the end of World War II. During the war, rationing and supply restrictions created barriers to spending, resulting in a personal savings rate equivalent to nearly 40% of GDP, nearly twice the current level. While the inflation rate did spike in the 12 months following the removal of wage and price controls in June 1946, it moved back to its longer-term range by 1948. Furthermore, studies by Milton Friedman and Anna Schwartz suggest that the true inflation rate was actually higher during the war and substantially lower following the war, i.e., the spike in the inflation rate was smaller than official data implies.

Overall, it is important that investors distinguish between what could be a large cyclical bounce in inflation and the longer-term structural factors which have resulted in muted inflation since the financial crisis and remain in place. While we do expect a demand boom, fueled by fiscal stimulus and pent-up savings to increase inflation readings this year, longer-term, the fundamental forces, which have kept inflation subdued since the financial crisis, remain in place. Therefore, we expect, as we move beyond the transient influences of this year, that inflation will return to the muted trend of the past 10 years, and the Fed's 2% target will once again prove a hard goal to achieve.



<u>*Disclosures*</u>

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