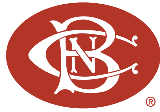

Wealth Management

QUARTERLY PERSPECTIVE
SUMMER 2021

Inflation Outlook and Interest Rates

Equities markets continued their rally in the second quarter, with strong performance across the board in both US and international markets. Returns were fueled by the ongoing economic reopening, as many states lifted almost all restrictions following successful vaccination campaigns. With the return to business as usual, first quarter GDP came in at 6.4% and is expected to be as high as 10% in the second quarter. Corporate earnings have rebounded significantly, even outpacing analysts' expectations. But as quickly as earnings have recovered, equity prices have moved even faster, leaving valuations stretched and well above historical averages.

Market Returns	2nd Quarter 2021	Year to Date
S&P 500 Index	8.55%	15.25%
Russell 1000 Value Index	5.21%	17.05%
Russell 1000 Growth Index	11.93%	12.99%
Russell 2000 Index	4.29%	17.54%
DJ US Real Estate Index	11.68%	20.28%
MSCI EAFE (net) Index	5.17%	8.83%
MSCI Emerging Markets (net) Index	5.05%	7.45%
Bloomberg Barclay's US Aggregate Bond Index	1.83%	-1.60%

Source: Zephyr StyleADVISOR

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Against this backdrop, the Fed has patiently watched the employment and inflation numbers, and equity investors have hung on their every word for signs of a change in their forecast for interest rate hikes. If they can be put off for the foreseeable future, then little stands in the way of a continuation of the equity rally. If, however, the recent inflation spike is more persistent than hoped, the Fed may need to raise rates sooner and faster than anticipated, which could quickly derail the equity outlook. Given this, many have asked, why is the inflation outlook so important, and why is meaningful inflation, which the Fed has been trying to produce for years, such a potentially negative factor?

Inflation: where it is, what the Fed thinks, and why it matters

The Fed considers 2% a healthy long-term inflation rate for the economy, but for the last several years inflation, as measured by Personal Consumption Expenditures (PCE), has been consistently below that target. During the pandemic, it dipped even lower as prices dropped on a lack of demand following the economic shutdown and stay at home orders. However, over the last several months inflation has picked up substantially, with both PCE and the Consumer Price Index (CPI) rising over 3.5% based on several factors, including:

- **Base effects:** Because prices were abnormally depressed last year, the year-over-year price comparison shows a sharp increase.
- **Federal stimulus payments:** Trillions of dollars have been pumped into the U.S. economy over the last 14 months, and this money is now driving an incredible increase in consumer demand for goods and services.

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- **Supply chain issues:** During the pandemic, many businesses cut back on production or closed completely due to a lack of demand. Those businesses are now struggling to keep up with significantly increased demand, especially in countries where restrictions may still be in place.

So, the question now isn't whether inflation is here, it's whether it's here to stay. The Fed has maintained that they see these pressures as transitory and likely to fade as stimulus programs end and supply chain issues work themselves out. While their current 2021 forecast is for PCE of 3.4%, their projection for 2022 drops to 2.1%. Because of this they have been slow to change their stance on rates, with no projected increases until 2023. For now, they have been focused on the second part of their dual mandate which is lowering the unemployment rate. Currently at 5.9%, unemployment is well above the pre-pandemic low of 3.5%, and until that comes down to under 4% the Fed is unlikely to turn off the spigot of low rates which could potentially slow the pace of rehiring.

Current and Historical Inflation

	50-yr. avg.	Apr. 2021	May 2021
Headline CPI	3.9%	4.2%	4.9%
Core CPI	3.8%	3.0%	3.8%
Food CPI	3.9%	2.4%	2.2%
Energy CPI	4.4%	25.0%	27.8%
Headline PCE deflator	3.4%	3.6%	3.9%
Core PCE deflator	3.3%	3.1%	3.4%

Source: BLS, Factset, JPM Asset Management

Some investors, however, are concerned that the Fed has been too complacent, and if they don't act quickly enough inflation could become much more difficult to control. If it does persist, and becomes entrenched due to continued demand strength, government spending and increased wages, it could eventually require not only significant rate increases, but increases at a faster pace than the economy can handle. That has the potential to lead to another recession and is the root cause of the fear among those who believe the Fed should be more proactive in managing inflation.

For now, however, Fed officials seem quite confident in their reading of inflation, and that it will subside as economic growth returns to more normal levels. That means short-term rates will stay low for an extended period, while intermediate and long-term rates potentially drift higher based on inflation expectations. The most likely scenario is that the Fed will begin tapering its $120 billion per month bond purchase program later this year, winding it down in 2022, and then begin rate increases in 2023. Time will tell whether their assumptions are correct, and in the meantime both equity and fixed income investors can expect an increase in near-term volatility as markets trade on inflation, unemployment and GDP readings.

Conclusion

For some investors, especially those that experienced the inflation of the 1970's and 80's, the idea of a significant uptick in inflation can be unnerving. But while near-term inflation drivers exist, so do the intermediate-term disinflationary pressures of globalization, aging demographics and increased technological efficiencies. In the meantime, we'll note that over longer periods, equity returns, especially those associated with value stocks, small caps and real estate have typically done well during inflationary periods. Additionally, our shorter duration fixed income holdings help protect bond investors from significant interest rate volatility in the event that rates move higher.

Our CNB Investment Committee will continue to monitor market conditions as they relate to inflation and interest rates and will adjust our long-term asset class expectations as needed. In the meantime, if you have any questions relating to your portfolio and the impacts of these forces, please feel free to reach out to your advisor.

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