Quarterly Investment Update

Quarterly Investment Update — 12 FAQs on Inflation

July 2021

William W. Priest, CFA

Executive Chairman,
Co-Chief Investment Officer
and Portfolio Manager

Epoch Investment Partners, Inc.

Kevin Hebner, PhD

Managing Director,
Global Investment Strategist

Epoch Investment Partners, Inc.

Key Takeaways

- A strong labor demand with a weak supply response could result in a wage-price spiral
- A sustained run-up in housing rents would be a substantial inflationary risk
- Inflationary pressures are likely to be transitory in all developed markets and most emerging markets

The massive fiscal stimulus and excessively loose financial conditions risk pushing demand well above potential GDP and driving inflation markedly higher. For similar reasons, Larry Summers of Harvard excoriates Bidenomics as the "least responsible" economic policy in 40 years.

1. Will the output gap be large enough to drive a sustained rise in inflation?

Short answer: Probably not. The argument of Larry Summers and the other inflationistas is that last year's output gap has already closed, yet the stimulus will keep on coming and this spells inflation. While this qualitative argument makes enough sense, the actual numbers involved are just too small. To illustrate, the U.S. output gap for this cycle is likely to peak at 1.5% to 2.0% (according to the International Monetary Fund (IMF), Congressional Budget Office (CBO) and others). Even with very generous Phillips curve estimates, we cannot see how this generates inflation sustainably above 3%. The period of peak stimulus is already well behind us and, for better or worse, divided government is the best protection against inflation.

2. Booming, but with bottlenecks: will supply constraints be large and persistent enough to produce runaway inflation?

Likely not. The conceptual reason is that the bottlenecks exist in competitive markets, where the best cure for high prices is, well, high prices. In fact that's the whole point of a market economy. Of course the invisible hand doesn't work instantaneously; it takes time, which could amount to three quarters or, in some cases, three years. This is true except for sectors that have been monopolized, are highly regulated, or otherwise protected from competition (like oil in the 1970s, or portions of health care, education and housing today).

Semiconductors comprise one of the more challenging bottlenecks, reflecting the complexity of global supply chains, and it has impacted numerous sectors, most notably vehicles. Further, even though most commentary focuses on goods markets, the bigger risk lies in the services sector, where bottlenecks often take years to resolve. One concern is that the combination of strong labor demand with a weak supply response could imply higher wages and the risk of the dreaded wage-price spiral.

3. How will we know if a wage-price spiral is taking hold?

This is a crucial question as the key risk to our benign view is that inflation expectations become embedded into wages. The two most important releases to watch are the Employment Cost Index (ECI) and the Atlanta Fed wage series, as they both control for compositional changes. This is critical as the low-wage leisure and hospitality sector accounted for nearly 50% of the 3.3 million jobs added in the U.S. YTD. So far both of these wage series appear tame and, through 2022-23, we expect wage growth to increase solidly, but not to escalate as it did in the 1970s.

4. Is housing a risk to inflation?

Yes, a sustained run-up in rents is the second biggest risk. Housing represents 17.8% of core personal consumption expenditures (PCE), and is an even higher percentage of the Consumer Price Index (CPI). Additionally, U.S. home prices are up 14.6% YoY, and the median national rent climbed 9.2% in the first half of 2021. Further, surveys by the New York Fed and Fannie Mae suggest renters are braced for hikes of 7% to 10% in the coming year.

5. Which past is prologue? What is the best historical analogy to today?

One candidate is 1950-53, when a temporary surge in inflation reflected a one-off increase in government spending for the Korean War. A second is the period immediately following WWII, when the war economy had to quickly pivot to civilian needs. In addition to the OPEC shocks, it took many years and multiple policy errors for inflation to become unanchored in the 1970s. Overall the historical analogues strongly suggest our current reflation will prove short-lived and that an awful lot would have to go wrong to experience a replay of the 1970s.

6. What is the historical track record in forecasting inflation?

Bad. The track record of economists, professional forecasters and the bond market is profoundly unimpressive. Further, both big shifts in inflation regimes since 1960 were surprises to bond markets and professional forecasters. Bottom-line: Be humble, as nobody can predict big changes in inflation.

7. Does monetary theory provide a useful guide?

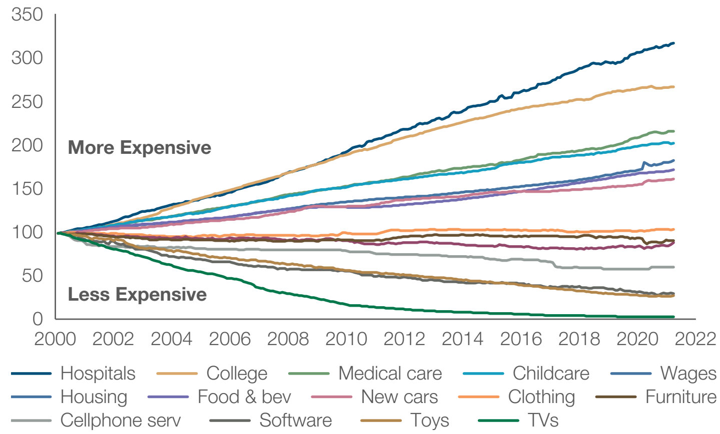
No. For the last 50+ years the MV=PT identity has not been helpful. Regardless, many worry that the massive expansion in money supply (M) could result in a sudden rise in prices (P). However, this requires velocity of circulation (V) to be stable and that hasn't been the case for decades. Moreover, even if V did revert it would more likely impact asset prices than the CPI.

