SPRINGTIDE

Market Note

The Inflation Watershed

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Aaron Dirlam, CFA®, CAIA®
Chief Investment Officer

Paul Courtney, CFA®, CAIA®
Director of Research

Summary

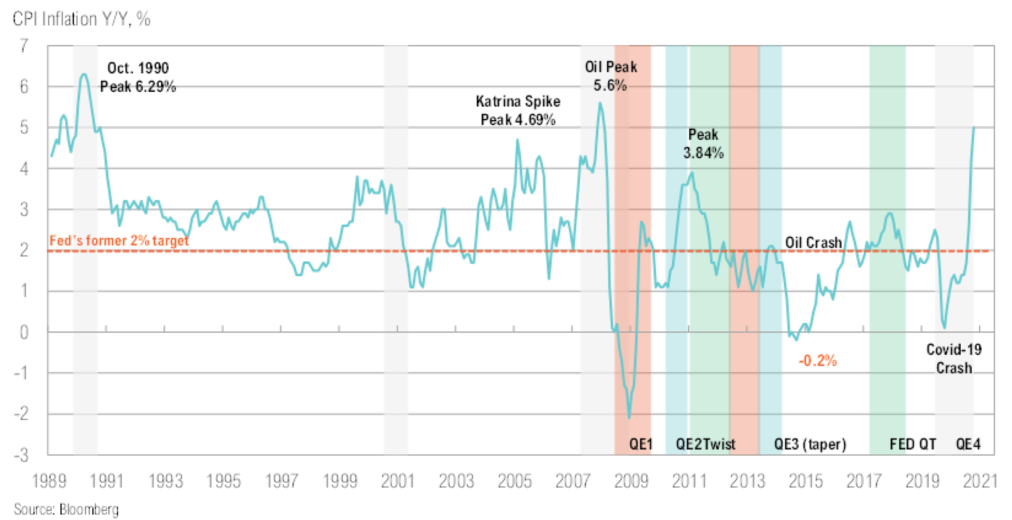
- For over a decade, the Fed has struggled to hit its internal inflation target despite responding to every episode of economic weakness with increasingly extreme and experimental monetary policy, including 0% interest rates and widescale asset purchases.
- Despite the Fed's previous challenges to generate higher inflation, we are now at a watershed moment in which inflation could materially increase and affect broader markets. Indeed, inflation has already moved past the Fed's former target of 2%.
- Inflation will not increase in a straight line. For example, in early 2021, inflation expectations and bond yields appeared to be rising in an unhealthy trajectory, but that movement has since stalled, a potential confirmation that the reflation is slowing.
- Taking a holistic view of government policy, market forces, and public opinion, we believe that inflation clearly poses a higher risk for investors than deflation in the coming years.

Economic Backdrop

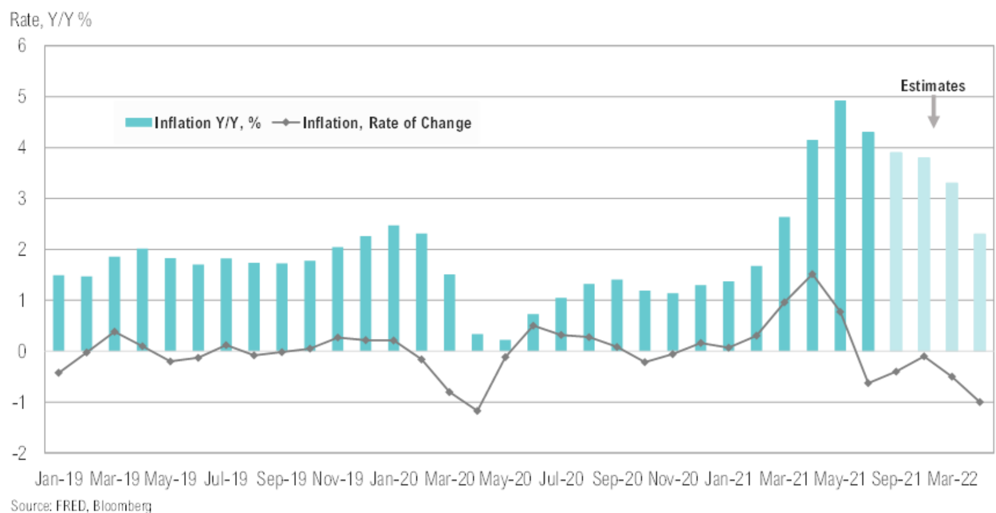
For over a decade, the Fed has struggled to hit its internal inflation target despite responding to episodes of economic weakness with increasingly extreme and experimental monetary policy, including 0% interest rates, quantitative easing (money printing), and even purchasing corporate and municipal bonds. Various monetary policy initiatives have pushed asset prices higher, incentivized higher aggregate debt levels, and created other imbalances, but they have not generated sustainable growth or persistent inflation. Even as the exact effects of specific policies are fiercely debated, it is clear in our analysis that, in aggregate, these efforts successfully boosted asset prices and economic growth while being implemented, but they hurt both asset prices and economic growth when they were withdrawn. Further, the past several rounds of these programs across multiple countries suggest that asset prices were increased only temporarily; the higher debt levels and other imbalances, however, persisted.

