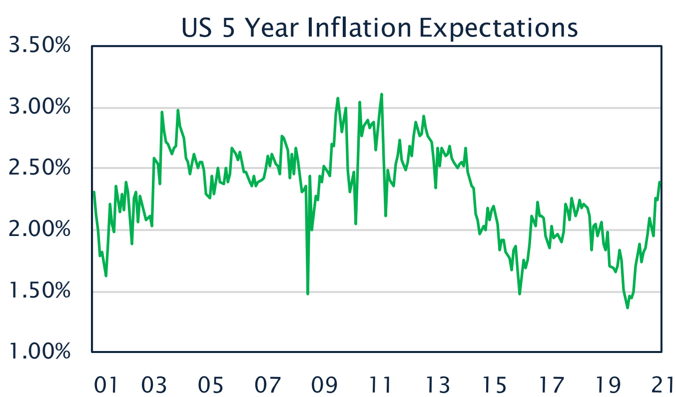
MAY 2021

INVESTMENT UPDATE

Bond investors, a notoriously paranoid group even in normal times, are experiencing an episode of existential dread, fearing that policymakers' aggressive COVID pandemic-fighting response will spur higher consumer price inflation, ending the long bull market for bonds.

The demise of inflation over recent decades has provided good returns for bond investors, while driving interest rates to historic lows. But there's a significant downside to persistently low inflation: Low interest rates penalize savers and make lending less profitable. More importantly, near-zero interest rates, which the US has flirted with for the last dozen years, seriously hamper the Federal Reserve's ability to stimulate the economy. The result is that the Fed has been forced to adopt new tools—quantitative easing, in the form of trillion-dollar asset purchase programs—to boost the US economy when the benchmark overnight Fed funds rate is at its "zero lower bound." In its fervor to move away from having its hands tied in this manner, the Fed announced last year that it would be abandoning its 40 year-long policy of all-out inflation fighting, in favor of a more balanced approach that would place more emphasis on economic growth and full employment.



This shift in Fed policy, which is expected to result in higher inflation over future business cycles, would have been enough, by itself, to unnerve bond investors. That it came at the same time that the Fed was flooding the market with liquidity, and while fiscal policy was providing massive stimulus to businesses and households, well, it's no surprise that market-based inflation expectations are now at their highest levels in almost seven years (see the chart on this page).

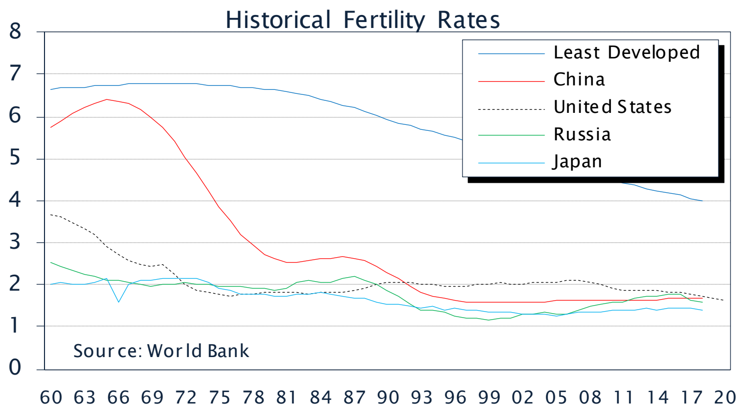
We are already seeing the first signs of renewed inflation as the US economy begins to reopen, but the Fed claims that these inflationary factors are transitory, and will not change their current highly expansionary policy until the economy is on a firmer foundation. The main cause for the current pop in inflation is easy to identify. Because inflation is typically calculated on a year-over-year basis, the current April 2021 Consumer Price Index (CPI) is compared to the reading from April 2020, when consumer prices fell during the initial shutdown. The calculation results in an outsized gain over the past 12 months, in what economists call a "base effect." April's increase in core CPI of 3.0% (up from 1.6% in March 2021) matches the highest reading since 1995. Base effects are, by definition, transitory; by next April these technical year-over-year comparisons should be back to normal.

There are other factors pushing up current inflation that should also subside over time, although these will be less predictable and more persistent than the base effects from a weak 2020. Most of these are attributable to supply disruptions as a result of COVID related shutdowns, some of which added to the April jump in CPI. We've all heard stories about how automobile plants have had to slow or shut down production lines due to shortages of needed computer chips, but that's just the tip of the iceberg. There are widespread shortages of all manner of goods, from bottlenecks of raw materials (check out the price of lumber and copper) to severe shortages of the actual shipping containers used to move goods and supplies overseas. According to FTN Financial, the cost to ship one 40-foot container from Shanghai to Los Angeles has gone from $1,500 a year ago (and that price had been stable for more than five years) to $5,200 last month. Despite a record pace of unloading, there were still more than 20 ships sitting offshore in California in April; that's down from 38 in January, but pre-COVID, it was unusual to have any ships waiting offshore.

