INFLATION

Yes or No?

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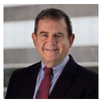
Where Investments and Values Intersect



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INTRODUCTION AND CONCLUSION

The inflation outlook has become a hotly debated topic in recent months. So far, this has had only a minor impact on financial asset pricing, but bond yields may be a coiled spring at risk of painfully adjusting higher when investors eventually discover inflation is an issue. The market consensus remains that stronger growth will have almost no impact on inflation. Current capital market pricing, including bond yields and longer-term inflation swap rates or breakeven inflation rates, indicate that investors expect inflation will only lift briefly and then recede, remaining well-contained over the long term. This belief is consistent with Federal Reserve (Fed) statements that consumer price pressures will prove transitory. We are not convinced and believe that monetary authorities and investors are too complacent about the pace and durability of the upward move in underlying price pressures.

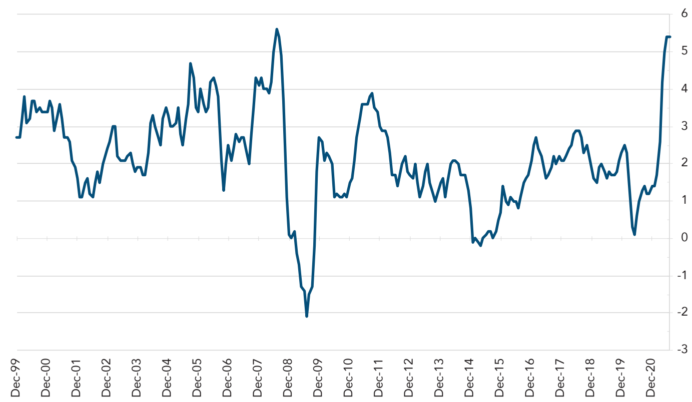
Our view has been that the U.S. economy will lead in the build-up in global inflation pressures since it already has powerful momentum, is receiving the greatest fiscal stimulus, and has experienced the most robust asset price appreciation. Yet, the Fed remains among the most dovish central banks. The current post-pandemic spike in U.S. core inflation will soon peak but be followed by resilience rather than a return to sub-2% inflation. Indeed, almost all the forces that drive the trend in consumer price inflation are currently contributing to higher price pressures, and many will prove persistent. Most asset classes have re-rated in response to extreme policy reflation, stronger global growth expectations, and plentiful liquidity. Some well-performing asset classes also benefit in an inflationary environment, including shorter-term inflation-protected securities and commodities.

THREE INFLATION COMPONENTS

We attempt to break current inflation into three components, although there are significant overlaps. Those components are (1) "transitory" or temporary inflation, (2) supply chain disruption inflation, and (3) core inflation. Our best assessment is that transitory inflation is already fading and will continue to do so for the next several months. Supply chain disruption inflation is proving to be more persistent than many thought and will hopefully dissipate over several quarters. Core inflation, evident in wage rates, is the most controversial part. Our view is this inflation has ticked up and will continue to be problematic after the other two pieces work their way through the system.

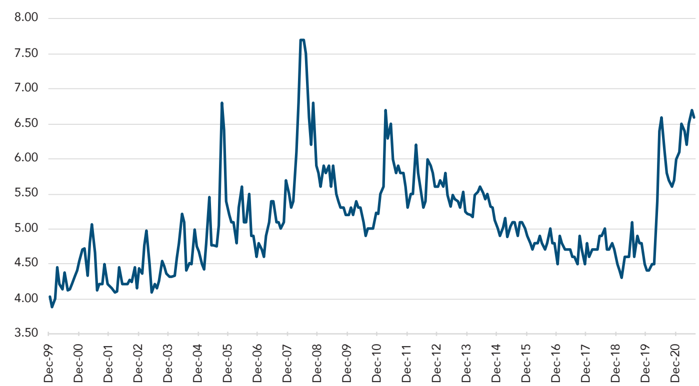
The gradual upshift in inflation has been underappreciated by most investors, many of whom have dismissed the recent spike and hold to the secular stagnation narrative. Crosscurrents are

