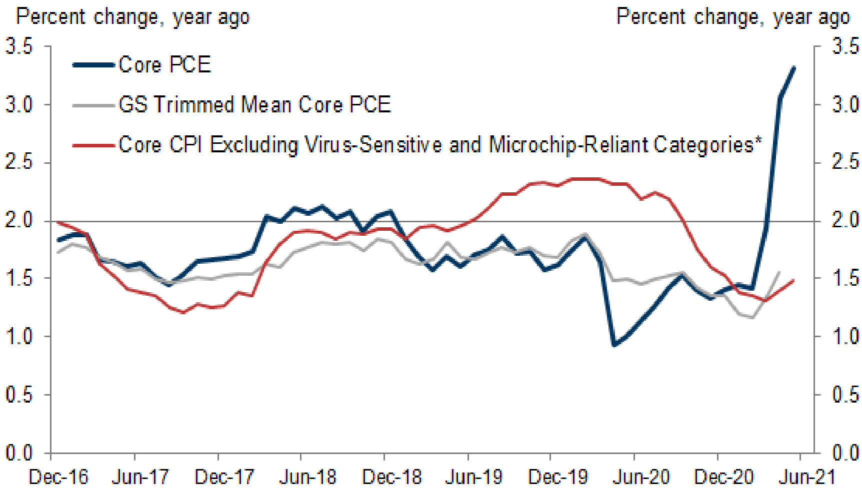
Inflation: Transitory or Here to Stay?

The release of May's CPI print marked the third consecutive month of inflation readings which were above expectations. What has puzzled market participants is why in spite of this surprisingly robust inflationary data, nominal yields have fallen back to levels not seen since early March. After reaching a high of 1.73% in Q1, many analysts expected 10Y yields to continue climbing towards the 2.0% level. Exactly the opposite has happened: nominal yields have retreated back to as low as 1.45%, and breakeven inflation as implied by 5 and 10 year TIPS have decreased to 2.4% and 2.3%, respectively (down from highs of 2.7% and 2.5% reached in early May).

The primary debate is whether or not the Fed will be right in claiming that higher-than-expected inflation will only be transitory. In order to justify its view, the Fed has argued that surprise inflation numbers in April and May were really the result of 1) comparing 2021 economic data to depressed 2020 numbers (i.e. base effects), and; 2) supply bottlenecks that will disappear once global trading activity fully resumes and companies have a better line of sight for making investments in incremental capacity.



*Excludes New cars, Used cars, Lodging away from home, Public transportation, Private transportation services, Apparel, and Recreation ex pets. Rescaled to average core PCE inflation over 2017-2019.
Note: May 2021 core PCE reflects GS preliminary tracking using CPI source data.

Source: Goldman Sachs Equity Research

The most straightforward explanation for the recent downward move in yields is that the market is currently simply choosing to believe the Fed, in spite of economic data that, if sustained, would make current inflation levels more than transitory. To be sure, three months of surprise inflation

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- The primary debate fueling the downward move in yields is whether or not the Fed will be right in claiming that higher-than-expected inflation will only be transitory.
- The Fed has argued that surprise inflation in April and May was the result of 1) 2020 base effects) and 2) supply bottlenecks
- The most simple explanation is that the market is currently simply choosing to believe the Fed, in spite of economic data that, if sustained, would make current inflation levels more than transitory.
- There are three dynamics which are lending further support to Treasury prices:
  - Sustained institutional demand
  - Overseas investors capitalizing on the carry trade
  - Fed open-market purchases in both Treasury and TIPS markets
- There are three barometers which will determine if inflation is transitory are:
  - The Atlanta Fed's "sticky CPI metric"
  - Owner's equivalent rent, or OER
  - Average hourly earnings growth (i.e. wage inflation)

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com data is not itself cause for alarm, especially in the context of the Fed's stated policy objective of targeting "average 2% inflation", as opposed to isolated month-to-month readings. Thus far, the market has been content to believe the Fed, because the factors which have contributed the most to surprise inflation readings are, for the most part, industries and sectors which were particularly affected by the pandemic, namely tourism and transportation.

Adding to this general comfort with Fed communication are three dynamics which are lending further support to Treasury prices:

1. Sustained institutional demand
2. Overseas investors capitalizing on the carry trade
3. Fed open-market purchases in both Treasury and TIPS markets

Sustained institutional demand

"The implication here is that a technical source of demand — banks buying U.S. Treasuries to satisfy liquidity requirements — has effectively put a lid on yields and potentially stripped them of some informational value regarding exactly what the market thinks of inflation risks. U.S. Treasury yields might be agreeing with the Federal Reserve that price pressures are transitory, but they could also just be artificially low thanks to a constellation of arcane money market rates." – **Tracy Alloway, *"One Reason U.S. Treasuries Don't Seem That Worried About Inflation,"* Bloomberg**

Since the Great Recession of 2008/09 global banks have faced more stringent capital restrictions which are designed to better protect financial institutions from surprise economic shocks. The practical result has been that banks now generally hold a greater share of Level 1 Assets (e.g. excess reserves, treasury securities, Ginnie Mae Mortgage Backed Securities, and Non-Government Sponsored Enterprise agency debt) then before. Over the last 12 months, banks have bought $350 billion worth of government bonds, and have shifted their High Quality Liquid Assets ("HQLA") from interest on reserves ("IOR") and reverse repo (which are yielding 0.1% and 0%, respectively) to U.S. treasuries which offer more attractive yields without affecting the banks regulatory capital position.

