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COMMENTARY

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Economic growth has been powering higher in 2021, as widespread vaccinations have helped the U.S. economy recover sharply from the COVID-19 recession of 2020. GDP growth in the first quarter clocked in at 6.4%, with full year projections at the highest level since 1951. Financial markets have followed suit, with the S&P 500 up 12.6% year to date through the end of May. This impressive economic growth has come with a cost: inflation. Expectations of coming inflation have been ramping up throughout the year and recent economic releases have shown that it has indeed arrived. The April Consumer Price Index (CPI) release showed that headline CPI rose 0.8% month-over-month and 4.2% year-over-year. The year-over-year figure was close to Wall Street estimates, but the monthly figure was well above. In the short run, the recent rise has been a positive signal, a consequence of an economy roaring back to life. The worry is that the reopening bump in prices we have seen will become something more sustained and problematic. In any debate about inflation on Wall Street, the issue of "transitory" vs. "sustained" is at the forefront, with broad implications for every asset class.

The school of thought that posits that inflationary pressures will be short lived or "transitory," as Federal Reserve officials have described in recent public speeches, often emphasizes the "base effects" of recent readings. This explanation stresses that this time last year prices were flat or falling as demand for many items declined during the worst of the pandemic shutdown. With the economy reopening, there was bound to be a jump in prices from the depressed period of a year ago and that once we passed the locked down months of last spring, year-over-year comparisons would start to look less worrisome. About 1% of the 4% gain in CPI in April was attributed to these base effects. The transitory inflation camp also points to supply chain bottlenecks as an explanation for recent inflation, highlighting the unprecedented speed of the economic recovery. At this point a year ago, companies were dramatically pulling back on investments in supply as they were living through a locked down economy with no clarity as to when economic activity would rebound. For many executives, the most recent comparison to the COVID recession was the Great Financial Crisis in 2008, in which the economic recovery was much slower. The speed of this recovery, helped greatly by massive fiscal and monetary stimulus, caught many by surprise. With production cut back and investments in new capacity put on hiatus last year, there have been dramatic shortages in many goods and commodities, sending prices higher. Once capacity is brought back online, supply will increase to meet demand, slowing the rate of inflation from temporarily high levels.

On the opposite side of the spectrum, there is growing concern in the investment community that inflation may be higher in a sustained way. This argument tends to put the blame on a few factors: a reversal in globalization, sustained commodity shortages, and most of all, expansionary fiscal policy. Globalization has been a disinflationary force for over three decades now, as goods manufacturing has moved to areas of the world with lower production and labor costs, spurred by economic liberalization in countries such as

China. A backlash to globalization, observed through the rise of populist political movements over the past decade, potentially signals the slowing of the pace of globalization. In the midst of this growing public support for "reshoring," the experience of COVID-19 has also made executives and policy makers reconsider the importance of local supply chains for critical supplies, in this case for products such as PPE and pharmaceuticals. This approach would sacrifice efficiency in exchange for resilience, a potentially inflationary trend.

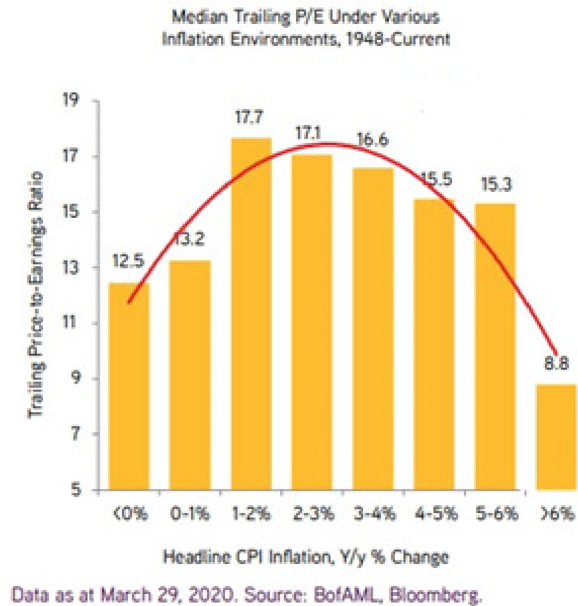
A long-term shortage of commodities is another common argument that inflation may be long lasting. Ever since the last peak in commodities in 2012, mining companies have cutback significantly on spending to open new mines, as demand has remained weak in the face of slow global growth post-financial crisis. Investors have preferred cash dividends in their pocket to the uncertain returns of costly projects in far flung regions of the world, a trend that has not yet changed despite a recent rise in the price of commodities. This is also a potential problem in energy, as years of low returns from cash burning projects combined with investor fears of a "green" future have led executives to cut back on new production in favor of cash return to shareholders. If spending does not keep pace with rising demand, future shortfalls may lead to increased prices, a situation that may last as major commodity extraction projects can take years to complete.

