Gresham

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Gresham's Views on "Inflation, Fed Reactions and Implications"

Inflation

U.S. inflation reached an annualized rate of 7.0% in December, its fastest pace in nearly four decades. A combination of pandemic-related supply shortages and surging demand driven by consumer balance sheets swollen by stimulus measures continues to push prices upward. Even the core price index, which excludes the volatile categories of food and energy, climbed to 5.5%. The question is whether inflation will peak in the coming months, as balance sheets are drained and supply chain pressures abate, or whether inflation has become a more permanent fixture in the U.S. economy?

To examine the possible future paths for inflation we must understand its component drivers. The recent pickup is almost entirely the result of increased goods prices, rather than services, as shown in Chart 1. More specifically, prices for durable goods, including autos and furniture, continue to drive much of the inflationary pressure. Used car and truck prices have soared a staggering 46% year-over-year while those for furniture rose 17.3%. There is strong evidence to support the idea that such pricing pressures are pandemic-related supply chain issues and are very likely to abate as Covid (hopefully) moves from a pandemic to endemic and global trade pathways normalize.

Surging Consumer Demand

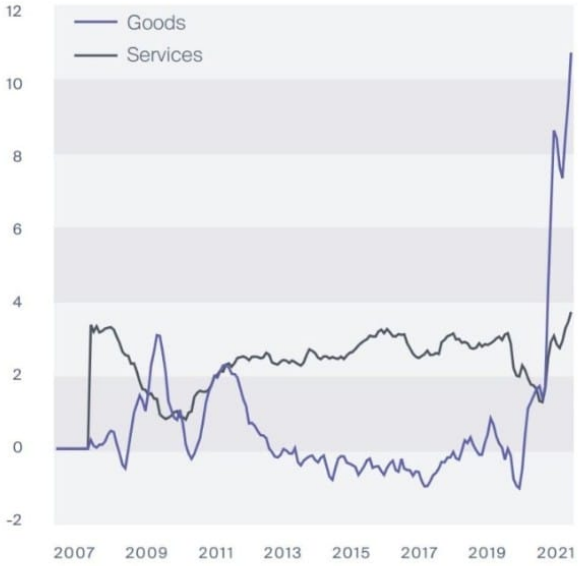
Recent supply chain disruptions are not solely to blame for the surge in goods prices; global supply chain stress is just as much a consequence of surging consumer demand, as shown in Chart 2. Output has been quite strong, just not strong enough to meet elevated demand. Headlines shout about logjams at ports but import throughput at the Port of Los Angeles, a prime target of such accusations, has been consistently running at 20% above pre-pandemic levels and still unable to meet demand. Similarly, global
goods production, world exports, container ship service, U.S. truck tonnage and even global semiconductor shipment volumes are all well above trend.

After the Covid pandemic hit, the U.S. government responded with three separate rounds of direct stimulus payments to consumers, enhanced jobless benefits, boosted child tax

credits and suspended student loan payments. As a result, unlike in any other recession in history, consumers' balance sheets expanded and savings rates reached historic highs, which was unprecedented during a recession. As will be discussed later, consumers' excess savings has normalized and balance sheets are being drained.

Chart 1. Increase In Price of Goods Has Driven Up Inflation

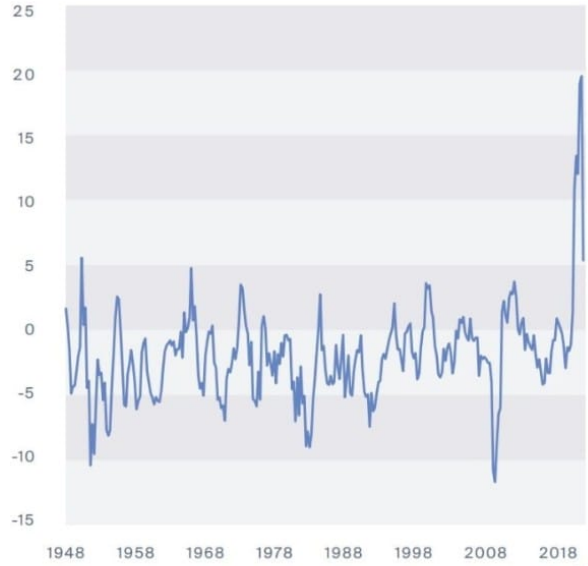
CPI Less Food and Energy (YOY % change)



Source: U.S. Bureau of Labor Statistics, FactSet

Chart 2. Surge in U.S. Goods Spending

"Difference in Goods & Services, Rolling 6-Quarters Growth Rates" (%)



Source: Bureau of Economic Analysis

Temporary Effects?

