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Second Quarter Outlook 2021

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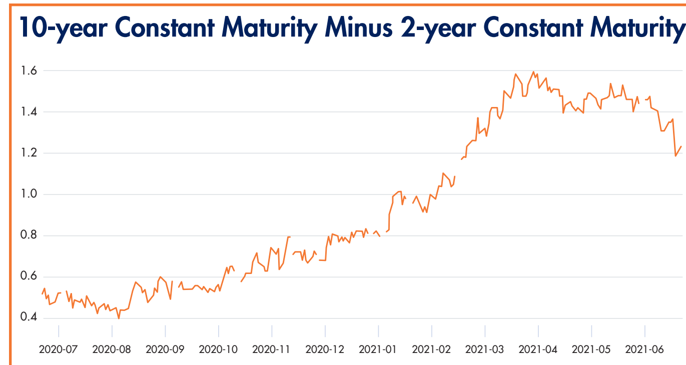
This Second Quarter Outlook will look at limited examples of either transitory or more sustained inflationary pressures that could result as the economy reopens.

Fed Reacts to Inflation Surprises

Little Confidence In Fed Inflation Forecasts Based on Past Record

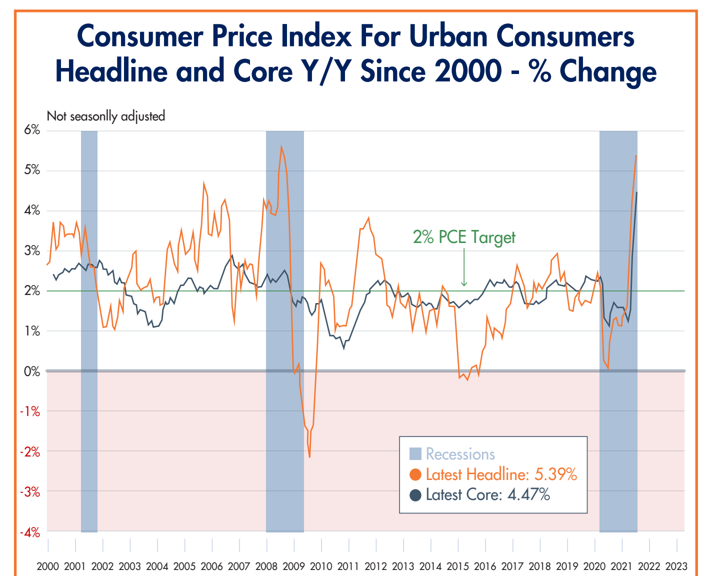
While still expecting inflation to be transitory, the Fed recently moved its timing forward for potential rate increases. This shift reflects concerns, based on recent data, for potentially higher than expected inflation. Last year, the Fed moved to its Flexible Average Inflation Target (FAIT) of 2%. The policy shift reflected the Fed's past inability to forecast future inflation. Those forecast errors led to proactive past policy mistakes. Based on the past record, there seems little reason to expect either the Fed or economists and financial markets to make more accurate future inflation forecasts. With that caveat, the resulting downward shift in the 10 YR/2 YR spread after the Fed's hawkish statement suggests fixed income investors also still expect future inflation to remain tame (see Figure 1.)



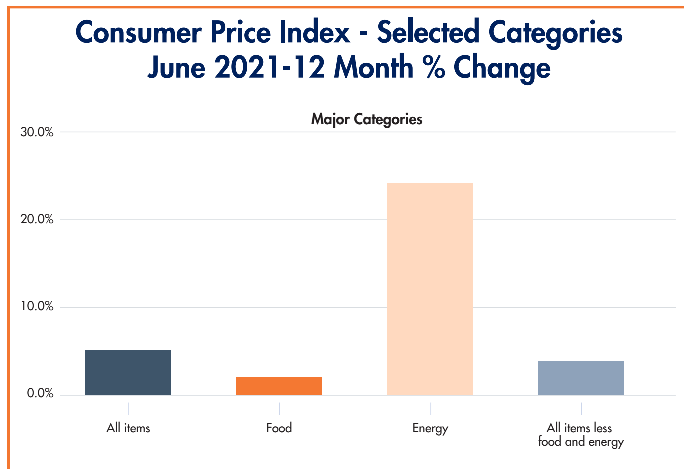
(FIGURE 1) Source: Federal Reserve Bank of St. Louis

Core CPI Understates Inflation Faced By Consumers

The Fed's "hawkish" move reflected the Consumer Price Core Index (CPI) upswing in May. The CPI upswing continued in June which – excluding food and energy – increased 4.5% over the last twelve months. In our view, that increase may understate the inflation that consumers actually face daily. Specifically, the CPI Headline Number which includes food and energy, increased faster – 5.4% – over the same period (see Figures 2 and 3.) This was the fastest rate since the 5.8% increase in August 2008.



