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Commentary from New Century Advisors – February, 2021

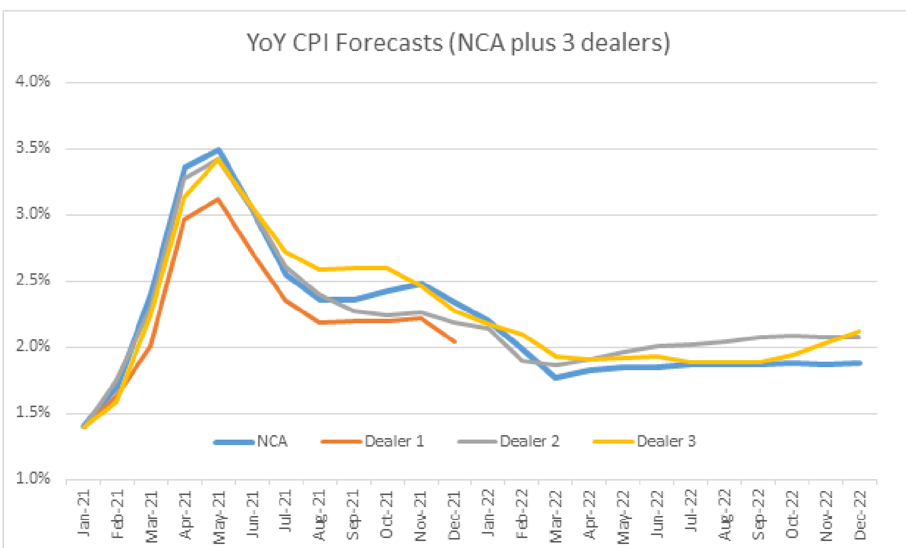
Inflation: When Should We Worry?

Thanks in part to an expected recovery in inflation, the Fed will grapple with the decision of when to taper their asset purchases – possibly as soon as later this year. After tapering come eventual rate hikes. At some point, Fed Chair Powell's comment that the Fed is, "not even thinking about thinking about raising rates," will become, "hey, we are thinking about it!"

As inflation investors we have two tasks: understanding the nature of the underlying inflation trend and understanding how the Fed and markets are likely to react to it. Neither is simple. Inflation has been low and stable for so long that most investors don't remember it any other way, or appreciate the destructive impact it can have on their portfolios.

Complicating matters for the Fed is that a market disruption, like the Taper Tantrum, could curtail what they hope is a productive, income-enhancing recovery. Back in 2013, 10yr rates rose 140bps in just a few months after then-Chair Bernanke said that the Fed could slow the pace of their asset purchases. That threw a wrench in the still-recovering real estate market which was at the center of the Great Recession.

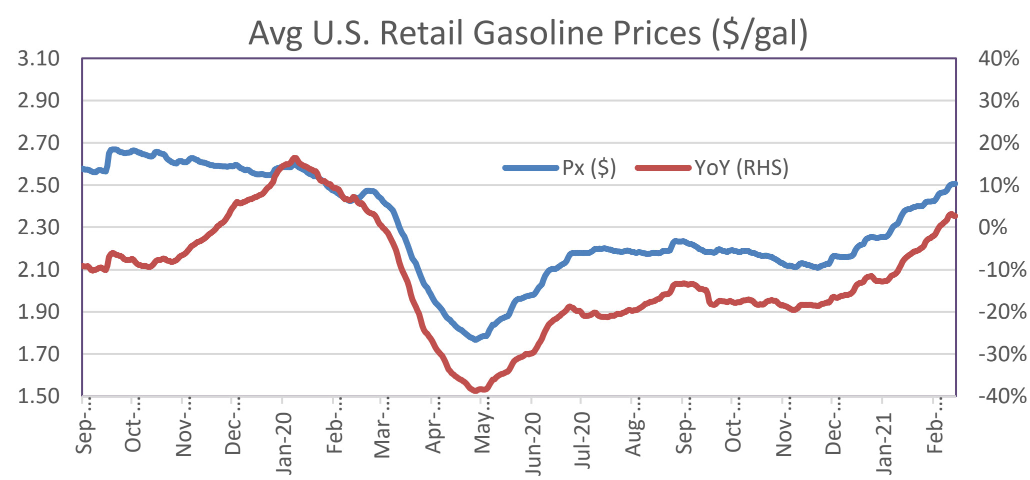
Inflation is expected to rise over the next several months, driven primarily by base effects from last year's collapse in prices. The street consensus, and NCA's own CPI model, have YoY CPI peaking at a potentially worrisome ~3.25% in May before drifting back closer to 2% at the end of the year.



The Fed knows this and has already talked about looking through such a rise. As Chairman Powell discussed at his press conference following the conclusion of the FOMC meeting on January 27th, "We'll see measured 12-month inflation move up [due to] base effects, and that's a transient thing that we think will pass." He added that the Fed would also view, "upward pressure on inflation," from a "burst of spending," once the economy reopens as likely to be transient.

But how will the Fed, or economists and investors in general, be confident that inflation is rising solely due to base effects vs. something more lasting? It is a good question, one which has implications not just for the longer-term inflation outlook, but for the path of monetary policy, rates, and financial markets at large. Is it enough if inflation simply starts coming in above forecast? What about one-off effects? Or perhaps inflation comes in-line with forecasts but rising underlying inflation is obscured by one-offs to the downside? It can be difficult to see the forest given all the trees.

It will be necessary to analyze specific sectors to tease out any new underlying trend. Consider gasoline, where much of the base effect damage lies. Just last weekend, the YoY change in retail gasoline moved positive for the first time since prices plunged last March. At just over $2.50/gal, the U.S. national average gasoline price is up over 40% YoY since it bottomed at the end of April, 2020. But, it is still down 13% from April, 2019, so that 40% rise is clearly nothing more than an unwind of the base effects of the plunge. It should be noted that the Fed focuses on core inflation, ignoring energy, when considering the underlying inflation trend and thus the outlook for monetary policy. That said, gasoline is a stark example of how base effects work and will be a key driver of the coming rise in the YoY headline measure.



Source: AAA

Some other notable areas that are still down big on a YoY basis, and are thus likely to contribute to the base effect rebound in the coming months: Apparel, -2.6%; Hotels, -11.5%; Airfares, -21.3%.

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Understanding what is an unwind of base effects and what may represent a more meaningful rise in underlying inflation pressures will be critical, and not just for the Fed and the path of monetary policy. Pension plans have inflation-linked liabilities, retirees need income in order to live, and younger generations have to save for retirement. Inflation – and the Fed's reaction to it – impacts every investor. Those that have not considered the potential impact that disruptive inflation could have on their portfolio ought to do so.

We will be watching closely because upside risks to inflation are plentiful, including:

- Easy/one-sided monetary policy (Fed to let inflation run hot to offset years of undershooting their target; ~4% cumulative miss over past 10 years)
- Increasing fiscal stimulus ($1.0-1.9T still to come; US Budget deficit of 16% in 2020, projected to be another 10.3% in 2021; historical average <3%)
- On-shoring/shortening of supply chains (reversal of decades-long globalization trend)
- Increasing inventories (reversal of just-in-time delivery)
- Weakening dollar (less of an impact on U.S. inflation now given net oil exports, but still impacts imported goods prices)
- Rising commodity prices (CRB Index up 7.8% YTD, 18.6% YoY, and 37.6% from the April'20 lows)
- Growing labor bargaining power (More labor friendly policies expected given Democratic administration/Congress; Federal increase in minimum wage proposed)

Keep these in mind as inflation rises in the coming months and you hear more talk about base effects.

For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help your fixed income allocation, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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