Deflating the Odds of Transitory Inflation

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"Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man." Ronald Reagan

In March, we wrote a whitepaper titled "Deflating the Inflation Story." In it, we outlined the reasons we believed that increased inflation readings during 2021 would be temporary. At the time, market participants were in the process of sharply re-pricing their inflation expectations higher. Since that time, investors have become more complacent about the risk of a more prolonged period of elevated inflation and appear to be buying into the Fed's narrative that higher inflation readings in the near term will be 'transitory.'

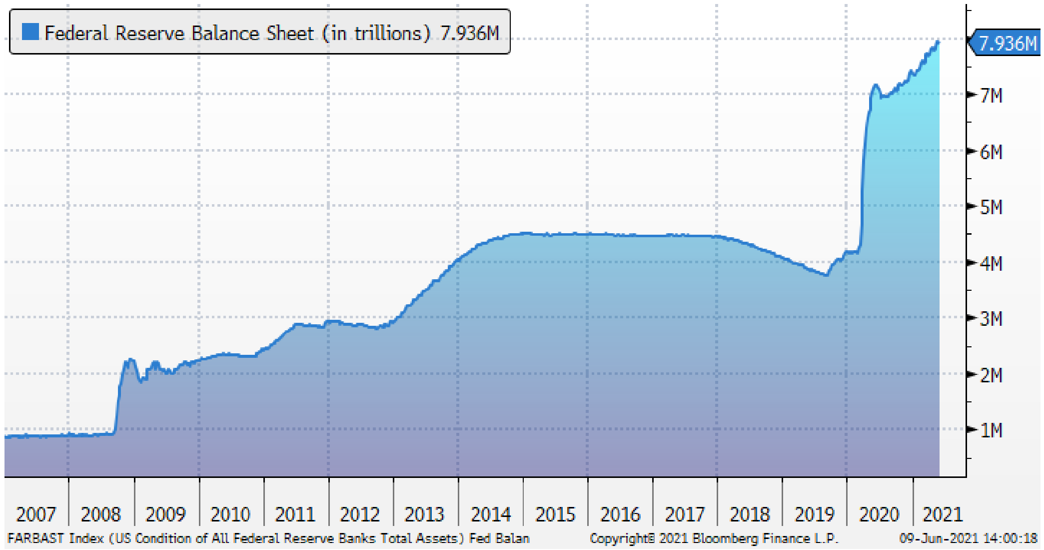
Conversely, our outlook for the future path of inflation now sees an increased *chance* for inflation to remain elevated for a more prolonged period. To be clear, our base case remains for inflation to settle back to a more subdued rate as we end this year, due to the reasons outlined in the March whitepaper. This update outlines several factors that we believe increase the probability of a more sustained period of inflation.

A Changing of the Guard:

The decline in economic activity due to COVID and its related 'lockdowns' was unprecedented. However, it was met with an extraordinary response from monetary and fiscal policymakers.

The Federal Reserve (Fed) reduced the Federal Funds rate by a total of 1.5% to near zero during two unscheduled meetings in March 2020. To help stabilize the financial system, it announced its intention to purchase assets and increase the size of its balance sheet (known as quantitative easing, or QE). Between the beginning of March and June of last year, the Fed's balance sheet grew by over $3 trillion and is now approaching $8 trillion – nearly double the size it was at the beginning of 2020.

The Fed has also indicated its intention to remain patient, even if inflation overshoots its target, until full and broad-based employment measures have been met. The move to an average-inflation-targeting approach has increased the Fed's tolerance for inflation, given it has consistently undershot its 2% target.



The fiscal response was comparable with that seen during World War II (as a percentage of GDP), totaling in excess of $5 trillion, or more than 25% of GDP. Additional fiscal stimulus appears likely with discussions over the potential for an infrastructure package. The passage of a bill could occur at a time when demand is already outstripping supply.

The combination of easy monetary policy and epic amounts of public spending pulled the U.S. economy out of the deepest slump on record faster than anybody expected. However, it could accelerate the tectonic shift that was already underway in macroeconomic policy and the role of government in the economy.

In the 1980s, President Reagan and Fed Chair Volcker prioritized curbing inflation and managing economic growth by adjusting the cost of private borrowing rather than spending public money. However, in the aftermath of the global financial crisis, a progressive shift away from neoliberalism has occurred.