(FIGURE 2) Source: Advisor Perspectives, U.S. Bureau Of Labor Statistics

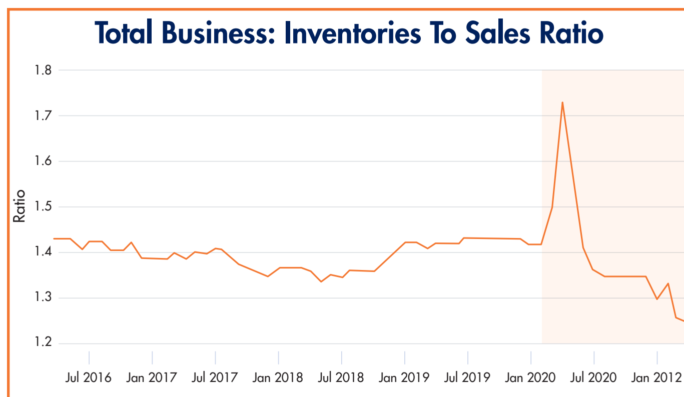


(FIGURE 3) Source: Advisor Perspectives, U.S. Bureau Of Labor Statistics

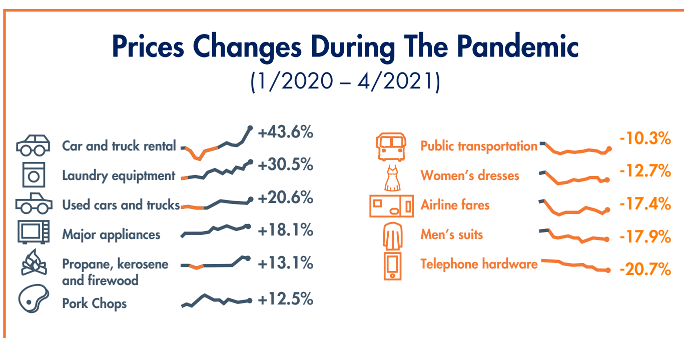
Consumer Price Index

Surprise Increase, Wild Price Swings, Transitory

With low inventory levels (see Figure 4) and the economy reopening, end demand shot up as consumers spent some of their salted away savings. Resulting upward price swings created a short but wild ride for some product prices (see Figure 5). Those will prove transitory.



(FIGURE 4) Source: U.S. Census Bureau

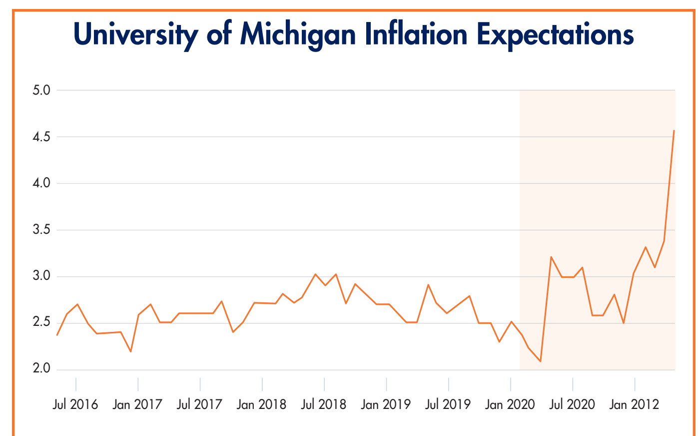


(FIGURE 5) Source: U.S. Bureau Of Labor Statistics, Axios

Increased Inflation Expectations

Medium Term

The sense of rising prices also produced a sharp increase for one year inflation expectations in the University of Michigan's Consumer Survey (see Figure 6). If faster price momentum continues, then increased inflation expectations will likely transfer to both higher corporate pricing decisions and workers' wage demands—both could prove more than transitory.