8. Which are more important, cyclical or secular drivers of consumer prices?

The latter. Over the last two decades, health care and education prices have more than doubled, reflecting the prevalence of monopolies, regulations and so on **(Figure 1)**. On the other hand, competitive goods markets tend to produce lower prices, as can be seen by the categories at the bottom (e.g., TVs, toys, clothing).

9. Is tech and the digitization of the economy still inherently deflationary?

Figure 1: Prices of select goods and services — health care and education have soared, while TVs and toys have plummeted



Source: Bloomberg.

Yes, but it has been receiving much less attention since the onset of the pandemic. The digital economy, broadly defined, represents about 40% of U.S. GDP and the lion's share of growth, especially over the last 18 months. Further, official data likely overstates inflation by 100+ bps (as they don't fully account for tech innovations).

10. Taper tantrum 2.0?

Certainly possible. The Fed is likely to announce its intent to commence tapering in the fourth quarter. Many investors are understandably worried about a replay of 2013's tantrum when the 10-year yield rose by over 100 bps. That sell-off occurred because investors thought tapering meant rate hikes were imminent. However, the first hike didn't occur until December 2015, a full 31 months after the tantrum began. Avoiding another tantrum will require flawless Fed communications, which is the main reason we expect higher rate vol in the second half.

11. Are risks elevated in other countries or is this just a concern in the U.S.?

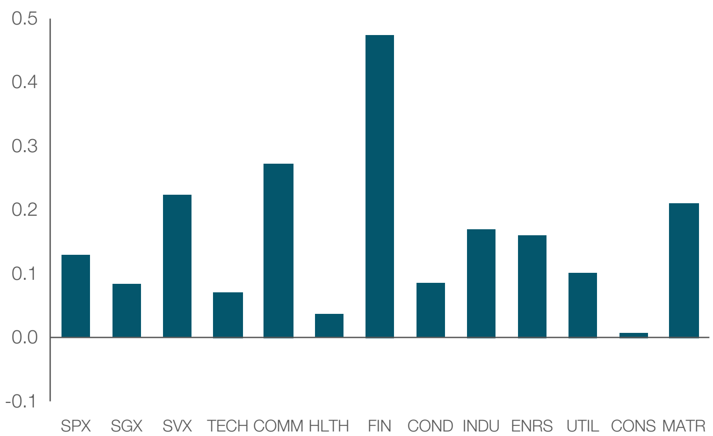
There has been an acceleration in inflation in the UK, Europe and many other regions. However, nothing has matched the pace in the U.S., primarily reflecting its much larger fiscal stimulus. We expect inflationary pressures to be transitory in all developed markets and most, but not all emerging markets.

12. How should investors position their portfolios?

Markets typically view a rise in short-term inflation breakevens as good news, signaling a cyclical improvement, and relative performance from early November to mid-May was roughly inline with historical correlations **(Figure 2)**. However, during the last two months the reflationary trade has faltered. The two-year breakeven declined by 40 bps, and performance has again been consistent with historical correlations, but this time in the opposite direction.

This chart is helpful for interpreting four different perspectives on the inflation outlook. First, investors who expect reflationary forces to be longer lasting than consensus should overweight FIN vs TECH and SVX vs SGX. Second, the opposite for those on “team transitory” who see inflation quickly returning to target. Third, a reasonable case can be made that the inflation trajectory is a real unknown, which argues for balance in portfolio construction. Finally, investors who expect runaway inflation should exit equity markets entirely. The U.S. experienced eight such periods since 1925 and they produced an average real return of -7% (vs +10% in non inflationary periods).

Figure 2: Correlation between 2Y breakeven and SPX



Source: Bloomberg, Epoch Invest.

While all four perspectives are possible, we believe the second is most likely. The reflationary period, which began in early November (when vaccines were approved), is now largely behind us, and we believe quality growth is likely to outperform. Epoch has always believed in focusing on companies that have an ability to produce free cash flow on a sustainable basis and have a proven track record of allocating capital wisely. 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 environment, with heightened risks around the inflation trajectory, we believe these principles are ever more important.

Before You Invest:

This material represents an assessment of the market environment as at a specific date; is subject to change; and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any issuer or security in particular.

The strategies discussed are strictly for illustrative and educational purposes and are not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. There is no guarantee that any strategies discussed will be effective.

This material contains general information only and does not take into account an individual's financial circumstances. This information should not be relied upon as a primary basis for an investment decision. Rather, an assessment should be made as to whether the information is appropriate in individual circumstances and consideration should be given to talking to a financial advisor before making an investment decision.

The S&P 500 Growth Index (SGX) is a market capitalization weighted index composed of large-capitalization U.S. equities that exhibit growth characteristics.

The S&P 500 Value Index (SVX) is a market capitalization weighted index composed of large-capitalization U.S. equities that exhibit value characteristics.

NEW YORK LIFE INVESTMENTS

Past performance is no guarantee of future results, which will vary. All investments are subject to market risk and will fluctuate in value. An investment cannot be made in an index. Diversification does not ensure a profit or protect against a loss in a declining market.

New York Life Investments engages the services of Epoch Investment Partners, Inc., an unaffiliated, federally registered investment advisor.

1805553 MSEP02k-08/21