Market Trends & Analysis

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New York Life Investments

Our multi-boutique business model is built on the foundation of a long and stable history, which gives our clients proven performance managing risk through multiple economic cycles. With capabilities across virtually all asset classes, market segments, and geographies, our family of specialized, independent boutiques and investment teams allows us to deliver customized strategies and integrated solutions for every client need.

Our investment managers offer deep domain expertise and diversity of thought generating deeper insights alongside strong conviction to deliver better outcomes. Our global capabilities combined with local presence drives more nuanced perspective and a more personal experience for our clients.

Markets respond as inflationary pressures build

Inflationary pressures are building as the economic recovery gains traction—and the markets are responding. On one hand, this is a normal part of a healthy economic cycle: production declines during downturns, only to face periods of scarcity as demand begins to rebuild. On the other hand, the COVID-19 cycle has been unprecedented in many ways, raising an important question for investors: *Could inflationary pressures be here to stay?*

After more than a decade of persistently weak inflation, stronger inflationary pressures could have a variety of important implications. Higher inflation could influence monetary policy globally. Less monetary accommodation would contribute to higher interest rates, impacting borrowing costs as well as the tradeoff between stocks and bonds. In the long term, inflation also acts as a tax on wealth and investment returns. Investor sentiment and positioning could shift.

We offer clients access to specialized, independent investment teams through our family of affiliated boutiques—and remain committed by providing a combination of diverse perspectives and a long-lasting focus on sustainable relationships.

Given these inflationary concerns and the investment implications, we asked our seasoned experts from several of our boutique investment firms to provide some perspective by sharing their insights on the market.

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MacKay Shields
Global Fixed Income Team

CPI surges in April, but limited implications for the long term

For some time now, we have been expecting a move higher in inflation readings as post-vaccine consumer demand exceeds recovery in productive capacity. While ahead of expectations, April's Consumer Price Index (CPI) print remains consistent with this view, with much of the price pressure occurring in a handful of categories experiencing these supply-demand imbalances, including labor shortages.

The April CPI print does not change our view that while we are likely to experience inflation that is higher than the prior expansion, it will still average only moderately above the Federal Reserve's two percent objective. As previously noted, an important driver is the impact of current supply constraints, which should resolve over the next six to twelve months—leading to some cooling of inflation pressures. Further, the longer-term determinants of inflation, including the policy setting, suggest only moderate price pressures thereafter.

Our medium-term inflation outlook is also informed by our understanding of the Federal Reserve's reaction function. Policymakers have signaled comfort with inflation running above their two percent objective as they seek a labor market operating at maximum employment. But their inflation tolerance has its limits. Specifically, we doubt that Chair Powell and most other Committee members would be comfortable with Core Personal Consumption Expenditures (PCE) inflation rising above 2.5 percent on a sustained basis, especially if such a move were accompanied by a rise in long-term inflation expectations. In this event, we would expect the Federal Open Market Committee (FOMC) to raise rates a bit more quickly than currently anticipated. Thus, to our thinking, the main risk to the outlook is not an inflationary spiral, but tighter monetary policy that would increase the probability of a recession in the years ahead.[1]

Having reflected our base case views, we also recognize a heightened degree of uncertainty above the inflation outlook. This stems from a confluence of factors, namely, an economy and labor force that are likely to have been reshaped by the pandemic in ways that are still not fully understood; a central bank that is willing to accept higher inflation in exchange for a strong labor market; and expansionary fiscal policy that will also reallocate resources towards lower- and middle-income households. As such, we will be closely monitoring the following in the period ahead:

- **Inflation expectations.** We remain attuned to any evidence that recent price increases are influencing consumption patterns, wage bargaining, and the willingness of firms to pass along higher input costs to consumers.
- **Federal Reserve leadership.** Powell's term as Chair of the Board of Governors of the Federal Reserve expires next February, and it remains to be seen if President Biden will reappoint him. If not, Biden could appoint a more dovish successor given the administration's policy agenda.
- **Fiscal policy.** The administration has proposed over $4 trillion of additional spending on infrastructure, improvements to the social safety net, and various family support programs in areas such as child care, education, and tax credits. While we ultimately expect a smaller spending package to emerge, it will still provide additional stimulus to the economy as it will only be partially financed through higher taxes.

