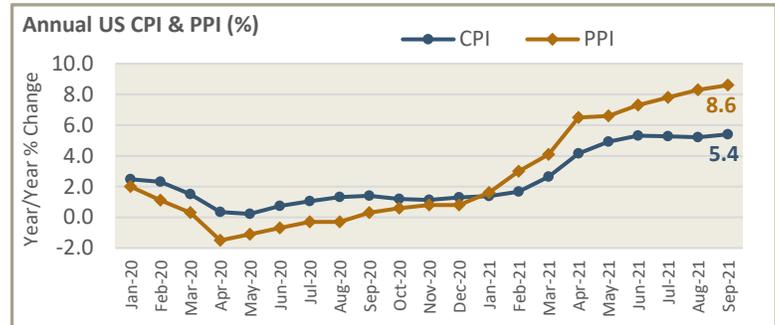


*"Inflation is the crabgrass in your savings."*

*- Robert Orben*

Over the last several months, inflation has become top of mind for investors, companies, policy makers, and consumers. The front page of the Wall Street Journal on October 1<sup>st</sup> 2021 featured a notable FactSet statistic; 224 of the S&P 500 companies had mentioned inflation during their 2Q 2021 earnings call – the most since FactSet began tracking this data in 2010 and up from just 60 mentions a year ago.

For the last 20 years inflation, as measured by the Consumer Price Index (CPI) and Producer Price Index (PPI), has essentially ranged between 1.5% and 2.5% per annum. As the global economy has tried to rapidly reopen following the rollout of Covid vaccines, we have seen inflation rates break out of this historical range, with the CPI and PPI increasing 5.4% and 8.6% YoY for the twelve months ending September, respectively.



Particularly notable are strong energy prices (+25% YoY) that are pushing up more moderate increases in core prices (+4%). However, even the increases in Core CPI (ex. Food/Energy) are solidly above levels for the past couple decades and, importantly, the Fed's target of 2%.

CPI Expenditure	Importance	9/2020-9/2021
<b>All Items</b>	<b>100.0</b>	<b>5.4%</b>
Food	13.9	4.6%
Energy	7.3	24.8%
Ex Food/Energy	78.8	4.0%

After 20 years of a benign inflationary environment, it is not surprising that consumers and businesses are reacting with concern. So, is this our new reality or a result of pandemic-driven supply chain disruptions? We are likely seeing a combination of factors, some that are transitory, meaning they will self-correct or abate over time, and some more enduring. Let's look at some examples of each.

**Transitory Inflation.** A contributing factor to current inflation rates is the depressed CPI changes experienced in 2020. Year-over-year CPI numbers last year were below 1% in April (0.3%), May (0.2%) and June (0.7%). For the same months in 2021 YoY CPI was over 4% in April (4.2%), May (4.9%) and June (5.3%). Averaging the rate since the onset of the pandemic provides an inflation in the mid-2% range, or within reach of the Fed's 2% target. As we finish lapping these depressed levels, we should see the rate of change ease.

During the lockdown of 2020 prices fell as economic activity (demand and supply) ground to a halt. Reopening has brought increased demand while inventories and output remain constrained by pandemic shutdowns, creating scarcity-driven price inflation. Supply chain disruption has been a major contributor to upward pressure on prices. Delta variant Covid cases have surged throughout the world, causing farm, factory, and transportation labor shortages and lockdowns. Added unemployment benefits have pared job-seeking workers, but these stimulus checks have ended, which should gradually bring people back into the labor market.

Another example of recent transitory inflation, familiar to anyone doing any construction recently, is the price of lumber. This chart shows the spike in price from \$400 pre-pandemic to nearly



\$1,700 in May of 2021. Since May, prices have fallen back to the \$600 level due to capacity coming back online and demand easing as costs rose.

**Sustainable Inflation.** In contrast, we believe that wage inflation could prove more sustainable over the coming years. After tracking in the 3.0-3.5% range for the last 5 years, YoY wage growth has been above 4% for the last 3 months.

There are several factors driving this increase, but the bottom line is that there appears to be a shortage of workers. Job openings are more than 150% of their pre-pandemic levels while labor force participation remains below 62%. Covid-related health concerns, early retirement, childcare constraints, low wage jobs compared to stimulus payments, and skill/geographic mismatches all contribute to the labor shortage. Some of these factors will likely persist, resulting in higher wages, particularly for low-paying service industry jobs.

Regardless of whether elevated inflation is transitory or more permanent, we are unlikely to see rates moderate until early 2022. The Fed is justifiably nervous to take any action to mute inflation, since raising interest rates could risk derailing a fragile economic recovery. Meanwhile, Congress could exacerbate the supply/demand imbalance with a large fiscal policy program.

What does all this attention on inflation really mean for us as investors? The market tends to be hyper-focused on inflation which leads to higher operating expenses and lower profit margins, and on higher interest rates, which depress equity valuations. Therefore, the market tends to react negatively to

upside inflation surprises. However, it is important to remember that by owning stocks we really own companies, and good companies can raise prices over time to offset cost pressures and grow earnings. And sure enough, equities tend to be negatively correlated with rising inflation in the short-term, but positively correlated over the long-term. This is in stark contrast to fixed income investments where inflation erodes the value of the income stream with no ability to reprice until an issue has matured. Real estate, floating rate fixed income, and alternative assets can provide income with less inflation risk.

With stocks, we believe paying more attention to the quality of the business we are purchasing and the price we are paying for these companies is a more fruitful use of time than trying to anticipate the direction of inflation and interest rates. In the short-term, we can expect higher inflation as the stop-start reopening of the global economy continues. Longer-term, we believe demographics, changes in globalization, and technological innovation will determine exactly where inflation rates trend.

