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1ST QUARTER 2021

Market Commentary

What investment can we find which offers real fixity or certainty of income? ... the man or woman who invests in bonds is speculating in the general level of prices, or the purchasing power of money.– Irving Fisher

After successful COVID vaccine announcements and a massive amount of monetary and fiscal stimulus, the market last year began anticipating an end to the pandemic and a broad economic recovery. Value stocks, broadly representative of industries more severely impacted by the pandemic, began outperforming during the fourth quarter of 2020 and continued to lead this year, with the Russell 1000 Value index outperforming its growth counterpart by over ten percentage points. Subsequent economic data continues to validate this view, at least in the US. The latest Purchasing Manager's Index (PMI), a barometer of manufacturing trends, posted one of its highest levels in a decade. The latest US unemployment rate of 6.8%, while well above the pre-COVID low of 3.7%, equals levels experienced in 2014 and fell significantly from the 13% peak in June 2020. After the 2008 recession, unemployment levels remained above 7% until 2013. Stimulus programs continue to drive consumer spending, but employment continues to improve. Wage rates increased 4.0% year over year, but these figures likely remain distorted by the disproportionate impact of the pandemic on lower wage employment in service industries.

The yield on the 10-Year Treasury increased from the record low of 0.51% on August 4 last year to a March peak of 1.74%, placing the yield back within its pre-COVID trading range. Inflation expectations also rebounded, with the 5-year inflation breakeven (the inflation rate implied by the yield difference between inflation-protected and nominal Treasury bonds) increasing from 0.80% a year ago to current levels around 2.4% - the highest expectation level since 2014. TIPS remain at negative yields, mirroring the expectation that **the return on nominal Treasury bonds will remain below the rate of inflation.**

While the Federal Reserve attempted to engineer a 2.0% inflation rate, actual inflation averaged 1.7% over the past ten years. Despite loose monetary policy, central banks in developed countries demonstrated an inability to generate their targeted levels of inflation, which would have eroded the real value of debt outstanding from the 2008 Global Financial Crisis. The 2.4% average inflation rate over the next ten years implied by TIPS yields lies over 0.70% above this target.

Why do markets now believe things will be different and project sustained inflation rates above 2%? Immediate concerns center on a potential imbalance between stimulus funds and available goods and services – the proverbial too much money chasing too few goods. Inflation will primarily depend on the extent to which consumers spend instead of save the record amount of fiscal stimulus they receive. Markets expect higher inflation over the next few years followed by a small reduction in later years. The 5-year inflation breakeven rate is currently around 2.6%, around 20 basis points higher than the 10-year number. In any case, slightly above trend inflation accompanying a robust economic recovery for a couple of years does not present a cause for concern, but a potential decade of negative real returns from fixed income will provide a drag on portfolios. Investors last suffered a ten-year real loss on bonds over the period ending August 1982. For the past 40 years, bonds provided positive long-term returns net of inflation. With current bond yields at or below inflation, this will likely not continue.

Quantitative easing, initially feared as a harbinger of hyperinflation, actually delivered powerful disinflationary effects. The mechanics of quantitative easing trap money within the banking system. For inflation to occur, money within the banking system must be lent out to consumers and businesses. However, banks have been content to accept the low rates offered by the Fed on the longer duration securities they deposit into the program. Regulation enacted since the 2008 Financial Crisis reduced the ability and willingness of banks to make riskier loans with the result that a sizeable portion of business lending migrated outside of the banking system. Non-bank lenders also stepped into the riskier segments of the residential and commercial mortgage markets.

Ultimately, investors care about positive real returns net of taxes and inflation rather than nominal returns. A prolonged period where stock and bond returns lag the inflation rate would present significant problems. Almost all the periods in recent history where a 70/30 portfolio suffered negative 10-year real returns had ending points between 1974 and 1982. One period occurred in the late 1940s, which captured some of the volatility of the Great Depression. The only other negative 10-year real return on a 70/30 portfolio occurred around the bottom of the 2008-2009 Global Financial Crisis. In this circumstance, bonds delivered positive real returns with equity volatility driving the poor performance. Stocks fare better than bonds during prolonged periods of inflation, as stocks represent ownership of companies able to increase prices and pass through inflation to customers and shareholders. Additionally, inflation reduces the value of debt, so companies with longer-term fixed rate debt could see substantial benefits in a higher inflation environment. The dynamics of stocks and inflation become complicated at higher inflation levels by taxation as companies pay taxes on nominal rather than inflation-adjusted profits. The ultimate evidence perhaps consists of the German hyperinflation of 1924, where a trillion-to-one hyperinflation rendered bonds and cash essentially worthless where German stocks, after experiencing extraordinary volatility, recovered and delivered an annualized real return of around 6% for the decade of the 1920s.

While a couple of years of above-trend inflation due to a post-pandemic recovery in demand appears likely, it becomes more difficult to identify what may drive a sustained, multi-year cycle of inflation. Despite simple platitudes such as 'too much money chasing too few goods', inflation remains poorly understood. Economic models in the 1960s could not envision the inflation that occurred in the subsequent decade. Similarly, monetarist models developed in response to the inflation of the 1970s failed to foresee the disinflationary impact of quantitative easing in the 2010s. Have circumstances changed enough from the last decade that sustained inflation across the developed world becomes a real possibility? Furthermore, given past failures, can investors rely on economists to accurately assess the potential negative impact of current fiscal and monetary policies?

