On The Mark

CAPSTAR FINANCIAL

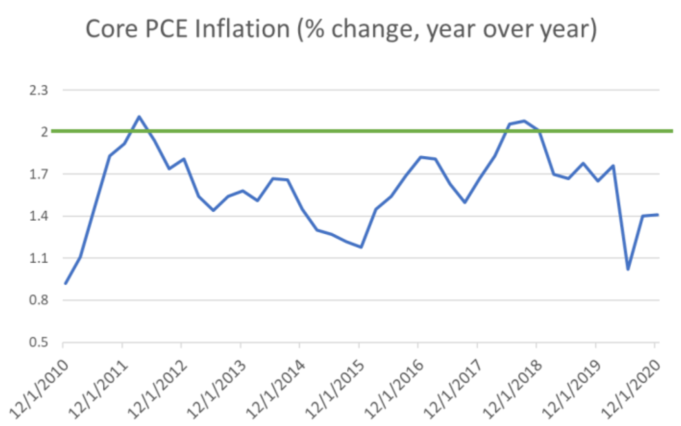
Is the inflation genie out of the bottle?

Key Takeaways

- Rising rates and the likely scale of US fiscal stimulus has raised concerns of inflationary pressures.
- Rising inflation does not differentiate between temporary and long-term sustainable inflation. This near-term increase in inflation could prove temporary.
- For investors, a period of higher inflation even if temporary paired with low rates could prove costly for excess cash which earns an even more negative real rate.

Interest rates have risen sharply in 2021. The 10-year Treasury yield rose from 0.93% at the start of the year to 1.64%[1] through March 12th. The speed at which yields have climbed has investors concerned about inflation. In addition, the trillions of dollars of fiscal stimulus spent by Congress and trillions of dollars in monetary stimulus by the Federal Reserve (Fed) has led investors wondering if inflation is inevitable, as indicated by the markets. Admittedly, given the vast amounts of spending, the risks are skewed to the upside. However, investors should evaluate the starting point of inflation given the unusual nature of the recent crisis.

The extraordinary measures taken by the US government and the Fed to curb the impact of the shutdown from Covid-19 have likely led to some distortions in the inflation data as measured over the year. For example, the shutdown of the economy caused demand to collapse and thus inflation to plummet in the first half of 2020. In 2021, as the economy begins to reopen, pent up demand for everything from restaurants to travel and tourism relative to constrained supply has contributed to an increase in inflation in the short term. Fed Chair Powell has signaled that they will not react to this rise in inflation as they perceive this to be temporary[2].



Source: Bloomberg

So yes, inflation has increased, but it's important to have perspective. Over the last decade, the Fed has rarely achieved its 2% target for inflation as measured by Core PCE (Personal Consumption Expenditures excluding food and energy). Therefore, if moderate inflation is occurring today because of economic growth and rising from very low levels, it is not a bad thing. On the other hand, to have long-term sustainable inflation, or envision the probability of a 1970's style 10% inflation headed our way, seems less likely for several reasons.

First, the economy is still a long way from operating at full capacity, the point at which inflation pressure is likely to become problematic. The US economy shed a record 22.2 million jobs during the crisis. While the economy has made steady progress and recouped 12.5 million of those jobs lost, it still remains short nearly 10 million jobs to close the gap[3]. Fed Chair Powell has noted the true measure of unemployment is close to 10%[4].

Second, the Fed has tools to keep inflation in check by targeting inflation at 2%, which it formally adopted in 2012[5]. Even if inflation moves a bit above 2%, the Fed can rein in inflation by raising short term rates. Fed Chair Powell has also indicated that interest rates will remain low until further substantial progress has been made toward the 2% inflation. If inflation were to surprise on the high side, the Fed would likely move faster to raise short term rates.

For investors there are two key implications. First, a period of higher inflation and low rates will make real rates on cash even more negative. As such, investors with excess cash on the sidelines and looking to protect and grow their real wealth may want to put their excess cash to work. Lastly, inflation is only one consideration and future returns may vary, but investors should take comfort that, on its own, a moderate increase is not typically negative for equities as higher inflation should coincide with stronger earnings growth.

[1] https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=yieldYear&year=2021
[2] https://www.pbs.org/newshour/economy/chairman-powell-says-higher-inflation-is-temporary-fed-will-be-patient#:~:text=will%2Dbe%2Dpatient-,Chairman%20Powell%20says%20higher%20inflation,%2C%20fed%20will%20be%20'patient'&text=%E2%80%9CWe%20think%20our%20current%20policy,higher%20inflation%20on%20the%20horizon.
[3] JPMorgan Guide to the Market
[4] https://www.federalreserve.gov/newsevents/speech/powell20210210a.htm
[5] https://www.stlouisfed.org/open-vault/2019/january/fed-inflation-target-2-percent#:~:text=As%20such%2C%20the%20FOMC%20adopted,2%20percent%20in%20January%202012.

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102177 | C21-17463 | 03/2021 | EXP 03/31/2022