Q2 2021 | Capital Markets Outlook

Robert J. Schoen
Chief Investment Officer,
Global Asset Allocation

James A. Fetch
Co-Head of
Global Asset Allocation

Jason R. Vaillancourt, CFA
Co-Head of
Global Asset Allocation

Don’t fall for inflation head fake

How do we view markets in March, when many folks are watching the NCAA college basketball tournament, probably shedding a tear over their busted bracket after a top-seed team has lost in the early rounds?[1] Let’s start with a metaphor. You are very likely to see in tournament games a play near the basket that involves a shorter player faking a shot to cause a taller opponent to jump too soon, and then earn a foul call. This move is a “head fake.” In economic data, we also have a version of the head fake. Most important metrics in the macro economy are measured as year-on-year percentage changes. When you have a short, sharp dislocation (something you might see as a result of a pandemic, for example), we then, in the following year, observe “base effects.” The rolling on of the high-volatility number from a year ago (and its subsequent rolling off) can make these 12-month percentage changes look like a shift in the longer-term trend if extrapolated into the future.

We will soon see impact from the 2020 Covid-19 pandemic on the economic data. A particular focus area will be inflation. Our message is simple: Don’t fall prey to this head fake.

Asset allocations

Shading in the table indicates the change from the previous quarter

	Underweight	Neutral	Overweight
EQUITY			●
U.S. large cap		●	○
U.S. small cap		○	●
U.S. value		○	●
U.S. growth		●	
Europe		○	●
Japan		○	●
Emerging markets		○	●
FIXED INCOME		●	
U.S. government		●	
U.S. investment-grade corporates		●	
U.S. mortgage-backed			●
U.S. floating-rate bank loans		●	
U.S. high yield		○	●
Non-U.S. developed country		●	
Emerging markets	●		
COMMODITIES			●
CASH		●	

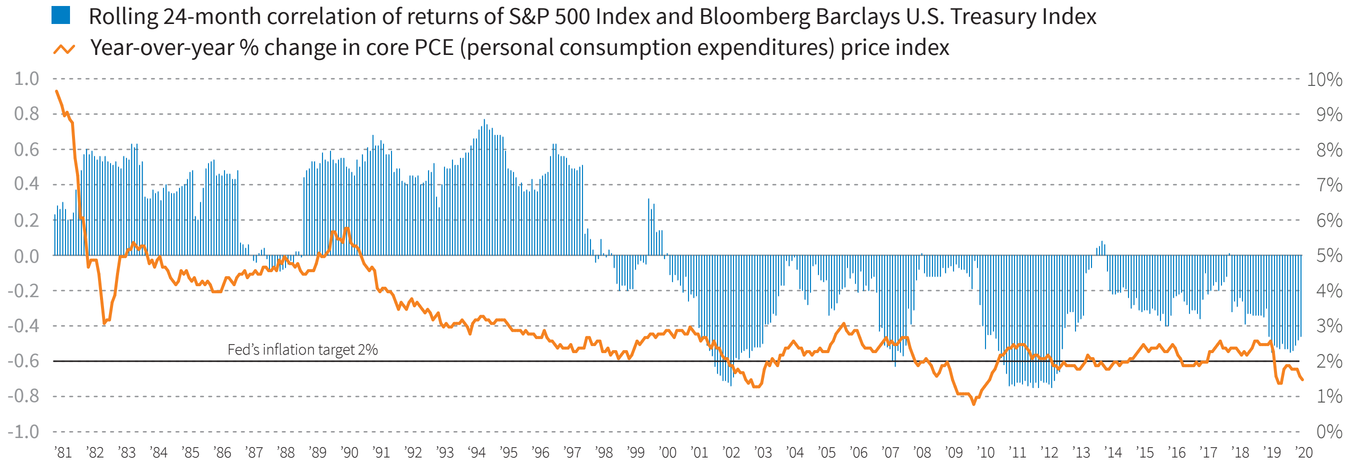
Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro	○	●	
£ Pound	○	●	
¥ Yen	○	●	

[1] Fun fact: Through the first 47 games of the 2021 NCAA Men’s Division 1 college basketball tournament, the teams seeded at least 5 spots below their opponents won 13 games — a record high in tournament history.

Could inflation erode stock-bond diversification potential?

Asset correlation (left scale) went from positive to negative as inflation neared Fed price stability target (2%)



Sources: Putnam, S&P 500 Index, Bloomberg Barclays U.S. Treasury Index, and Bureau of Economic Analysis (PCE). Past performance is not a guarantee of future results.