CPI Inflation



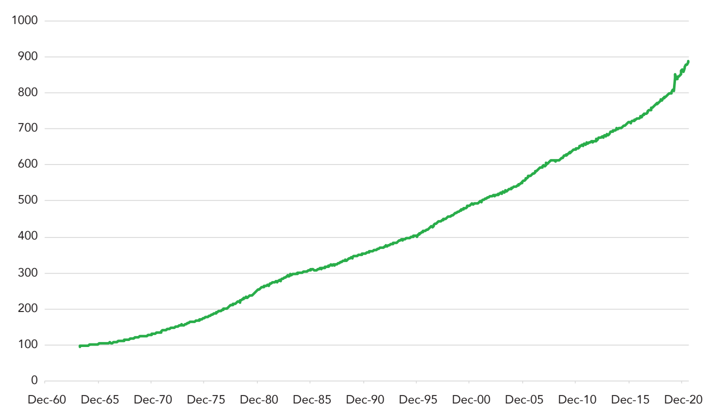
Source: Bureau of Labor Statistics as of 7/31/21

Inflation Expectations



Source: Bureau of Labor Statistics as of 7/31/21

Wage Rate Growth



Source: Bureau of Labor Statistics as of 8/31/21 likely to muddy the overall inflation picture for the next few quarters. In addition, the base effects of this year's surge in inflation will work in the opposite direction next year, especially since core and headline consumer prices have jumped much higher than underlying measures of inflation. This could briefly drive the illusion of inflation receding from above 3% in the first half of 2022 until price pressures bottom at a higher run rate than in recent years. According to recent measures, the underlying "sustainable" inflation trend is below 3% but rising. In fact, inflation already exceeds the pre-pandemic rate and rising across a broad set of goods and services, excluding rental inflation. Rent inflation, which tends to be sticky, has been subdued but recently turned the corner and is poised to pick up meaningfully. Shelter is in a unique, sticky cycle with considerable weight in the price basket.

The markets' reaction to higher-than-expected inflation has been relatively docile as the Fed appears to have done a great job convincing investors (and perhaps themselves) that signs of persistently higher inflation will be transitory. We expect a durable cyclical pickup in price pressures, with the underlying trend of PCE inflation near 3% rather than 2% by the end of next year. This trend will be driven, in part, by the U.S. economy growing faster than expectations - well above the pre-pandemic pace (and the economy's long-run potential) through the end of next year. A move in inflation from less than 2% to 3% would be a meaningful change for capital markets and investors.

A LITTLE HISTORY

After experiencing a sharp and self-reinforcing rise in consumer price pressures during the 1970s, the Fed aggressively hiked interest rates to curb high inflation by the early 1980s. This action laid the groundwork for the subsequent three-decade period of structural disinflation. That said, inflation-fighting was abandoned in the aftermath of the technology crash in the early-2000s when the U.S. and parts of Europe had a brief deflation scare for the first time in decades. The pendulum swung further following the Great Recession when central banks began a full-scale war against the threat of deflation and drove interest rates sustainably below the rate of CPI inflation.

By the mid-2010s, central banks had won the war on deflation but continued the fight to the present day. As such, the Fed and most other central banks immediately responded to COVID-19 by shifting to an aggressive strategy and deploying extreme monetary reflation measures, despite massive fiscal stimulus shouldering the burden. Interest rates were slashed to zero (or lower), quantitative easing was ramped up, and central banks adopted several unorthodox policies to eliminate any sign of credit strains. In short, the Fed and other major central banks shifted from proactively forecasting economic growth when setting policy (pre-Great Recession) to becoming reactionary and decisively lagging economic improvements (in the 2010s) to now explicitly targeting higher inflation.