Early last year in our piece titled *Inflation?*, we laid out the case that most of the headline inflation numbers that we were about to witness in 2021 and into 2022 would be temporary supply shocks which have happened before and are typically resolved within a few months as capital spending catches up to spur investment in new capacity. Covid has been a complicating factor, but we expect this to be temporary as spending forecasts now show significant increases. Similarly, consumer demand driven by excess savings will wane and we have already seen balance sheets begin to drain.

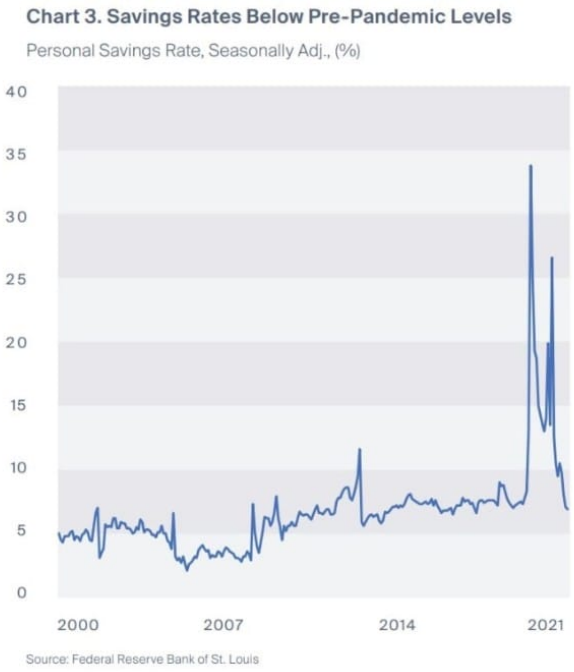
We largely continue to believe that, but with an important caveat. In that inflation article, we also discussed the possibility that some larger structural forces that contributed to a nearly 40-year disinflationary period were coming to an end and that we expected inflation to become a more persistent force in the U.S. economy after we got through the non-recurring effects of stimulus-induced spending and supply chain challenges. However, we now believe that labor constraints, which we once thought to be a temporary inflationary factor, may become more permanent.

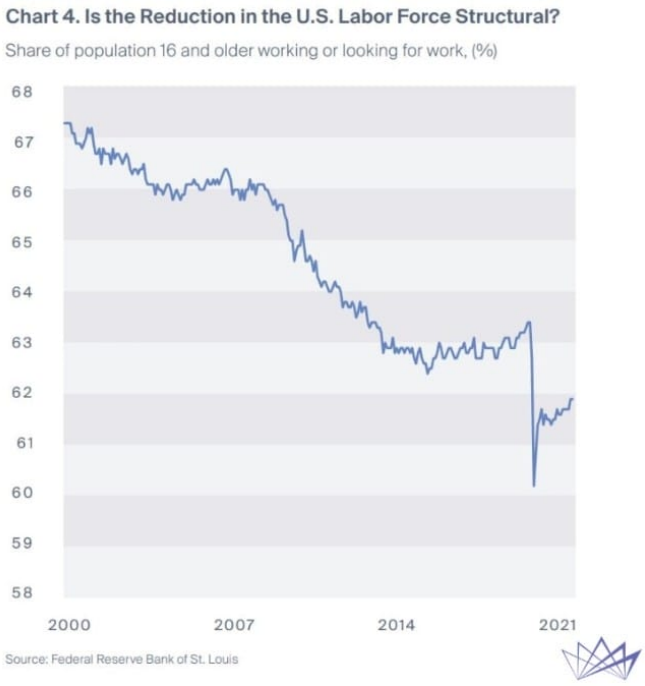
Tightening Labor Markets

History shows that the willingness to work is directly tied to personal finances. Recently, stimulus payments to consumers, unemployment supplements, a rising stock market and increasing home prices have created $2.7 trillion in excess household savings and disincentivized consumers from returning to work. As a result, most expected labor markets to be tight until enhanced unemployment benefits ended or these excess savings dissipated. Further, if labor markets become too tight, wages will rise (as they have) and accelerate the pull of workers back into the work force. It appears we have passed that point as the personal savings rate fell below its pre-pandemic level, reaching 6.9% in November, as shown in Chart 3.

The U.S. unemployment rate for December reached a post-pandemic low of 3.9%, giving workers more leverage on pay, as wages rose nearly 5%. Importantly, and for one of the rare times since the Global Financial Crisis over 13 years ago, wage increases were concentrated in the bottom quintile of earners. While the uniquely rapid spread of the Omicron variant has undoubtedly affected labor participation, it appears there is something more structural to these shortages as labor participation remains below expectations.