We believe the COVID-19 pandemic represents a watershed moment in terms of policymakers' willingness and ability to generate inflation. The severity of the crisis and economic devastation from the lockdowns have prompted monetary (the U.S. Federal Reserve) and fiscal policymakers (the U.S. Congress and the Department of Treasury) in concert to abandon any concerns of overheating markets and other imbalances. Together, they have embraced outcomes-based policies linked to full employment and higher inflation. As a result, quantitative easing programs in the form of massive asset purchases have doubled the size of the Fed's balance sheet from $4 trillion to over $8 trillion while Congress has generated a deficit equal to more than 15% of Gross Domestic Product (GDP).[1,2] The total public debt of the U.S. jumped by over 20% to 127% of GDP, and direct-to-consumer stimulus checks helped fuel a 25% increase in the money supply.[3,4] Combined with the swift vaccine rollout, this tidal wave of stimulus has led to a rapidly accelerating economy.[5] As economic slack has disappeared, inflation has

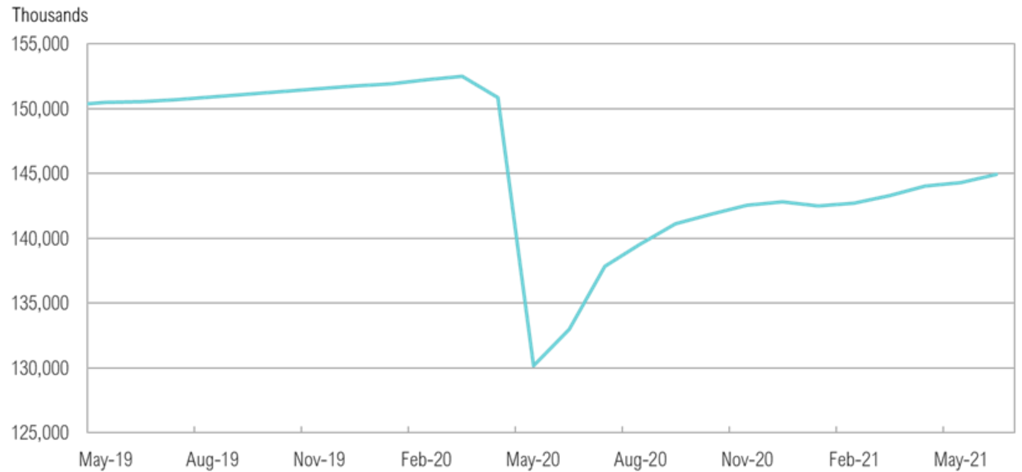
increased beyond the Fed's former inflation target of 2%, and the year-over-year change in headline and core Consumer Price Index (CPI) currently sit at 4.9% and 3.8%, respectively.[6]



Despite rising prices, policymakers appear willing to pursue expansionary policies long past what the current inflation readings would justify. We believe there are several reasons for this. First, policymakers have been unable to hit prior inflation targets consistently, a source of frustration and embarrassment. Several key current and former Federal Open Market Committee (FOMC) members, including Treasury Secretary Janet Yellen, have publicly stated they believe the Fed acted too quickly to withdraw support after prior downturns. This is a mistake they do not want to repeat.[7,8,9] The second reason is that despite higher prices, year-over-year inflation numbers have been skewed higher by the pandemic. This dynamic suggests that even if prices stay elevated, the widely quoted year-over-year rate of change will likely moderate in coming months, creating the perception that inflation is slowing down.