Overseas investors capitalizing on the carry trade

Another potential reason for the decline in treasury yields in the face of rising inflation is the relative positioning of U.S. rates to other developed market rates. Though the yield on the German 10Y bond has increased from its early 2020 low of -0.75% to -0.25%, it is still firmly negative, and is expected to stay negative for the foreseeable future, as the European Central Bank (ECB) has indicated that it remains committed to purchasing $2.2 trillion of bonds until March 2022. Similarly, the yield on the Japanese 10Y government bond has retreated from its March 2021 highs of 0.16%, to just 0.04%. In that same period, the U.S. dollar, as measured by the U.S. Dollar Index (DXY) has depreciated to multi-year lows. High U.S. yields relative to other high quality sovereign debt, in conjunction with a weaker dollar have created ideal buying conditions for overseas investors to purchase U.S. debt, providing further price support.

Continued Fed open-market participation

Lastly, and perhaps most importantly, is the fact that U.S. Treasury prices are still distorted by the Fed's open market purchases, which continue at a steady clip of $120 billion a month, or roughly half of the Treasury's net issuance over the past 12 months.

Additionally, from March 2020 to February 2021 the Fed bought over $175 billion in TIPS, relative to $150 billion of net TIPS issuance in the same period. Of the over $1.5 trillion dollars of outstanding TIPS, the Fed currently owns more than $300 billion. This is particularly relevant when considering the recent direction of breakeven inflation as measured by the TIPS markets. By providing such aggressive price support in the TIPS markets, the Fed is effectively creating the breakeven inflation expectation it wants the market to believe. Therefore, the decrease in breakevens should not be interpreted as the market's distributed opinion, but rather a partially synthetic representation of the Fed's current policy stance.

Who will be right?

It is pretty much impossible to know if recent inflation readings are a short term result of idiosyncratic market conditions, or if they reflect the beginning of longer-term, and potentially more difficult to control, price increases. The primary risk, from a policy point of view, is that the Fed loses credibility in its ability to execute on its stated policy objectives. In our view, this would either take the form of the Fed continuing to hold rates down in spite of inflation readings that are above expectations (e.g. if there was simultaneous, longer-term weakness in employment data along with greater-than-expected inflation), *or* if higher-than-expected inflation data persisted even after the Fed begins hiking rates and tapering its open-market purchases (e.g. if economic reality becomes unresponsive to policy changes).

In order to navigate future policy uncertainty, we believe it will be increasingly important to monitor the "stickier" components of inflation data. Sustained strength in CPI components that are generally slower to move would signal that inflation will not end up being as transitory as the Fed would like the market to believe. The key barometers we will be watching are:

Exhibit 4: Atlanta Fed core CPI inflation Y/Y: sticky vs. flexible prices

Source: Morgan Stanley Research, FRB Atlanta

1. The Atlanta Fed's "sticky CPI metric"
2. Owner's equivalent rent, or OER
3. Average hourly earnings growth (i.e. wage inflation)

The Atlanta Fed's sticky-price consumer price index, is a weighted basket of items that change price relatively slowly. It includes items like household furnishings, vehicle-related expenses, miscellaneous personal goods, food-away-from home, and alcoholic beverages. In May, the index increased 4.5%, following a 5.5% increase in April. On a year-over-year basis, it was up 2.7%.

Similarly, OER, which usually takes between 12-18 months to reflect increases in home prices has recently demonstrated signs of unexpected strength. In May, OER rose 0.31%, which represents the largest increase since June 2019.

Lastly, average hourly earnings have also started showing signs of unexpected strength, as employers have started raising wages in order to attract people back in to the labor force. It is still too early to tell if these wage hikes are the beginning of a sustained trend, since a primary reason why labor force participation has decreased are stimulus and unemployment checks which reduce the incentive for people to work. The phasing-out of stimulus and unemployment checks should, in theory, motivate more people to get back to work, relieving some of the upward pressure on wages. In our view, continued wage strength, in spite of an increase in labor participation, would also signal inflation that will be less than transitory.

BSP View:

Our view is that core PCE growth (which today stands at 3.1%) will settle in between the 1.5%-2.0% range in the next 12-18 months, though the exact path to reach that point is, in our view, still highly uncertain. If there is anything that we have been reminded of over the course of the pandemic is that consumers (and corporations) often do not behave in the way we expect them to. Who could have in earnest predicted that the American consumer, always eager to spend, would hoard stimulus checks, or that otherwise hardworking people, would so willingly engage in fraud in order to not have to go back to work? Equally, it is hard to say if corporations will take full advantage of the opportunity to increase prices, or if they will opt to grab market share with more modest price increases. In times of drastic social change, it is simply much more difficult to reliably predict consumer, and even corporate behavior.

What we *can* say is that the overall market climate does feel somewhat panicky, and therefore prone to overreactions in the short term. Though our inclination is to believe that the Fed will not lose credibility and that it will ultimately be right in claiming that inflation will be transitory, we do believe there will likely be at least one "blip" along the way, likely in the form of a surprisingly high non-farm payroll reading, a decline in job openings, a sudden spending of previously hoarded savings, or perhaps just a blowout CPI reading of over 6%.

Consistent with our philosophy of "staying-the-course" through a variety of market environments, we would see a short-term blip in equity markets as a buying opportunity, especially in longer-duration equities. Having said that, and given the tremendous run-up in equity valuations since March 2020, we also believe it's time to moderately trim equity positions, or at a minimum, to buy short-term portfolio protection (i.e. SPY put spreads). Additionally, while we have always constructed equity portfolios with the necessary diversification between cyclicals and long duration stocks, in the medium term we continue to favor cyclical sectors such as: Basic Materials, Consumer Discretionary, Industrials and Financials.

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