KEY TAKEAWAYS:

1. Inflation was rising cyclically before the pandemic.
2. Concerns about inflation have surfaced periodically over the last few years but have become empirically observable in 2021 (e.g., lumber, semiconductors, used cars, and housing).
3. Labor shortages and resulting wage rate growth are problematic.
4. Year over year CPI in April was 4.2%, 5.0% in May, and 5.4% in June (the highest readings in 13 years).
5. If inflation is "too much money chasing too few goods," note the growth in the money supply, which peaked at over 30%, and the fiscal authorization of trillions of dollars of spending.
6. A CAPEX boom will likely add to inflationary pressures.
7. Might higher inflation lead to higher interest rates?
8. Might higher inflation lead to USD weakness?
9. Increases in inflation expectations can become self-perpetuating.
10. The likely decline in headline inflation in 2022 (as "transitory" inflation and hopefully supply disruption inflation declines) might give a false hope that inflation is not a problem.

THE COUNTER ARGUMENTS

Counter arguments to an inflation pickup often revolve around the long-term secular disinflationary forces of productivity, globalization, and demographics. Continued technological innovation is a powerful disinflationary force that will continue to work against an inflationary cycle. Likewise, demographic influences, especially in the developed world – notably the aging population and significantly reduced birth rates – have a disinflationary impact and are not likely to dissipate. The globalization argument has generally played out as nationalistic and protectionist forces have significantly reduced foreign trade.

WHAT TO DO?

#1 KEEP U.S. TREASURY POSITIONS SHORT DURATION

Government bond yields remain historically depressed and have significant upside from a cyclical and longer-term perspective. Our view is the adjustment would occur with U.S. and G7 government bond yields moving higher in a series of waves, despite central bank anchoring. The first jump in bond yields this year was driven by a sharp upward revision in investor expectations of economic growth over the next couple of years. The subsequent waves higher will likely be driven by investors progressively questioning and eventually abandoning the secular stagnation narrative while acknowledging the stickiness of consumer price inflation. Likewise, the Fed and other central banks should eventually capitulate, although they currently seem determined to lag well behind.

Ten-year Treasury bonds yield 1.3%, and compared to ten-year inflation expectations, are nearly 100 basis points below the average relationships seen in the last decade. Real rates look very depressed. The valuation paradigm priced into the equity market is effectively betting on negative real rates for a long time, with globalization, the internet, and an accommodative Fed the linchpins of the story.

Our view is that U.S. Treasuries should continue to lead the cyclical selloff in G7 bonds, given that the inflation impulse will be strongest in the U.S. economy. Also, the lagging nature of central banks means the selloff will continue to result in a bear steepening of the curve, with the long end being impacted the most by a continued upward revision in longer-term inflation expectations.

#2 BE PREPARED FOR A LOWER DOLLAR

Despite dramatic fiscal stimulus and the associated relative growth advantage, the U.S. dollar has been unable to bounce materially this year. With momentum measures shifting from oversold to neutral and speculators no longer net short, the U.S. dollar may soon be poised for another round of selling pressure. Higher U.S. inflation expectations, possibly combined with a relatively loose monetary policy stance (versus the rest of the world) would provide the fundamental support for a sustained decline in the U.S. dollar.

#3 BE LONG U.S. FINANCIALS

The U.S. financial sector has not historically been an inflation hedge, and performance during inflationary periods has been mediocre. Nonetheless, financials are likely to perform well in the coming years should inflation move higher, since the relative performance of the U.S. financial sector has correlated with 10-year Treasury yields over the past decade. Strong growth, rising inflation, and higher inflation expectations will lift long-term bond yields and a steeper yield curve augers well for banks' net interest margins. Higher bond yields will likely lift sentiment towards the sector and foster a re-rating from currently depressed relative valuations. The broader U.S. value index (the financial sector is a major component) should also benefit relative to growth stocks in a rising bond yield environment.

#4 LOWER EQUITY DURATION

Investors should think about their equity portfolio in terms of duration, much like they might think about their fixed income holdings. That is to say, higher inflation accompanied by higher long-term interest rates should prompt investors to seek out equities with shorter durations where cash flows are returned to investors (through dividends or share repurchases) more quickly. This strategy is far less risky than holding stocks whose values are tied mainly to their terminal values, where an increase in the discount rate directly impacts a company's present value. Yield partially offsets the multiple compression that accompanies higher inflation. An upshift in longer-term inflation expectations erodes the appeal of companies perceived to benefit or contribute to global disinflation, many of which are included in the technology sector and growth index.

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