- **Productivity growth.** The pandemic forced firms to consider novel ways to maintain their operations with less labor. Along the way, firms stepped up their technology investments. We view these productivity gains as disinflationary. Work from home also represents a disinflationary force, since it allows firms in many sectors to access a wider source of labor while also lowering real estate costs. If the pandemic serves as an enduring jolt to business processes, the resulting productivity gains would limit the potential for sustained inflation in the years ahead.

The months ahead are likely to see continued elevated and volatile inflation prints as consumer demand remains strong and supply shortages persist. But supply constraints should largely resolve by this time next year, taking some of the pressure off prices—especially as consumer spending will cool off from its current blistering pace. Still, a tightening labor market and accommodative monetary and fiscal policy will eventually set the stage for somewhat brisk consumer price inflation in the years ahead.

CBRE Clarion Securities

Infrastructure and inflation

Inflation has been contained over the last 25 years in the U.S., but the recent spike in the CPI is challenging investors' view that inflation will remain tame in the medium term. There is a case to be made around base effects, but due to several factors, principally easy monetary policy across the world, future inflation is a more relevant risk today than it has been for a long time. While sustained inflationary pressures are not our base case, today's extraordinary macroeconomic environment suggests investors should consider some inflation protection in their portfolios.

One of the investment benefits of infrastructure is that it can serve as a hedge against rising inflation. Over 90% of infrastructure assets in our universe have explicit or implicit mechanisms to pass inflation on to the end-user. However, passively investing in the asset class does not guarantee a hedge to inflation, and significant qualitative assessment is still required. The degree of inflation protection depends on several factors, and investors should look to address the following questions:

- **Regulatory regime:** Is the link to inflation explicit? What is the time lag between actual and recovered inflation?
- **Competitors and contract structures:** If not regulated, how monopolistic is the asset to ensure pricing power? Do the contracts allow for inflation-linked revenues or have fixed escalators? Can the asset be substituted with a competing asset?
- **Variable costs:** Are the revenue increases eroded by increases in operating costs like labor or fuel? Are interest costs fixed or variable, and what is the duration of the debt?

We separate our assessment of the fundamental impact on the assets and companies, and then the performance of the asset class aspects.

Fundamental impacts

Revenue

- Majority of infrastructure companies have some top-line inflationary protection. This is typically the result of a pricing or revenue mechanism tied to inflation—either explicitly through CPI-linked cash flow streams, fixed annual escalators, or regulatory mechanisms that account for inflationary impacts over a predefined regulatory period.
- Regulated utilities are allowed to charge their customers and earn revenues over a predefined cost basis which incorporates inflationary impacts in their cost structure. However, there is often a lag in capturing the inflation. Such a revenue model benefits when inflation and interest rates rise because the allowed regulated return resets higher to compensate for a higher weighted average cost of capital.
- Fixed escalator contracts face some risk from inflation if costs are escalating faster than the top-line, which would begin to squeeze operating margins.
- Companies with more GDP sensitivity (e.g., transportation) should enjoy more top-line appreciation from an improving macroeconomic environment. Stagflation would be the largest risk to such business models, whereby economic growth proves inferior to inflationary forces.

Operating costs

- Inflation may lead to higher operating costs, and labor can be a particular concern.
- Many companies, given their large scale, have the ability to offset such cost increases through operating efficiencies—which we believe serves to deter the negative impacts of inflation.
- Companies with long-dated liabilities may benefit from an offsetting pension liability reduction that can help annual pension funding needs.

Borrowing costs

- An inflationary environment tends to align with a period of rising interest rates. This can have a direct impact on the earnings power of all companies employing the use of leverage. As capital-intensive businesses, such rate increases can cause a negative drag on profitability as interest expenses rise.
- Listed infrastructure companies utilize most fixed-rate debt with long-dated maturities. Hence, the near-term effect is negligible and would not impact earnings. This is a benefit as the lag in the inflation capture will likely arrive prior to the increased financial costs.
- In some regulated models, rising debt costs are simply a pass-through to the users and have no material impact.

Performance impacts

- A rising inflationary environment can potentially have near-term negative valuation impacts on listed infrastructure, as well as equities more broadly. Assuming an inflationary environment that leads to rising rates, there will tend to be a negative net present value effect to the discounting of cash flow streams.
- While infrastructure is not low growth and has some upside revenue capture in inflationary environments, the immediate impact of rising rates tends to have a more immediate, negative effect on valuations until the fundamental implications are more well understood.
- In fact, infrastructure has been underperforming since August 2020, when inflation expectations and interest rates increased.

