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MACRO MUSINGS

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Should We Worry About Inflation?

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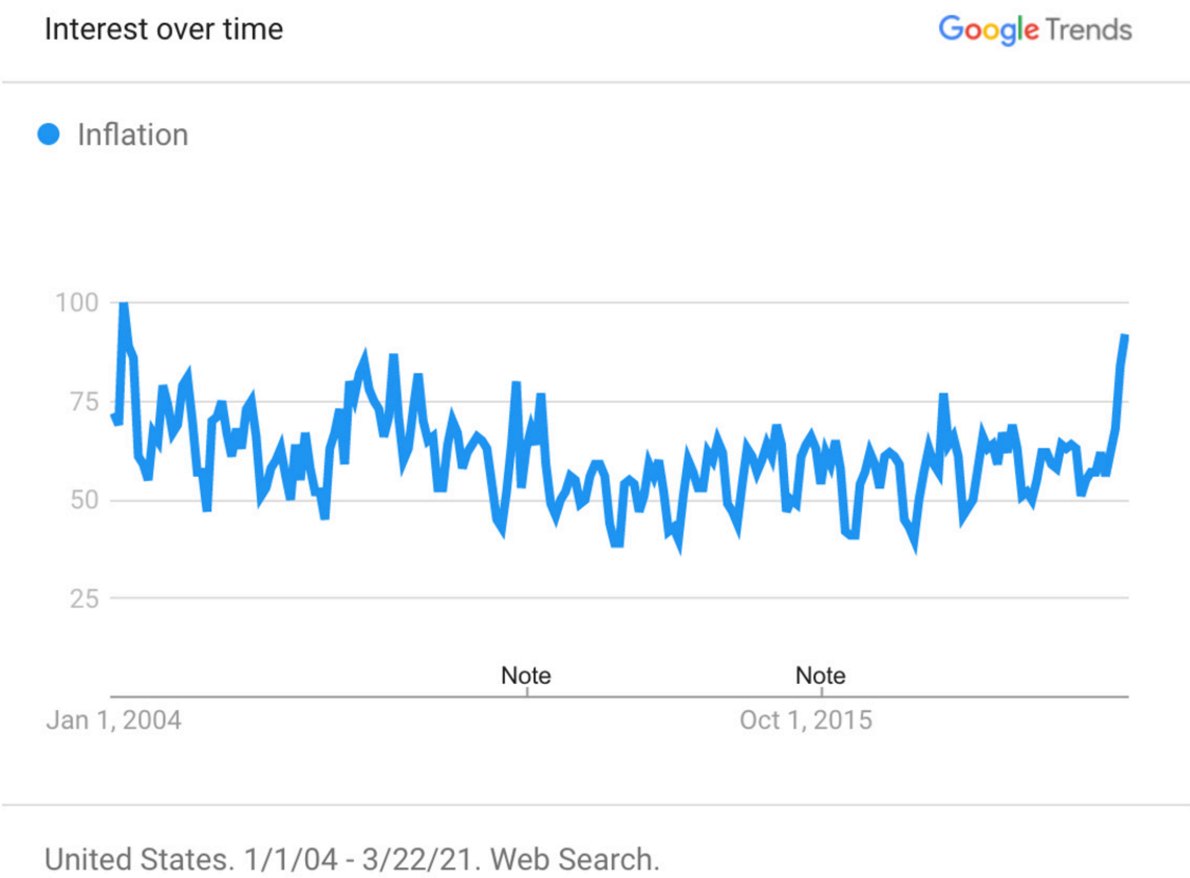
SUMMARY

- Inflation worries have been in the news lately, with some economists suggesting that the fiscal rescue package, mass vaccinations, and supply constraints will lead to a significant rise in prices. We share the Federal Reserve's view that any spike in inflation will be temporary.
- Even if inflation comes in higher than we anticipate, an analysis of historical stock market returns suggests that real economic growth is a more significant driver of equity returns than inflation. Years that saw strong economic growth saw strong market returns, regardless of inflationary conditions.
- Higher inflation expectations have also helped drive bond rates higher. While the speed of rising rates seems concerning, it is not all that different from the start of previous business cycles. In addition, there is little evidence to suggest that the current rise has negatively impacted financial conditions.

EVERYONE IS TALKING ABOUT **INFLATION**

The combination of a large fiscal rescue package, an accelerating vaccination campaign, pent-up demand, excess savings, and rising commodity prices has fueled concerns that we are entering a new regime of high inflation.

This message seems to be seeping into the public consciousness, with Google searches for "inflation" at multi-decade highs:



The key question debated amongst policymakers, and market participants is how much inflation will be "transitory" vs. "structural." The difference is crucial because if inflation rises but only temporarily, the Fed will remain accommodative for a longer period of time. Since last year, they have been adamant in their stance that they are willing to let inflation run a little hotter until jobs have fully recovered. If inflation is rising for structural reasons, then the Fed may not wait until 2023 to raise rates.

Identifying the difference can be difficult. How long can inflation rise before it is no longer transitory? This is a significant challenge for the Fed, as prices are expected to rise in the coming year.

