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Inflation: How Hot is Too Hot?

Bruce Simon, CFA, CWPA®, Partner & Director of Research

Financial markets have been rattled in recent weeks by meaningful price hikes in many goods and services. The year-over-year increase in the Consumer Price Index was 4.2% in April, a 13-year high and reflective of the sharp price increases that are cascading through various parts of the US economy. Economists and market strategists are debating whether the increases represent a temporary (i.e. a few quarters) or semi-permanent (multi-year) phenomenon. Investor uncertainty has been magnified by the large variances between economic forecasts and actual results, such as April's surprising employment report (which missed projections by about 750,000 jobs). Although the Fed has encouraged a rise in inflation by its efforts to stimulate the economy, have they gone too far?

Although the forces impacting future inflation are multiple, conflicting, and complex, **we believe the weight of the evidence argues for a temporary spike in inflation rather than a return to the high inflation decades of the 1970's and 1980's.**

Here are some of the most important factors pushing up prices in the short-term:

- **Base effects:** The high year-over-year comparisons of prices due to the depressed state of the economy one year ago produces large headline increases in inflation. A better measure is to track inflation over a two-year timeframe, which reflects the trend toward higher prices without the eye-popping annual increases.
- **Supplier constraints:** The sharp economic recovery caught many suppliers unprepared to deal with a big spike in demand. Most notable are the increase in lumber prices as a result of limited sawmill activity and a shortage of new cars and household appliances caused by a lack of semiconductor capacity. These constraints will dissipate over time as producers expand volumes to meet this demand, although some industries may take years to catch up.
- **Fiscal stimulus:** The $5.3 trillion stimulus passed by Congress in the last year has undoubtedly boosted spending and improved consumer balance sheets. With the $300/week in additional unemployment benefits set to expire in September (and some states cutting it off earlier), we expect this boost to spending to soon diminish. In the meantime, cash-rich consumers are anxious to reinstitute long-delayed vacation plans, boosting prices for airline tickets, hotels, and rental cars.

Some of the factors behind the recent uptick in inflation are likely to be more persistent. Employers have been raising wages in order to attract workers back into the workforce (so far, with limited success as judged by April's disappointing employment report). Wage hikes are difficult to unwind once enacted but may be necessary to reduce chronic shortages in lower-paid jobs (such as restaurant workers) that can't meet growing demand. Additional stimulus being contemplated in Washington may further stoke demand and raise prices. New work-from-home opportunities have resulted in a shift from big cities to suburban locations, with attendant changes in buying behavior (e.g. more cars, appliances, and home improvement projects) that are likely to persist as the pandemic subsides.

Despite the growing evidence of high price increases across many parts of the economy, the bond market remains relatively unfazed. After a sharp rise earlier in the year, the bellwether 10-year US treasury bond yield has fluctuated in a narrow range between 1.55% and 1.75% for the last two months. Expectation as to the Fed's plans for future rate hikes have not wavered, indicating that most investors are inclined to agree with the Fed's view that the spike in inflation will soon pass.

Arguably the most important factor in driving inflation may in fact be a change in *inflation expectations,* which causes buyers to accelerate purchases to avoid future prices increases, thus creating a self-fulfilling prophecy. It took decades for the US economy to overcome the perception of future high inflation after the Fed aggressively raised rates in the early 1980's to choke off the inflationary spiral.

We believe the forces of deflation (e.g., low labor force growth, an aging population, and improved productivity through technological innovation) will ultimately be the key determinants of inflation in the longer run. In the meantime, however, the forces propelling higher prices are likely to be with us, at least until the post-pandemic economic boom dissipates. Our expectation is that headline inflation may run at 4% or higher over the next several months, but return to a range of 2-2.5% in 2022, a level the economy and capital markets can easily handle.

Bruce D. Simon, CFA, CPWA®, Partner and Director of Research

Bruce is a Partner and Director of Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.