Several types of listed infrastructure that may benefit from inflation-linked revenues

Infrastructure revenue model	Sub-sectors	Inflation link
REGULATED	■ Electric ■ Gas ■ Water ■ Long-haul pipelines	**Implicit** ■ Lagged ■ Cost pass-through ■ Returns rise with interest rates
DEMAND-DRIVEN (COMPETITIVE)	■ Toll roads ■ Airports ■ Passenger railroad ■ Ports ■ Midstream	**Varies** ■ Built into toll increases ■ Regulated portion of airports benefit pass-on costs ■ Other assets benefit from rising GDP activity
DEMAND-DRIVEN (MONOPOLISTIC)	■ Freight railroad	**Implicit** ■ Lack of competition ■ Substitutes leads to pricing power
CONTRACTED	■ Towers ■ Data centers	**Explicit** ■ Escalators built into contracts
	■ Renewable generation	**None** ■ Typically fixed contracts

Source: CBRE Clarion Securities, 2021.

In summary, listed infrastructure benefits from inflation-linked revenues, which may provide a long-term hedge against inflation and rising interest rates. Investors seeking inflation protection should consider an allocation, and importantly a manager who can actively position a portfolio in an inflationary environment.

CANDRIAM

Strong economic recovery and loose monetary/fiscal policies bring inflation back into the spotlight

In the short run, there are many reasons for tensions to persist: higher commodity prices, surging shipping costs, bottlenecks in some industries (semiconductors in particular), depleted inventories, but also price increases in the service sector due to the reopening of economies. All these factors have combined to push prices higher: producer prices, as well as consumer prices, have significantly accelerated in many countries in April. Moreover, the Purchasing Managers' Index (PMI) surveys are generally pointing to higher input prices and lengthening supplier delivery times—signaling that inflationary pressures are likely to persist for some time.

Given our current expectations of mild inflation, and higher but low real interest rates, we remain overall overweight equities. Contrary to bonds, equities have historically performed the best in a (mild) inflationary scenario.

However, this phase could reasonably be regarded as temporary (i.e., lasting a couple more months) as supply adjusts to the reopening and inventories are rebuilt. This might take a bit more time than expected as global supply chain disruptions have been significant. But most central banks are likely to remain patient before removing accommodation, looking through the transitory surge of prices as activity is gathering momentum. Indeed, most economies are far from full employment. Despite the rebound in activity, around ten million jobs were still missing in the U.S. in April 2021, and the euro area was even further away from its pre-crisis employment rate. While we continue to believe central banks will avoid premature tightening, the nervousness of market participants is understandable and inflation scares are likely to stay with us for some time. Especially since some central banks might see merit in having a bit higher inflation than before the pandemic. Didn't the Federal Reserve vow to tolerate a period of above-target price rises? All those betting on a permanent surge in inflation, however, are likely to be disappointed: if the economy were to get too hot, central banks are not short of tools to calm down tensions.

Given our current expectations of mild inflation, and higher but low real interest rates, we remain overall overweight equities. Contrary to bonds, equities have historically performed the best in a (mild) inflationary scenario. Even if equities' price-to-earnings (P/E) tends to deflate as rates increase, sensitivity to revisions in the growth momentum is even more important. Moreover, some corporates manage to pass on higher costs to consumers, which limits the impact on earnings. On the opposite side, we maintain a shorter duration and underweight bonds in such an environment. The returns offered by these long-dated securities become less attractive as they may no longer compensate for inflation.

Going one step further, we expect cyclicals and value stocks to do best during the inflationary and rates appreciation period as they have tended to be positively correlated to rising rates. This transition has already supported a sectorial rotation towards value and cyclical sectors, which is still at play. Hence, our strategy is geared towards stocks leveraged to the recovery, a steepening of the yield curve, and rising commodity prices. More specifically, we are buying small- and mid-caps in the U.S., the United Kingdom, and Latin America. Further, we have a positive stance on U.S. and Economic and Monetary Union banks, which we believe have the potential to benefit the most from the expected yield curve steepening.

Epoch Investment Partners

America's risky economic experiment: Will the inflation genie escape from the bottle?

While the aspirations of Bidenomics are laudable, the ambitious policy framework features historic levels of fiscal stimulus and a novel approach to monetary policy that is alarmingly tolerant of inflation. These plans have been described by Larry Summers of Harvard as "the least responsible economic policy in 40 years." The iconoclastic professor has also emphasized, "If inflation expectations are allowed to ratchet up—which certainly appears to be a possibility—the costs, both economically and politically, could be very high."