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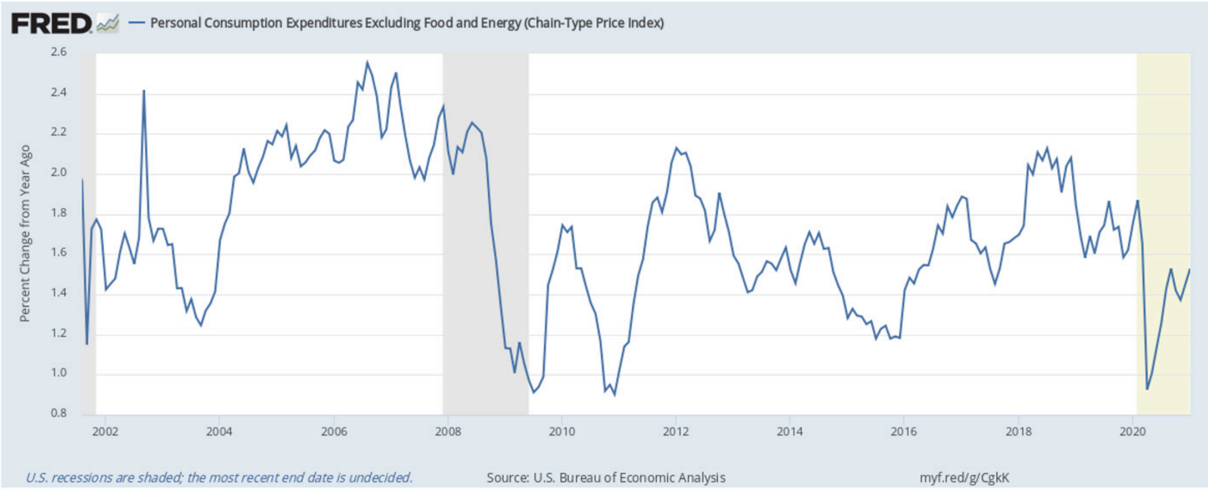
The Fed's preferred measure of inflation is the Personal Consumption Expenditure Excluding Food and Energy, or Core PCE for short. This statistic removes volatile categories like food and energy prices, which can obscure the trend in headline inflation. Core PCE is off the pandemic lows, but remains subdued:



Our view is that:

1. In the near term, we expect both headline and core inflation to rise over the next twelve months as the economy recovers.
2. The primary drivers of this pick-up are supply-side constraints across key sectors (like the shortage in semiconductors and shipping containers), easy year-over-year comparisons to last year's inflation levels (driven lower by the recession), and rising oil prices.
3. Longer-term, we believe the secular trends that have helped keep inflation in check over the past decade remain intact. Technological innovation, an aging population, globalization, and a strong, independent central bank are all deflationary forces that have helped keep inflation low.
4. For the market, economic growth appears to be a much more significant factor than the level of inflation (more on that below).

ECONOMIC GROWTH **MATTERS MORE THAN INFLATION**

An excellent study by the Leuthold Group implies that the market has historically been more sensitive to the rate of economic growth than changes in inflation.

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The following tables show that real GDP growth, not inflation, has been the primary determinant of average market returns and the frequency of negative annual performance:

Table 1
Average Annualized 1-year S&P 500 Total Returns by Real GDP Growth and Inflation Mixes

		Inflation				
		Super Low	Low	High	Super High	Weighted Average
Real Growth	Super High	20.10%	18.50%	14.50%	14.50%	17.22
	High	17.70%	18.60%	13.10%	12.20%	15.25
	Low	11.50%	16.50%	13.00%	14.90%	14.03
	Super Low	8.90%	-3.50%	8.40%	4.30%	4.36
	Weighted Average	14.95	12.47	12.66	10.54	

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Table 2
Frequency of a Negative Annual Total Return

		Inflation				
		Super Low	Low	High	Super High	Weighted Average
Real Growth	Super High	7%	0%	18%	9%	8.5%
	High	15%	0%	17%	31%	14.9%
	Low	24%	8%	13%	20%	14.8%
	Super Low	25%	63%	33%	48%	42.9%
	Weighted Average	11.4%	15.3%	13.2%	25.5%	

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When real growth was High or Super High (defined as 3.1% real GDP growth or higher), the market averaged double-digit returns regardless of the inflation level. The frequency of negative returns did increase with higher inflation, but most of the time, stocks were still positive even within the Super High inflation group (defined as annual inflation greater than 3.83%).

The groups showing weaker market performance correspond to the periods of lower economic growth. Average gains were lower across the board, and the frequency of negative returns increased when growth was in the Super Low bucket (Real GDP growth of 1.8% or less). The level of inflation did not matter that much.

For 2021, consensus estimates for GDP growth range above 6%, which places it in the Super High bucket, and inflation is projected to be in the Low bucket. Even when inflation ticked up to High, average returns were still excellent.

HIGHER RATES ARE TYPICAL DURING **NEW ECONOMIC CYCLES**

Worries over inflation are one reason for the rapid rise in the 10-year Treasury bond yield. Since reaching an all-time low of .51% in August, yields have climbed back above 1%, with 70% of the increase occurring in the past three months alone.

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The increase in yields has been fast, but this is not unusual in the early stages of a business cycle. In fact, yield curve "steepening" often occurs at the end of recessions (chart from macrotourist.com, recessions in red):

When viewed in this manner, the increase in the 2/10 yield curve is in-line with previous instances of yield curve steepening that have been observed in the early stages of a new business cycle.

When will higher rates become a problem for the economy? One way to gauge this is by looking at financial conditions. The Chicago Fed's National Financial Conditions Index (NFCI) looks at various credit indicators across the banking system, as well as stock, bond, and money markets. If rising rates pose a risk to liquidity, we can expect to see financial conditions deteriorate, indicated by a rise in the NFCI. When the NFCI heads lower, financial conditions are improving:

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Financial conditions have continued to improve, despite the increase in long-term bond yields over the past six months. The Fed is supporting the market with low short-term rates and bond purchases, which is a significant factor in keeping financial conditions loose. Unless conditions start to tighten, it is hard to say that rising rates are negatively impacting liquidity.

In summary, we don't view inflation as a long-term problem yet, and we believe any short-term rise in prices will be transitory and dwarfed by robust economic growth. The conditions present today—have proven to be a winner for the stock market historically. While a continued rise in rates may induce market volatility, it is nothing unusual. Our overall stance remains constructive.

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