In congressional testimony in early January, Fed Chairman Jerome Powell remained optimistic many of the current inflationary pressures are temporary and will abate as we move further into 2022. However, he also noted the possibility of a permanently smaller U.S. labor force that could be a lasting issue going forward. Chairman Powell stated that many U.S. workers, given the country's current demographics, who were close to retirement and stopped working, may not come back, since their spouse earns enough or the value of their house or retirement portfolio has sufficiently appreciated to retire. J.P. Morgan recently estimated that more than one million workers above the expected trend line have recently retired. As a result, the U.S. labor force participation rate remains stubbornly slow in returning to its pre-pandemic level, as shown in Chart 4.



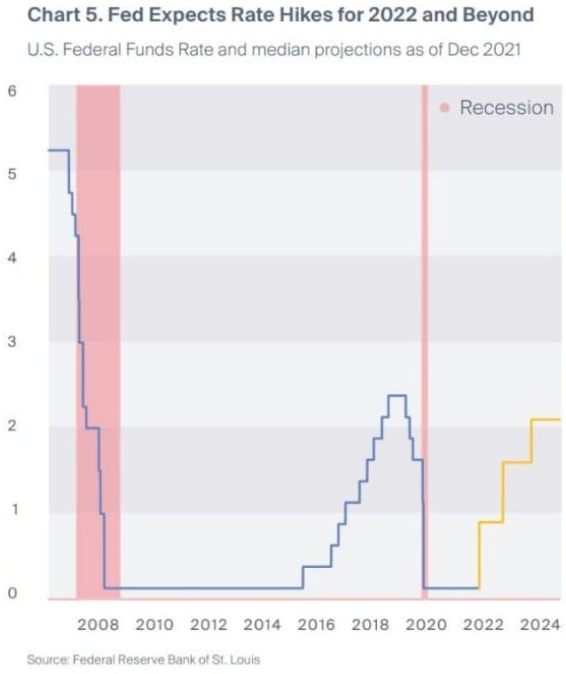


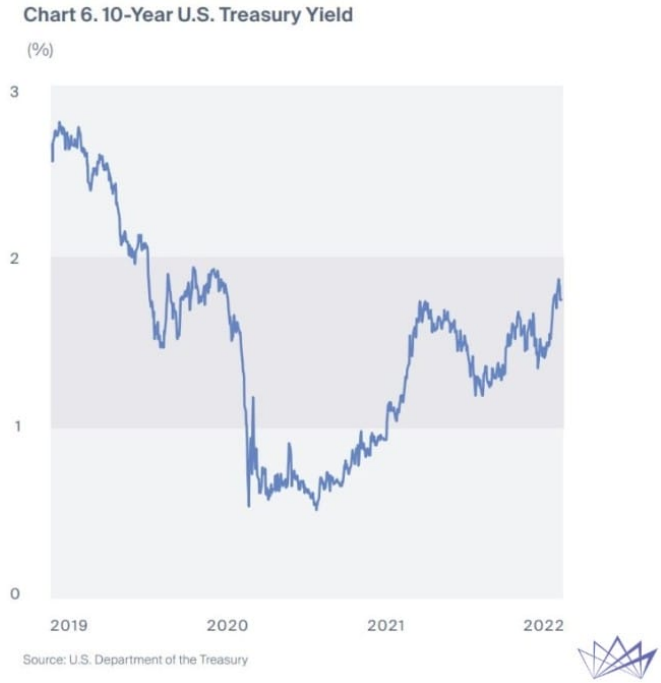
Federal Reserve Response

While many elements of the current inflation spike appear temporary, wage growth likely is not. As one analyst suggested, “it’s easy for copper prices to decline, but it’s much more difficult to cut someone’s wages.” As a result, the tone of Fed commentary has changed dramatically in the last few months, primarily in response to rising wages. In 2015, the Fed started to lessen its supportive stance by raising interest rates and normalizing monetary policy. The Fed responded very slowly, waiting over a year before increasing rates a second time. Softness in the economy stalled policy normalization and the onset of the pandemic forced the Fed to completely reverse course. In contrast, Chairman Powell recently stressed how much stronger the current U.S. economy is than during the prior period and that the desire to accelerate tapering was unanimous among the Fed Governors. Projections of future interest rates now show an expected three to four hikes in the coming year, as shown in Chart 5.

It is difficult to predict where the interest rate hikes will end. We have seen estimates of as many as ten 0.25% rate hikes, a path that would place short-term rates near 2.5% and close to the Fed’s inflation target, which is not unusual in a historical context. At the longer end of the yield curve, the 10-year U.S. treasury yield has spiked sharply higher as shown in Chart 6, surpassing 1.8% in nominal terms. To impute a real interest rate, we subtract expected future inflation, say 2.5%, to arrive at current real yield estimate of -0.7%. All of these numbers are fluid and imprecise but normalized 10-year real rates should certainly not be negative. Estimates vary widely, but many economists suggest that real rates might normalize closer to 1.0% – 2.0%, which is down from long-term historical averages that are closer to 3.0%. This would mean nominal long-term interest rates would increase to 4% or higher, which feels

like a long way away after more than a decade of easy money and interest rate repression.