Many commentators, including Professor Summers, have compared the current situation to "The Great Inflation" of 1965-1982. From our analysis, we characterize that period as having four key features:

1. Complacency, which followed a long period of benign inflation (1953-65)

2. Fed prioritized employment over inflation

3. Accelerated government spending (from 1964)

4. Supply shocks (energy crises of 1973 & 1979)

How valid is "The Great Inflation" as a qualitative analogy to today? While we can probably check off the first three boxes without too much debate, the fourth is trickier. Although there are certainly some supply-side issues today (e.g., semiconductors, lumber), these are likely to be transitory and are not quantitatively in the same league as the twin oil shocks of the 1970s.

It is also worth emphasizing that "The Great Inflation" didn't take off quickly, in the span of a few quarters or even a few years. It took an extended period, requiring multiple catalysts and numerous policy errors. Consequently, we believe a better historical analogy for today is provided by the early 1950s. U.S. GDP growth soared in 1950 and 1951 when Korean War spending ramped up, leading to a transitory burst of inflation. However, by early 1952, spending had normalized and with it, so did economic growth and inflationary pressures.

Consequently, our base case view is relatively benign, although it is certainly possible that the rise in inflation proves longer lasting than we currently envision. In fact, market pricing suggests a 40% probability that the CPI exceeds 3% over the next five years. This could happen if we begin to see inflation expectations becoming embedded into wages, which can lead to a vicious cycle entangling consumer prices and labor costs.

What would such a scenario imply for investors? To answer this question, we have analyzed the relationship between breakeven inflation rates and equity market performance. As inflation expectations start to rise, particularly for short-term break evens, the evidence suggests investors view a little inflation as good news for the cyclical growth outlook. Consistent with that, outperforming sectors have historically included financials, materials, and energy, with value having tended to do better than growth. However, if expectations keep rising and we see 10-year breakevens also creep up toward 3%, then things have usually turned pear-shaped, as almost all sectors exhibited negative returns.

Given this risk, which is especially pronounced for long-duration equities, what should investors do? Epoch has always believed in focusing on companies that:

a) have an ability to produce free cash flow on a sustainable basis; and

b) possess superior management with a proven track record of allocating capital wisely—including investing today for future value creation.

We are confident these companies are the most probable winners and the ones most likely to provide investors with the best returns. In today's challenging investment environment, with heightened concerns about the inflation trajectory, we believe these principles are ever more important.

NYL Investors

Crossroads?

As vaccinations and economic re-openings accelerate, 2021 will likely be viewed as the crossroads of the global pandemic and the start of a return to "normalcy." But when we think about the implications the pandemic has had on the economy and the impact of historic monetary and fiscal policy, will 2021 also be viewed as the crossroads for inflation? Undoubtedly, this is the most important question for financial markets this year, and the answer will have far-reaching consequences for investors.

Recent economic releases and anecdotal evidence from company earnings reports indicate inflationary pressures are upon us, but what is not certain is how transitory or persistent this pressure will be. Therein lies the key question for the Federal Reserve, which has gone to great lengths to communicate to the market that, yes, inflation is here, but once bottleneck issues are resolved and base effects from pandemic levels normalize, they expect these pressures to ease.

We doubt the recent CPI release will alter the Fed's current stance and view that near-term inflation pressures will be transitory. Much of the run-up in prices was concentrated around the reopening theme and some supply shortage driven pressures.

Consequently, the Fed continues to espouse the validity of its monetary policy and has succeeded, so far, in convincing the market their over accommodative policy is here to stay. That's not to say the market has not challenged the Fed, as evidenced by the 80-basis point move higher in 10-year notes in the first quarter. Markets have been and always will be forward-looking, and this rate move is a direct result of expected inflationary pressures. It is our view, these rate moves higher will persist, but likely in a gradual fashion, as the Fed will most likely over-communicate policy shifts to mitigate sudden moves higher.

When thinking about asset allocation in a rising rate environment, especially after several years of ever lower rates, investors need to focus on what type of fixed-income products will help achieve their objective. Duration, or the sensitivity of fixed-income securities to changes in interest rates, is more important than ever to monitor. After multiple years of attractive total returns across the fixed-income landscape, the first quarter served as a reminder that fixed-income assets are not without risk, as the Bloomberg Barclays U.S. Aggregate Bond Index returned -3.37%. To be clear, this return was driven by the index's sensitivity to interest rates, not from deterioration of credit spreads. Compare this to the return of -0.07% for the 1-3 year aggregate benchmark, and one starts to remember how impactful duration can be to fixed-income portfolios.