While these supply chain disruptions are expected to eventually dissipate they will persist for a few more months. COVID cases, while dropping in the US, are still spiking in many parts of the world. This uneven recovery means that demand from vaccinated countries will exceed the impaired supply coming from less-vaccinated emerging economies; inventory accumulation will be nearly impossible for manufacturing facilities that produce finished goods, as well as retailers that sell those goods. Severe shortages can be seen in the "backwardation" pricing of certain commodities, where spot prices are higher than futures prices out past two or three years (crude oil prices are currently inverted as far as six years out). This is not normal, as storage and other carrying costs typically keep futures prices above those of spot prices. The result is that raw materials prices look like they will be elevated for at least the next year, as these supply disruptions continue to work through the global economy.

Supply chain and commodity prices aside, the single biggest factor that could cause inflation to persist is rising wages. In the modern US economy, with services accounting for more than two-thirds of US GDP, wages and benefits are a critical component of any company's cost structure, and the economic statistic with the highest correlation with consumer price inflation. The US and other developed economies have reaped big benefits from the ability to shift manufacturing (and some services) to countries with lower-cost labor forces over recent decades. Productivity has played an important part as well, as automation and other technological advances have made giant strides in reducing the demand for labor across many industries, further reducing labor costs.

The April US labor market stats showed a much smaller increase in payrolls than had been predicted, leading some economists to conclude that the extended unemployment benefits currently in place are providing a disincentive for low-wage earners to reenter the labor force. It's a hard stance to argue with, given widespread anecdotal evidence of restaurants' reported difficulties in finding servers and back-of-the-house staff. There's also a compelling argument to be made that remote schooling is keeping many parents out of the job market as they tend to their kids. And particularly in larger urban areas, there has been an exodus of people leaving for (literally) greener pastures in the suburbs, which has further shrunk the numbers of potential employees.



Extended unemployment benefits will begin to roll off in the third quarter of this year, and we expect hiring for lower-wage positions to pick up. But we're not alone in wondering if we may be witnessing the early stages of a turning point in the stagnation in wages that has occurred over recent decades. There's a growing acknowledgement, exemplified by the effort to increase the minimum wage to $15 per hour, that wages for low-income workers in the US haven't even kept pace with modest increases in inflation. Will the COVID outbreak usher in a period of faster wage growth, and if so, what does that mean for future inflation?

We won't know the answer to that question for many months, but looking at recent economic history we find little evidence of a resurgence of the main driving force behind periods of persistent inflation, namely, an extended period of excess demand combined with supply constraints (including labor). Transitory factors are underpinning the current pop in inflation, but for it to persist, we need help from demographics, and demographic trends, on a global scale, are very much disinflationary.

The issue is population growth, or rather, the lack of it, combined with aging populations worldwide. We've touched on this in past *Investment Updates*, but since the last time we visited this topic the stats have gotten even worse. As the chart on this page shows (US data is updated through 2020; data for other countries is only available through 2018), the birthrate—the average number of children that a woman gives birth to over her lifetime—in the US has been steadily dropping since the financial crisis, falling below the critical level of 2.0 in 2010, and now stands at 1.6, its lowest-ever level. Here and across the developed world, women aren't giving birth in sufficient numbers to replace themselves and their partners, which means that (not including the effects of immigration) the US population will eventually begin to shrink. Unfortunately, COVID has only made matters worse. The pandemic started barely a year ago, so we only have a couple of months of data from mothers who conceived post-COVID, but the early returns look grim. Births were down 4% in 2020, but that trend was much worse late in the year, with December births down 8% from the previous year. Recent headlines paint a pretty bleak picture for population growth among essentially all developed economies. Even China's "single child" policy, which began in 1980, continues to impact their economy, with reports showing China's population set to decline in 2022 (China claims that it won't happen until 2024, as if that really matters).

These demographic trends throw a big bucket of cold water on the "inflation is coming" crowd. A young, growing population—one that's buying new homes, starting families, spending on household items and other durable goods, while pursuing high paying jobs—is the fire that ignites measurable and persistent inflation. It's hard to make a case that, once we move past the current disruptions in global trade, growth in aggregate demand is going to exceed the productive capacity of the global economic machine. Further, aging populations across the globe will become increasingly dependent on social programs, straining budgets and necessitating higher taxes, a further drain on economic growth. These are trends that were already in place pre-COVID; the events of the past year are not likely to reverse them.

We're in an unprecedented economic period; this past year has been unusual in ways we couldn't imagine just a few months ago. And while that has caused a lot of disruption in economics and world trade, the long-term trends underpinning global economic growth and inflation remain intact. It's prudent to take steps to protect against inflation this year, and we may have to continue to do so in 2022, but from our vantage point, inflation is not a long-term concern.