All puffed up

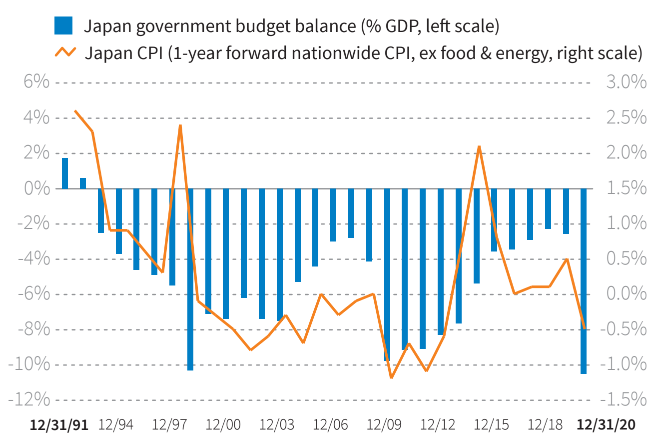
Many economic prognosticators have recently concluded that the $900 billion stimulus bill from December 2020, the $1.9 trillion American Rescue Plan, and the more than $600 billion unspent proceeds in the Treasury General Account will combine to unleash a wave of inflation. They also worry this will undo 40 years of the Federal Reserve's hard-fought credibility on price stability. Furthermore, newfound inflation would also very likely undermine the diversification benefit that comes with owning bonds together with equities, which has been persistent over the past two decades, the thinking goes.

For a whole host of reasons, we disagree with this premise. Reports of the death of 60/40 investing have been greatly exaggerated. To dispel the idea that the United States is on its way toward a new inflation regime, we would first point out that many of the same prognosticators were also warning of runaway inflation in the wake of the 2008 GFC (Great Financial Crisis) when global central banks began large quantitative easing programs. The 2008 fear was that large central bank balance sheets would flood the system with liquidity, which would then find its way into generalized goods and services prices. Inflation, however, failed to materialize, in large part because the secular forces driving disinflation have been and continue to be quite powerful, and perhaps not well understood.

The large positive fiscal impulse in the United States for 2021 will become a fiscal drag in 2022 due to base effects. Also, remember Japan's experience: Japan has run double-digit budget deficits several times over the past 20 years, while also passing substantial short-term supplemental budget stimulus packages. With all of that, Japan still failed to generate sustained core inflation above 1%.

Inflation did not last after Japan's stimulus packages

Government budget balance and inflation



Sources: Bloomberg, OECD, Japan Ministry of Internal Affairs and Communications. Past performance is not a guarantee of future results.

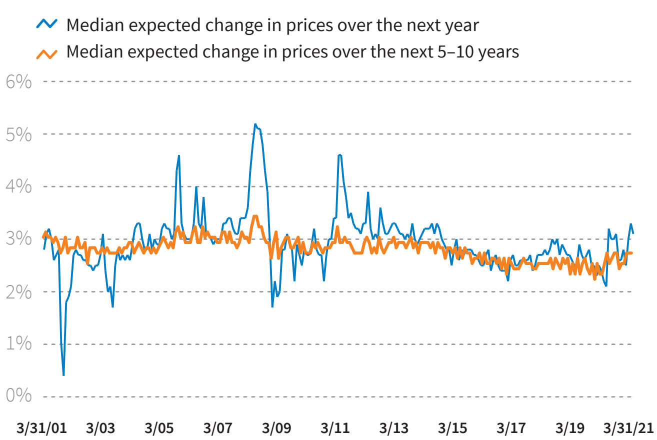
Pressures weigh on prices

Developed-market economies generally have two secular challenges in common — aging populations and heavy debts — both of which are disinflationary. In the case of the former challenge, some economists might postulate that higher dependency ratios put upward pressure on inflation. This stems from the aging society, which steepens the slope of the Phillips Curve as the labor pool shrinks. A recent book, *The Great Demographic Reversal*, by Charles Goodhart and Manoj Pradhan, has earned much attention on this subject, but the academic literature and empirical evidence for this theory are far from conclusive. Japan, the world's third-largest economy, is an important data point that would refute this theory, as its aging society has not pushed up inflation.

Debt dynamics are also likely to be a substantial drag on any inflationary pressures in the world's advanced economies. If bond markets were to sniff out a rise in inflation expectations and respond with upward pressure on interest rates, the cost to service debt would rise and drain government budgets, all else equal. Those debt-servicing efforts would likely prevent resources from being put toward growth- or productivity-enhancing projects.

Long-term inflation expectations are more stable than short term

Short- and long-term consumer inflation expectations



Source: University of Michigan Consumer Survey. Past performance is not a guarantee of future results.

Fed not buying the fake

Finally, it is instructive to take a step back and review the drivers of inflation in the United States, where the Fed cares mostly about core inflation. Their preferred metric is core PCE inflation. The cost of shelter and healthcare make up more than half of the index, and we believe these measures have been and continue to be well behaved. Two components — Recreation and Food & Beverage costs — together make up about 10% of the index. Even if demand were to explode after the economy reopens, a doubling or tripling in the cost of these leisure expenditures would barely register as an increase in core inflation, in our view.

The critical question from an investment standpoint is whether markets will be able to look through the upcoming bump in inflation readings as "transitory." That is how Fed Chair Powell referred to them in his latest post-FOMC press conference on March 17. We suggest investors, at least for the next several months, should measure macroeconomic data relative to the same period in 2019 rather than 2020 to get a clearer picture of underlying trends. For our part, we will stay the course with our recent investment strategy favoring cyclical recovery trades, including overweights to commodities, equity (in particular, value, small-cap, and ex-U.S. exposures), and high-yield credit.

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