Three potentially inflationary and interrelated secular trends emerged prior to COVID and accelerated by the pandemic: **De-globalization, De-carbonization and De-liberalization**:

De-globalization: Globalization and its accompany-ing erosion of the bargaining power of labor in developed countries proved to be a powerful disinflationary force. While globalization will not disappear, a powerful counter-trend of deglobalization exists that began before COVID and accelerated by the pandemic. The wage-price spiral that drove 1970s inflation depended on annual cost-of-living adjustments in the contracts of unionized employees. As private sector labor unions declined, market supply and demand became the driver of employment compensation. Declines in the cost of manufactured goods were the largest contributor to the low inflation rates of the past 30 years, offsetting increases in services such as healthcare and higher education. Globally integrated supply chains and the just-in-time inventory management they enabled drove these price declines. Wary of vulnerabilities highlighted by the COVID pandemic, companies look to build redundancies in their supply chains and bring manufacturing and inventory closer to end markets. This will necessarily involve substantial investment and potentially increase costs, or at least stem the cost declines enjoyed by consumers over the past few decades.

De-carbonization: The political momentum to address climate change will reshape not only the energy industry, but also construction, manufacturing and service industries. Consumers will ultimately bear the costs of transitions to renewable energy and materials. Additionally, this trend possibly could ignite a 'Commodity Supercycle 2.0' where increased demand for materials employed in renewables – notably copper, lithium and rare earth metals – results in rising prices and an uptick in investment in new production. Like the original commodity cycle in the 2000s, it could also end with a bust – a combination of overvalued stocks and falling prices. The impact of de-carbonization on prices depends upon the speed and scope of implementation. The gradual replacement of aging thermal plants with renewables that has been in place for the past decade has shown no impact on consumer energy prices. A faster transition, driven by government mandates and extending to decarbonizing the production of essential materials such as plastics and concrete, could have a substantial inflationary impact.

De-liberalization: Across the developed world, the political and economic consensus on market capitalism that formed in the early 1980s has come under strain. Left wing parties have become more progressive in response to rising income inequality along with a renewed emphasis on social and environmental issues. Right wing parties have shifted toward protectionism and other nationalist economic policies. Both groups look to expansionary fiscal policy to finance their agendas. Some combination of tax increases on corporations and high net worth individuals, higher minimum wages and broadened social safety nets appears likely. Autocratic regimes appear ascendant across many developing countries and appear ready to resort to populist policies similar to those that stoked past episodes of inflation and economic instability.

Expansionary fiscal policy is needed to provide the 'fuel' by which increasing prices from these trends can be transmitted into general inflation rather than requiring a zero-sum recessionary and ultimately deflationary budget adjustment, which was the result, for example, of rising oil prices in 2008. Sustained inflation requires a feedback loop like the wage-price spiral that drove inflation in the 1970s. A consumer with unchanging income must respond to price increases with reduced consumption. Additionally, reserves trapped within the banking system need to become loans to consumers and businesses.

While these trends escalate inflationary risks, sustained inflation is by no means a certain outcome. Japan may be the model for the developed world – despite multiple rounds of fiscal and monetary stimulus and a debt / GDP ratio more than double that of the US, the inflation rate over the past ten years averaged a meager 0.5%. Bond markets failed to anticipate either the inflation of the 1970s or the disinflation of the past 40 years, so investors should not trust current yields to reflect future trends in either interest rates or inflation.

The introductory quote notwithstanding, **bonds offer liquidity, price stability and a hedge against deflation, which ensure they remain a part of portfolios that require periodic distributions**. As real yields declined over the past several years, we reviewed the size and duration of fixed income allocations to ensure they remain relevant to client objectives. While consensus opinion appears to favor value stocks, particularly commodity producers, during periods of sustained inflation, growth stocks deserve consideration. While at greater risk should real yields increase, we could just as easily see inflation without a corresponding increase in real yields. Treasury yields remained below inflation rates throughout most of the 1970s. Growth companies relying on intangible assets, such as software or biotech, suffer less from the accounting profit and taxation distortions created by inflation and generally possess the ability to increase prices. We also selectively like higher quality areas of real estate and infrastructure. While we remain wary of multitenant office and retail, industrial properties should see continued support from trends in online retailing and onshoring. While traditional energy infrastructure faces challenges from de-carbonization, technology-oriented segments such as cellular towers, renewable energy generation, and logistics offer stable income streams that can adjust to higher than expected inflation. Rather than trying to win with a large bet on inflation that could place achieving long-term financial goals at risk if it failed, **our goal is to create a robust portfolio that can survive either a prolonged period of inflation or deflation**.

- Stephen C. Browne, CFA
Chief Investment Officer
Chief Compliance Officer

Smart Investing Webinar:
Tuesday, April 13th, 2021 at 11:30 Central on Zoom

How much of a threat does inflation pose to your portfolio? With bond yields now below expected inflation, how will rising interest rates impact existing bond portfolios? Join us as we address these questions, as well as an introduction and discussion on the 'Three Ds'- De-globalization, De-Liberalization* and De-carbonization– secular trends, which combined with expansionary fiscal policy, may bring about a period of sustained inflation and negative real returns on fixed income investments.

Presenters for this webinar will be Chief Investment Officer, Steve Browne, CFA and Bryce Cooper, CFP.

De-liberalization: *Across the developed world, the political and economic consensus on market capitalism that formed in the early 1980s has come under strain. Left wing parties have become more progressive in response to rising income inequality and a renewed emphasis on social and environmental issues, while right wing parties have shifted toward protectionism and other nationalist economic policies. Both groups look to expansionary fiscal policy to finance their agendas. Some combination of tax increases on corporations and high net worth individuals, higher minimum wages and broadened social safety nets appears likely. Autocratic regimes appear ascendant across many developing countries and appear ready to resort to populist policies similar to those that stoked past episodes of inflation and economic instability.*

Link to join the webinar:

https://us02web.zoom.us/j/82618953825?pwd=Skc2V0x4WUV6MFd1OURacE1DaTVRZz09

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