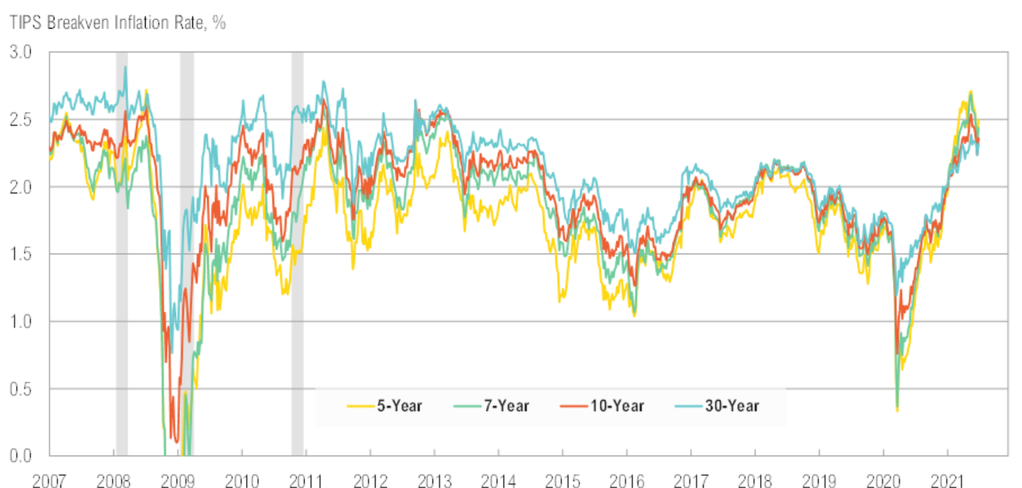


Furthermore, the labor market still has a long way to go to reach the Fed's stated goal of full employment. Based on the total nonfarm payroll employment reported by the Bureau of Labor Statistics, a little over five million jobs would need to be generated to reach pre-pandemic levels.[10] Even at the blistering, stimulus-boosted pace of the past six months—almost 350,000 net new jobs per month, on average—that milestone would still take well over a year to achieve. Earlier this year, the CBO forecasted the number of employed Americans (at 150MM in January) would not recover to pre-pandemic levels until 2024.[11]



The Case for Deflation

We are not expecting inflation to increase in a straight line. The transition to an inflationary environment will take time and will probably be volatile, especially considering that many of the deflationary forces that have been in place for several decades have not gone away. In early 2021, bond yields were rising in an unhealthy trajectory, but have since stalled, confirming that reflation is slowing. Further, market-implied inflation expectations—as proxied by Treasury breakeven inflation rates—have come down from their May highs. The five-year breakeven inflation rate has dropped from a local high on May 17 of 2.72% to 2.47% at the end of June while the ten-year breakeven inflation rate



ended June at 2.32%, down from 2.54% on May 17. Despite the declines, these numbers remain above the Fed's 2% inflation target and at their highest levels in eight years.[12]

Notably, inflation is a lagging indicator. Once its initial base effects have worn off, inflation typically bottoms several years after a recession, as was the case in 1982, 1991, 2001, and 2009.[13] Productivity generally rebounds substantially after bad recessions, which tends to hold down unit labor costs, as there are fewer workers and they need to work more efficiently. These factors could all be exacerbated by the unusual circumstances of the pandemic, which severely affected supply chains and allowed higher cost producers to gain market share. As supply chains heal, however, lower cost producers will again take market share, which will likely put additional pressure on pricing. Technological advances that have sought to address the severe economic and social disruptions of the pandemic, such as replacing people with artificial intelligence tools, improvements in work from home accommodations, and evolving mobile applications, are also likely to be severely deflationary.

In short, the pandemic accelerated some of the most powerful structural deflationary forces of the past few decades, namely higher government debt levels and substantially increased use of technology. These factors are arguably more deflationary today than they have ever been. If everything else were equal, we would expect lower inflation in the coming years and lower interest rates, too. But all else is not equal.