Market Indicators and Implications

Currently, the market believes the Fed still has the tools to control inflation to the extent these inflationary pressures proved to be something other than temporary. While nominal bond yields have spiked higher recently, the market's imputed inflation expectations – calculated as 10-year treasury yields minus 10-year TIPs – remained between 2.4% and 2.6% for most of 2021, as shown in Chart 7. This should provide some comfort to those investors who are afraid of runaway inflation, but it bears watching in the future.

Are there other market implications for this regime shift beyond rising interest rates and likely underwhelming (and probably negative) performance for longer-dated bonds? There are certainly stock-specific and sector-specific implications if interest rates do rise as described above. One narrative worth exploring is the growth stock unwind for these supposedly interest rate sensitive companies.

Unbalanced Equity Market Structure and Growth Stock Narratives

According to Morgan Stanley, over 40% of the S&P 500 and 75%(!) of the Nasdaq Composite members have sustained drawdowns of over 20% and nearly half of those companies are down over 50%(!) in the last few months. These losses, until recent index declines in January, have been masked by positive index performance that has been held

aloft by a few large stocks while its foundation erodes from underneath.

As we discussed in U.S. Outperformance? in early 2019, there are a small number of companies that currently constitute a disproportionate share of the market cap of U.S. equity indices. While market historians like to remark on the unbalanced nature of indices during the tech bubble, the current index concentration in its top five stocks has become even more unbalanced and makes the tech bubble appear like a minor blip, as shown in Chart 8. This same distortion exists in the performance of the indices. Just five stocks drove 37% of S&P 500's 20% gain from April through the end of 2021, and since the end of 2019, the performance of Apple, Google, Microsoft, Amazon, Tesla and Facebook has contributed nearly half of the S&P 500 index gain of 52%.

Typically, these safe-haven stocks at the top of the market can withstand pressure but are ultimately not immune as we have witnessed in recent weeks. The current narrative circulating in markets is that the stakes for growth stocks are particularly high in the face of Fed tightening. These companies trade at high multiples, implying little margin for error, and rely on the promise of expanding profits and continued high revenue growth, which seems challenging in the face of rising interest rates that will pressure the present value of companies' future cash flows.

One of our managers has an insightful and variant perspective on divining value in these types of companies. He believes that "growth stocks underperform as interest rates rise" is a false narrative. However, false narratives can persist for long periods and drive significant capital flows.

On the other hand, he believes that when money has no cost (i.e., zero percent interest rates)

it ceases to be a regulator on behavior in financial markets, but when rates rise, constraints and governance return. Many of these formally high-flying companies “whose business models are fragile, went public and received valuations that made no sense. Many of them now have share prices that have collapsed and will never recover.” However, he goes on to say that some of these companies “whose business models are unique…will endure this drawdown and eventually grow into last year’s higher prices and beyond.” Increasing interest rates by a few percentage points will not significantly disrupt businesses with unique and disruptive models that drive rapidly growing revenues and healthy margins.

High growth companies with (formerly) high valuations appear to be an emerging battleground for finding value and separating the wheat from the chaff after years of zero cost money allowed many to fake it and raise another round of capital to fill their coffers rather than generating defensible and growing earnings.

A Note on Private Markets

The divergence in valuations for growth names in public and private markets continues to increase. As the market continues to punish unprofitable names in the public space, particularly those whose top-line growth narratives are in question, the private markets continue to pay a premium. Valuation pressures are likely to work backward into the private markets to resolve this discrepancy over the coming quarters.

Conclusion

We continue to believe, like the Fed Governors, that many contributors to the current rise in inflation are temporary, driven by both 1) large governmental stimulus that swelled consumer balance sheets and spurred on spending, and 2) Covid-induced supply chain disruptions that slowed the natural response to meet this demand. However, the labor market shortage appears to be shifting to more of a structural rather than temporary phenomenon, as some portion of the U.S. population may have elected early retirement and removed themselves from the U.S. labor force.

These shortages and the related increasing wage pressure have prompted the Fed to telegraph a program of raising interest rates sooner and more aggressively than expected. Unlike prior similar efforts during the so-called Taper Tantrum, the current economy appears much stronger and labor markets appear structurally tighter, giving the Fed little room to backtrack.

As a result, we appear to be entering a regime change for markets. The obvious effects will be to interest rates as they normalize toward positive real rates at nominal levels higher than

those to which investors have become accustomed over the last few years. Additionally, rising interest rates have begun to weigh on certain segments of the equity market which appear to be presenting the beginnings of a better entry point for investors, particularly in a few select high-growth companies which once carried lofty valuations. It is impossible to time markets effectively but accelerating the phase-in of current capital deployment or beginning to reallocate cash balances held in reserve is worth considering.

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