(FIGURE 6) Source: University of Michigan

Low Inventories

Expanded Suppliers List Results in Over-ordering, Transitory

As product demand shoots up, with current low inventories, producers will face shortages of parts and components to meet their requirements. Computer chips represent the headline example. As a result, producers will do what they normally do – over-order – by seeking out secondary and tertiary parts suppliers. Prices shoot up in response. This will prove transitory, with some lag. As an example, lumber prices declined sharply from their recent highs.

Fed's Transitory Inflation

Durable Goods Prices Pulling Back, Transitory

The Fed expects future inflationary increases, beyond its two percent average inflation target, will prove transitory. Its outlook rests on forecasts that the demand surge placed on barebone inventory levels coming out of the pandemic will ultimately be more than satisfied as inventories rebuild and then overbuild—timing uncertain. No doubt, prices will pull

back as peak goods demand recedes in response to higher prices. As the tide of spending on goods gradually recedes, those naked to transitory price increases will be exposed. Will prices eventually pull back to their prior levels or will they retain some or all of these increases? This will prove to be the true test for the Fed's transitory price outlook.

Over-ordering of Components

Results in Moderate GDP Growth Late Next Year, Medium Term

Probably sometime later this year or early next year, producers will likely reach the point of "over-stuffed" inventories relative to their needs. Cancelled orders will follow. Component and parts prices will drop sharply. This will likely show up sometime later this year or in early 2022. With excess inventories, end demand then will be met by drawing down inventories rather than from production. At the macro level, meeting end demand out of inventory rather than from production will likely moderate GDP growth later next year. At the micro level, particularly for high tech components that obsolete quickly, investors will likely see inventory write-downs beginning at year-end 2022.

Services, Influenced By Wages

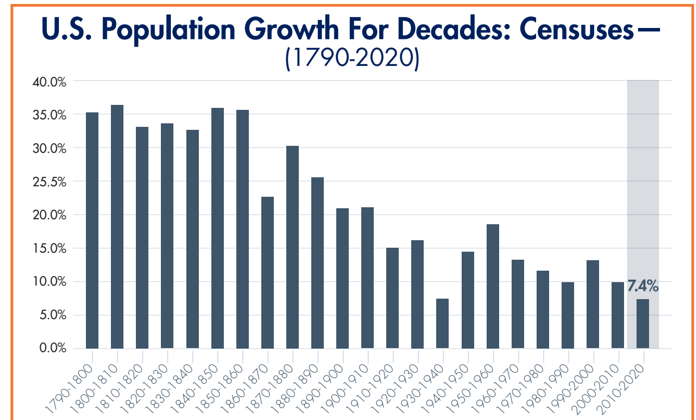
May Prove Important to Inflation Outlook Over the Next 18 Months

Services represent about two-thirds of GDP. With the service industry now opening up, pricing for this sector will likely prove more important, directly and indirectly, than durables to the inflation outlook over the next eighteen months. For many services, labor represents a much higher percentage of total costs than for manufacturing and industrials. Therefore, future service price movement will importantly reflect potential increased labor cost pressures—and more likely stickier than durables as wage increases also prove stickier.

Wages, Major Business Cost

Population Growth Slowing, Potential Cost Push Inflation, Long Term

Upward wage pressures may also result from diminished population growth facing this country – as well as many other major economies. The recent 2020 decennial census showed that the U.S. population grew 7.4% over the last decade; the second slowest growth rate ever, and roughly half the growth rate of the 1990s (see Figure 7.)