Finally, the factor most cited to drive inflation above trend for a sustained period of time, and most political by definition, is the expansion of fiscal policy. For much of the post-financial crisis period, loose monetary policy, enacted through the Federal Reserve, has been used to drive demand, much of it through the "wealth effect" mechanism. Low interest rates and other "monetary" tools have been a large driver of asset price appreciation, which increases wealth that can be spent in the economy. Most of the "wealth effect" is transmitted through institutions, corporations, and wealthy individuals, each of whom have a fairly low marginal propensity to spend (i.e. any additional income they receive they tend to save). Fiscal policy enacted through Congress, especially the recent expansion of stimulus checks during COVID, has put more direct cash into the hands of people with a much higher propensity to spend, driving demand higher along with prices. If we are entering a paradigm shift of monetary dominance to fiscal dominance, this demand driven inflationary trend may remain in place.

While issues such as "reshoring", commodity shortages, and increased fiscal spending may be the factors driving inflation higher, its ultimate sustainability may be determined by the Federal Reserve. Historically, when the economy gets hot and inflation begins to rise, the Fed raises interest rates to cool the economy. Today, the Fed remains firm in its belief in the transitory nature of recent inflation, which it has used to justify keeping monetary stimulus in place while unemployment remains high. The Fed has also recently revised its monetary policy framework, announced in August 2020, reframing their view on inflation to tolerate inflation above its long-term target of 2% for short periods of time to offset periods in which it is lower than its target. This change, combined with today's conditions, may result in inflation remaining hotter, for longer, than we have seen over the past few decades.

In assessing the causes, and sustainability, of a rising level of inflation, the implications for investors are many. For equities, the implications are different depending on the level of

inflation and sector of the economy in question. Speaking of the market broadly, the valuation of the stock market peaks with mild inflation, somewhere between 1-3%, with much lower valuations in deflationary and highly inflationary environments. Inflation will also impact different sectors of the stock market in different ways. Natural resource and commodity companies will often be beneficiaries, with rising commodity prices sending their sales and profits soaring, while the flipside is true of companies that are seeing their costs rise much faster than their revenues. Companies with the ability to raise prices faster than costs will also do well. These tend to be companies that sell products and services that either have, or are perceived to have, no substitute, and thus demand will not change if the price rises by high single digits. On the contrary, in today's environment, the equities most at risk may be high flying growth companies, often in the technology sector. Their valuations have been buoyed by low interest rates, as their cash flows, which are currently low but projected to be higher in the future, have been discounted to the present at near 0% interest rates. If interest rates are to ultimately go higher to fight inflation, the valuations on such companies should decline meaningfully. Outside of equities, bonds will perform poorly if high inflation is sustained for an extended period. This is especially true of long duration bonds, which we tend to avoid due to the embedded interest rate risk, especially now. Real assets such as commodities and gold have historically done well in such environments but tend to have full cycle risk adjusted returns much lower than equities and bonds, in part due to a lack of associated cash flows. To earn a return on gold, the price must go up, which is not the case with a dividend paying stock or interest paying bond.



Whether or not inflation is transitory or more sustained will not be known for several quarters, as we pass the most depressed months of the pandemic and as supply chains gradually return to normalcy. While the high inflation of the 1970s may be the feared worst-case outcome, it is possible we are entering a period in which inflation is higher than the experience of the past few decades but remains contained to an average of 2-4% annual growth over multiple years, a potentially negative but not catastrophic outcome for most investment assets. We expect the narratives on both sides of the inflation debate to rotate in and out of favor on any given day, often following gyrating price action in the equity and fixed income markets, as we pass through the summer months, with the argument remaining unsettled. The factors discussed above are not static and we expect that the issue of inflation, and it's causes and consequences, will be of increasing interest to investors.

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