The Case for Inflation

Even with the powerful counteracting forces at play, we continue to believe that inflation poses more of a risk to investors than deflation does. This view hinges on our belief that policymakers will continue to err on the side of further expansionary policies, funded with quantitative easing. Unlike before the pandemic, when stimulus lifted asset prices but did little for the real economy, these policies will likely include direct-to-consumer stimulus, which effectively pump printed money into the economy.

Recent comments from both the Fed and Treasury corroborate this view. In a recent press release following the G7 finance ministers meeting in London, Treasury Secretary Janet Yellen made her case for President Biden's then $4 trillion fiscal spending proposal:

> *"If we ended up with a slightly higher interest rate environment, it would actually be a plus for society's point of view and the Fed's point of view… we've been fighting inflation that's too low and interest rates that are too low now for a decade."*

Comments from Powell after the June FOMC meeting suggested the Fed was more attuned to higher inflation than Treasury, but at the soonest, they indicated a potential rate hike eighteen months from now with no specifics on when and how quantitative easing would slow or end. In terms of the Fed's thought process regarding inflation, Powell quipped, "You can think of this meeting that we had as the 'talking about talking about' meeting." (CNBC) He was jokingly referring back to his June 2020 comments in which he claimed that the Fed was not yet even "thinking about thinking about raising rates." In other words, times had changed!

On June 22, 2021, Powell reaffirmed the Fed's interest in future expansionary policies and explained the range of metrics they would use to determine when to increase rates:

“We will not raise interest rates preemptively because we fear the possible onset of inflation. We will wait for evidence of actual inflation or other imbalances… [W]e will not just look at the headline numbers for unemployment… [W]e will look at all kinds of measures.”

Finally, public sentiment has recently become pro-stimulus. Current polls indicate that almost twice as many Americans now support increased spending plans, especially on infrastructure, than those who oppose new spending.

Public Sentiment Shows Continued Support for Further Stimulus
Stimulus Sentiment Polling Results, *May-20 – May-21*

Date	Poll Name	Favor Additional Stimulus (%)	Oppose (%)	No Opinion/ Neutral (%)
3-May-2021	Morning Consult + Politico*	91	4	5
8-Mar-2021	Morning Consult + Politico	75	18	7
3-Mar-2021	Monmouth Poll**	81	14	5
1-Mar-2021	Pew Research	70	28	2
23-Feb-2021	Small Business for America's Future	76	24	0
19-Feb-2021	Morning Consult + Politico	76	17	7
3-Feb-2021	Quinnipiac Poll	78	18	4
1-Feb-2021	Yahoo News	74	13	13
22-Jan-2021	Reuters Poll of Economists	90	10	0
21-Dec-2020	Civic Science	78	16	6
1-Oct-2020	Civic Science	74	12	14
1-May-2020	Civic Science	59	20	21

* Question referenced stimulating the economy to recover from coronavirus pandemic.
** Question referenced stimulus checks at or above $1,400.

Further, the number who favor additional stimulus appears to be increasing, compared to last year’s surveys. For instance, a recent poll by Morning Consult and Politico found that 91% of respondents favored additional stimulus to help the economy “recover from the coronavirus pandemic.” That’s higher than it was before any states had reopened or vaccinations had begun. Even as pandemic conditions have improved, the public has become more interested in further stimulus, not less. We believe that this increased public appetite is causing policymakers to view additional monetary and fiscal support as their implied mandate.

Looking Forward

The opinion of the majority of Americans, the explicit policy of the Fed and Treasury, and recent actions by policymakers suggest a bias towards further stimulus in the years ahead. Despite rising inflation and a rapid economic acceleration, the Fed has kept interest rates at zero and is now maintaining one of the most aggressive paces of quantitative easing in history. To the extent QE may never be unwound, which we believe is a reasonable assumption, this represents the monetization of deficit spending. Further, some of this deficit spending will likely be in the form of direct-to-consumer stimulus. Whether that stimulus occurs now or after another interlude of economic weakness, policymakers will likely opt to print money in an attempt to spur growth, one way or another. Bringing all of these underlying factors together, we believe that inflation will be a significant risk for investors over the coming years.

Sincerely,

The SpringTide Investment Team

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Citations

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