Ultra-short and short-term funds can help clients mitigate interest rate risk while staying invested and potentially generating returns well above extremely suppressed money market yields. With duration profiles materially lower than typical intermediate fixed-income funds, these strategies are an important tool for investors to utilize as they navigate the shifting inflation and interest rate landscape.

Multi-Asset Solutions Team

Asset allocation approach to managing inflation risk

To weigh the impacts of inflation on portfolios, investors must consider: Is inflation here to stay?

In the next 12 months, we expect base effects and transitory factors, such as supply chain constraints and higher energy costs, to drive inflation volatility. Volatility in rates and equities is likely to follow. That said, there is a difference between today's shortages and an overheating economy. It takes time to refill job openings and to get idle workers to where new jobs are being created; but unless we expect a shortage of production capacity in the economy, supply-demand imbalances will correct in the next few quarters. Monetary policy need not over-correct in the meantime.

Looking to the longer term, we believe that a sustained shift higher in inflation seems unlikely. Some disinflationary forces, such as labor cost arbitrage and the globalization of supply chains, could be in the process of reversing. However, others, such as an aging U.S. and global population, and the impact of technological advancement—accelerated by the pandemic and super-charged by the lagged impact of last expansion's CAPEX—make an overall disinflationary impulse more likely.

Given our relatively benign outlook for inflation and monetary policy, inflation need not significantly shift investment strategy. Instead, investors may take a tactical approach by leaning into or out of asset classes based on relative valuation and the strategic direction of interest rates.

Options for a near-term inflationary environment include:

- **Rotate into asset classes that benefit from rising inflation and rates.** Cyclical and value equities in sectors such as materials, energy, and financials have historically outperformed as economic growth and inflation were rising. In fixed income, short duration high-yield bonds and floating rate loans have tended to benefit from rising rates or a steepening curve.
- **Leverage future sources of expansion.** The fiscal impulse towards infrastructure and green energy may support those asset classes. Commodities may stand to benefit from this trend as well as the general cyclical improvement.
- **Look for companies with pricing power.** Even if inflationary pressures are temporary, sudden price changes and the associated supply chain disruptions can be challenging. With earnings expectations for the rest of the year already sky-high, investors must be careful in discerning which businesses can maintain earnings momentum through these frictions.
- **Consider multi-asset income.** Diversification is still important for investors, but the yield from traditional fixed-income assets may remain lower than long-term historical averages. This is where investors have begun to look for other ways to consider the 40% fixed-income allocation: a multi-asset approach to income. A rebounding economy has historically been aligned with some outperformance for value sectors, dividend payers, the high-quality segments of high yield, and international developed equities. Investors can consider these areas for building the income part of their portfolio. The combination of long-term trends, cyclical macro tailwinds, and careful security selection—could create the foundation for a strong "new economy" core allocation.

1. MacKay Shields recently wrote that the FOMC may not need to raise rates very aggressively to bring inflation back down. Moderate rate increases may serve to stabilize long-term inflation expectations at the FOMC's two percent objective, an outcome that would feed through into actual inflation outcomes.

Index Definitions

Bloomberg Barclays U.S. Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate-term investment-grade bonds traded in the United States. **Bloomberg Barclays U.S. 1-3 Year Aggregate Index** consists of a broad selection of intermediate-term investment-grade bonds traded in the United States of maturities ranging from one year to three years.

Definitions

Capital expenditures (CAPEX) are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment. **Labor cost arbitrage** comes from a financial concept that refers to identifying the cost differential between two similar or identical products or services in two or more markets and capitalizing on the difference in cost. **Diversification** is the process of allocating capital in a way that reduces the exposure to any one particular asset or risk. Diversification cannot assure a profit or protect against loss in a declining market. A **basis point** is one hundredth of a percent or equivalently one percent of one percent or one ten thousandth. **Free cash flow** is the cash left over after a company pays for its operating expenses and capital expenditures. **Value creation** is the primary aim of any business entity. Creating value for customers helps sell products and services, while creating value for shareholders, in the form of increases in stock price, insures the future availability of investment capital to fund operations.

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