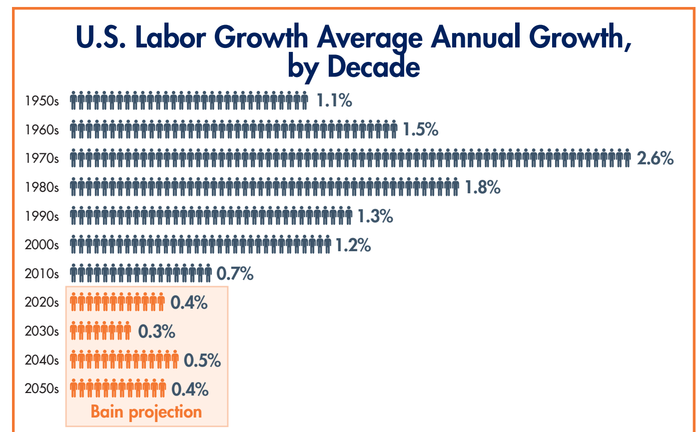


(FIGURE 7) Source: William H. Frey Analysis Of U.S.Dcecennial Censuses—1790-2020

Slowing Labor Force Growth

Leads to Substitution of Productivity Tools, Long-Term

Economic growth simplistically reflects work force growth plus productivity improvement. With slowing labor force growth (see Figure 8), unless productivity increases faster than in the recent past, economic growth will likely slow past the COVID recovery. Potentially offsetting these concerns will likely be the accelerated use of technology and productivity tools. That trend could eventually lead to future productivity improvement, thereby boosting economic growth.

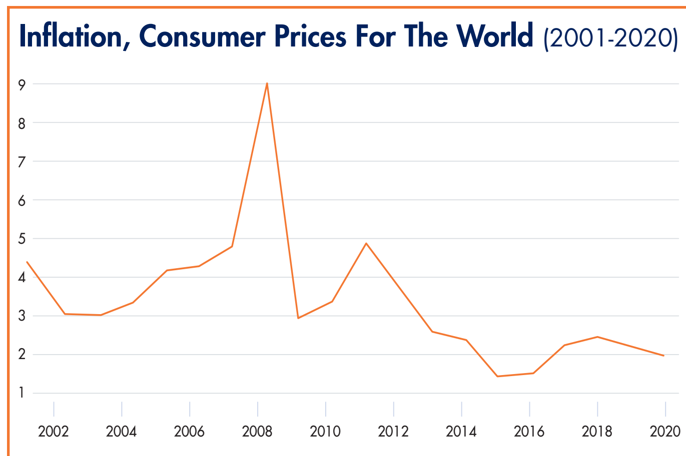


(FIGURE 8) Source: Bain & Company, Us Bureau Of Labor Statistcis, Us Census Bureau

Increased Regionalization of Supply Chains

Inflationary, Long Term

The World Trade Organization admitted China in 2001. Since then, China exported low-cost labor to the world in the form of products. That change brought down long-term global inflation rates (see Figure 9) as well as wages. As



(FIGURE 9) Source: World Bank

a result of supply chain problems experienced during the pandemic, at the margin, producers will likely regionalize supply chains. Increasing costs from that shift could lead to stepped up long-term inflation trends globally.

Investment Conclusions

Equities

By the end of this year, assuming inflation remains within expectations, production and demand will likely be in greater balance resulting in declining cyclical momentum. As economic momentum slows, equity markets may show increased volatility later this year as the economic outlook for the second half of 2022 may show less clarity. With that, investors will likely look more favorably toward growth stocks. As part of that transition, investors should look beyond those growth stocks that benefitted them in the last decade. New sources of growth including broadly med/health tech, will likely appear in the "New Century" post the pandemic as old sources of growth ebb.

Fixed Income

The Fed's most recent "hawkish" statements will likely lead it to speed up reducing its balance sheet and raising the funds rate. With that likelihood and an uncertain inflation outlook, investors should stick with shorter-term duration fixed income investments. This will avoid the price risks that longer-duration debt faces from potentially rising interest rates.

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The S&P 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value, the index is widely regarded as the best single gauge of large-cap U.S. equities.

The Russell 1000 Value Index measures the performance of those companies in the Russell 1000 Index with lower price-to-book ratios and lower forecasted growth values. The Index is calculated on a total return basis with dividends reinvested and is not assessed a management fee. It is not possible to invest directly in an index.

The Russell 2000 index is an index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

The Russell 2500 Index is a broad index, featuring 2,500 stocks that cover the small- and mid-cap market capitalizations. The Russell 2500 is a market cap-weighted index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities.

The MSCI World Index captures large and mid-cap representation across 23 Developed Markets (D.M.) countries. With 1,633 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the U.S. and Canada. With 920 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (E.M.) countries. With 1,125 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. An index is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance to certain asset classes. Indexes are unmanaged portfolios and investors cannot invest directly in an index. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Past performance is not a guarantee of future results.

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