Voters have increasingly questioned the orthodoxy of previous policies, such as fiscal austerity, which may have contributed to sluggish economic growth following the great recession (2007-09). Meanwhile, politicians have become more relaxed about budget deficits and public debt at the same time that the Fed's modus operandi has shifted to being more tolerant of higher inflation.

This attitude shift has opened the door to new goals for monetary and fiscal policy that extend beyond acting as a shock absorber to stabilize output during economic downturns. Going forward, there is the potential for more frequent fiscal injections into the economy.

In many ways, policymakers in the U.S. appear willing to pursue a form of Modern Monetary Theory (MMT), which suggests that governments have room to boost economic growth through fiscal stimulus and that inflation – rather than the deficit or public debt levels – is the metric to signal when too much stimulus has been applied to an economy.

Shortages:

While the pandemic news in many parts of the developed world is improving, shortages of materials and transportation (shipping) have severely impacted the supply chain. Exacerbating the situation has been a large number of unusual events such as the Suez Canal blockage, winter storms in Texas that impacted energy operations, and cyberattacks on the largest fuel pipeline in the U.S. and the world's largest meat supplier.

Currently, a record number of manufacturers are reporting supply chain disruptions, and business surveys have pointed to record delays in delivery times. Perhaps, the most widely publicized is the global shortage in semiconductor chips that is impacting everything from phones to game consoles and appliances. Automakers have been forced to idle factories due to a lack of essential components and are now redesigning vehicles to use the most common and accessible chips.

Unfortunately, this issue is unlikely to be resolved in the near future. The manufacturing of chips is concentrated in the hands of very few players, and the barriers to entry are particularly high, as are the costs for building new manufacturing facilities (estimated to be ~$15 billion for an entry level facility). The CEO of Intel, Pat Gelsinger, recently suggested that the backlog won't be resolved "for a couple of years."

Backlogs are expected to continue in other goods as well. The Logistics Managers' Index – a monthly survey of corporate supply chain managers – highlights the expectation for supply chain issues to continue over the next 12 months.

In the near term, companies, such as Starbucks, have been forced to increase prices (and remove menu items). Longer term, the exposed vulnerabilities of the supply chain may encourage companies to reduce dependence on foreign producers and move certain operations back 'onshore' – despite the higher cost. In other words, a major deflationary force of the past 30 years – globalization – may have peaked.

Labor shortages are also a concern, with company surveys consistently showing the challenge in finding workers. In the latest National Federation of Independent Business (NFIB) report, nearly half of all small business owners had open positions that they were unable to fill.

The lackluster participation rate can be explained partly by generous unemployment benefits, childcare obligations as many schools remain closed, and lingering health concerns.

All three of these huddles should begin to fade as the summer progresses. The supplemental unemployment benefits of $300 per week from the Federal government are schedule to expire on Labor Day; however, many states (25 at the time of writing) have announced they will discontinue these benefits before that time. Meanwhile, continued progress on the vaccine front and a decline in cases should allow schools to reopen and alleviate fears around the virus allowing people to feel more comfortable returning to work.

In the interim, the search for workers has resulted in companies, such as McDonalds, Chipotle and Amazon increasing wages or offering hiring incentives. Other companies may be forced to do the same to attract workers. Average hourly earnings in the leisure and hospitality sector have increased at an annualized pace of 14.5% over the past three months. **Importantly, once a company has increased wages for employees, it is hard to reduce them, and companies often pass along the increased labor costs to consumers in the form of higher prices.**

<u>Input Costs:</u>

The prices of raw materials have surged as the world economy reopened. The Bloomberg Commodity Index, which tracks 23 raw materials, has risen to its highest level since 2011. The passage of an infrastructure bill in the U.S. could put additional upward pressure of commodity prices.

Conclusion:

Our base case remains that the bump higher in inflation will be temporary, and inflation measures will mean revert (to sub 2%) over the next 12 months.

However, **the risk of a more sustained period of inflation, averaging between 2-3%,** has increased relative to the start of the year due to the combination of monetary and fiscal stimulus, the willingness of politicians to spend, global supply chain disruptions, labor shortages, and the rise in the price of materials.

The future path of inflation, and the Fed's response to it, will have consequences for the economic recovery as well as the performance of financial markets. Therefore, we will continue to monitor economic developments and take an active approach to portfolio positioning.

Disclosures

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