Elevated Inflation – Transitory or Taken Root? November 2021

OVERVIEW

- **Inflation has consistently been described as "transitory" over the past several months, most notably by the Fed.**
- **The transitory factors are proving more persistent but are still expected to fade in the near-term.**
- **Over the last 40+ years, equities have been a strong nominal performer even in periods of elevated inflation.**

Background

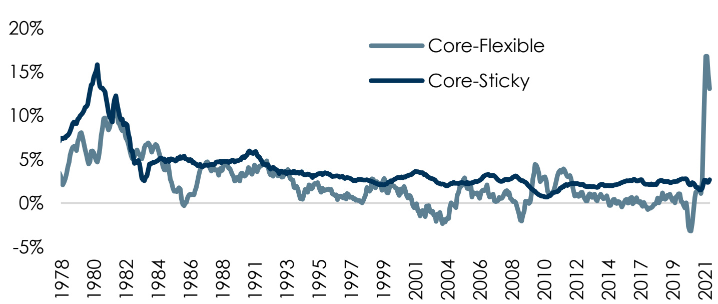
Inflation has surged in 2021, with the consumer price index (CPI) hitting a recent high of 5.4% year-over-year and the less volatile Core CPI, which excludes food and energy, reaching 4.5%. These were the largest gains for the two indices since 2008 and 1991, respectively. The Federal Reserve, responsible for promoting stable prices as half of its dual mandate, has consistently described this inflation as caused by transitory factors that will quickly fade. This is a sentiment echoed by many other analysts, who point to pandemic-induced supply chain snarls and the rapid recovery of consumer demand as temporary drivers causing most of the increase. However, with "transitory" inflation already proving more persistent than initially expected and forecasts calling for it to last at least into 2022, there are growing doubts about this narrative.

What Factors are Considered Transitory?

This discussion requires recognition that some components of inflation naturally fluctuate more frequently than others. In fact, this is the primary reason "Core" CPI exists in the first place - food and energy are typically two of the more volatile components, making inflation changes based on these prices a poor guide for monetary policy.

However even within Core CPI, there is a broad range of price sensitivity. An analysis performed by the Federal Reserve in 2010 identified "flexible" components, in which prices change every four months or less, versus more static or "sticky" components. of the CPI market basket. Flexible price items (outside of food and energy) consist mostly of automobiles, apparel, and lodging away from home. Sticky prices are typically less responsive to current economic conditions and includes a number of service categories, including food away from home, medical services, and housing categories. This analysis found that approximately 18% of the Core CPI market basket were flexible price items.

Atlanta Fed Sticky and Flexible Inflation Since 1978



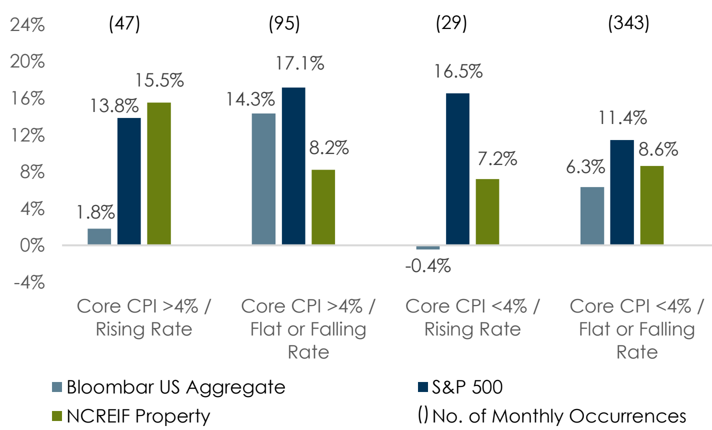
Source: Atlanta Fed

The Atlanta Fed provides sticky-price CPI and flexible-price CPI indices, and as would be expected, sticky-price CPI exhibits a relatively smooth trend. Core-sticky CPI was up just 2.7% year-over-year in September, while core-flexible CPI was up 13.5%,

Reading Today's Tea Leaves

The impact of flexible-price items on current inflation has been substantial. When Core CPI peaked in June, used vehicles, at a little over 4% of the index, accounted for over 40% of the monthly increase while used vehicle prices soared 45.2% year-over-year. This was directly attributable to a surge in consumer demand for vehicles combined with a semiconductor shortage slowing new vehicle production, both of which are expected to be temporary. While other examples are less extreme, firm price increases have been seen more broadly, with unusual demand or supply disruptions repeatedly blamed as the culprit. The transitory narrative still makes logical sense, but as ships continue to pile up in ports these price increases are proving to be longer lasting and current inflation dynamics are now expected to persist into 2022. For now, sticky-price inflation still remains within a "normal" range relative to the last 25 years, and structural forces underpinning recent history's low inflation environment should regain ground as pandemic effects fade.

Average 1-year Returns Since 1978 (Rolling Monthly Data)



Source: Bloomberg, Morningstar, Rising Rate defined as >100 bps 1 year change in 10-Yr UST

ACG's Position

Inflation predictions today are as challenging as ever, but current risks do appear skewed to the upside. Inflation specific hedges are available, but such tactical adjustments can prove costly (and not always effective). Furthermore, a diversified portfolio across equity, fixed income, and real assets is already well positioned to withstand various environments. Both equity and real assets have historically provided positive real returns in high inflation periods. Core fixed income tends to be a less effective inflation hedge, with returns primarily driven by the interest rate environment. The two are linked since lenders demand a higher yield when inflation ticks up - but a number of other factors influence rates as well, leading to mixed results depending upon the inflationary environment. At the strategy level, opportunities for further hedging exists via active managers who seek to mitigate the adverse impacts of inflation through tactical sector and/or security selections.

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