Situation analysis

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Rising inflation unlikely to prompt Fed action for now

Today's Consumer Price Index (CPI) report led to higher interest rates and a slightly higher stock market opening, with the S&P 500 eclipsing the all-time high during the trading day as investors priced in economic growth acceleration and an ongoing economic reopening process. Supplies of many goods had fallen as a result of pandemic-related economic shutdowns, leading to imbalances and higher price levels. Economic activity exposes deficiencies, and price increases signal that demand is returning, leaving suppliers to fulfill the resultant output gap.

Challenges finding qualified workers and certain supply chain issues contributed to May's 4.9 percent year-over-year gain in headline consumer prices, the fastest pace of price growth since August 2008, when energy prices drove similar gains. Excluding the volatile food and energy sectors, core price inflation rose 3.8 percent, the largest gain since May 1992. Of note in this report, in addition to a 27.8 percent gain in energy prices, rental car costs doubled, used car prices jumped 29 percent and airfares soared 24 percent, reflecting individuals' increased mobility and confidence. A key question for investors is whether these large gains indicate prices will accelerate in coming quarters (what we would call **persistent** inflation) or if producers will respond to these signals by increasing output to meet the return of demand, resulting in so-called **transitory** inflation.

Transitory relative to persistent inflationary pressures are important to investors, especially in how they value future cash flows from stocks or bonds. When inflation proves to be persistent, we have historically seen investors demand higher interest rates to compensate for rising costs, which places downward pressure on bond prices. Also, investors typically pay less for one dollar of corporate earnings as interest rates rise, due to the cost pressures introduced by rising prices and rising bond yields becoming more enticing for investors relative to stocks. For the past 30 years, inflation has typically been transitory; year-over-year gains have been episodic and inflation pressures usually eased as demand fell in response to higher prices or output increased to meet rising demand.

We believe current inflation pressures are transitory for now, reflecting imbalances in supply and demand as the economy reopens. Airlines and car rental companies had cut flights, mothballed airplanes and cut rental car fleets due to the collapse in demand during the pandemic. Those companies have not yet increased fleets to meet the recent rebound in travel (U.S. airline passenger traffic is just 29 percent lower than 2019 levels after spending most of 2020 at less than half of 2019 levels). As we progress into full reopening and reach our expected steady state economy after the pandemic, we anticipate such price pressures will abate.

However, we must evaluate risks that could indicate inflation persistence. While it is not our base case, there is a risk that the combination of unprecedented and long-lasting fiscal and monetary stimulus will contribute to an uncomfortable rise in inflation beyond what we would consider transitory. One concern relates to the extraordinary measures the Federal Reserve (Fed) has taken to support the economic recovery, including near-zero interest rates and ongoing asset purchases. Additionally, significant government fiscal stimulus has led to high savings rates in the U.S. and abroad, and that accumulated savings could turn into expenditures as mobility increases. Additional fiscal stimulus in the form of a new infrastructure bill remains a possibility this year or next. Finally, labor markets have been strained with unfilled job openings, high unemployment and low labor force participation. These lead to concerns of rising wages, supply chain bottlenecks and growing demand due to easy money policies from the Fed and government stimulus. Policymakers' actions will be important in determining the nature of inflation in coming quarters. Additionally, we believe labor market issues are likely to near resolution as we reach a full reopening, and a physical return to school for many late this summer.

Next week's regularly scheduled Federal Reserve Open Market Committee meeting (June 15-16) will provide key clues to the Fed's reaction to recent data, although we do not anticipate a change in course this month. The Fed has maintained low interest rates and purchases of U.S. Treasury securities and government agency-backed mortgage bonds to support the economy through the pandemic. The Fed pledged to maintain these measures until we experience substantial improvement in employment and inflation exceeds its target for some time, and recent speeches indicate the Fed believes neither of these targets have been achieved. We anticipate the Fed will reduce asset purchases beginning in early 2022 and may not increase its policy rate until 2023 due to a focus on supporting the labor market recovery. This patient approach intends to prioritize the labor market recovery, while increasing the risk of higher inflation.

Our current investment positions reflect a modest preference for stocks relative to bonds, given our expectations for improving growth and inflation. We continue this emphasis, along with a preference for lower-quality bonds and other yield enhancement strategies in fixed income to moderate the pressures from rising interest rates in the face of rising growth and inflation. We believe these measures are sufficient for the current environment. Should we believe inflationary pressures may transition to a persistent state, we may look to additional strategies for portfolios, including an emphasis on real assets, such as commodities or real estate.

A consultation with your financial professional can help to identify the best strategies for your current situation. We will provide additional updates as conditions evolve, including a note after the Fed meeting on June 16.

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Past performance is no guarantee of future results. All performance data, while obtained from sources deemed to be reliable, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for direct investment. The S&P 500 Index consists of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general. The **Consumer Price Index** is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is one of the most frequently used statistics for identifying periods of inflation or deflation.

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