CETERA® INVESTMENT MANAGEMENT

COMMENTARY

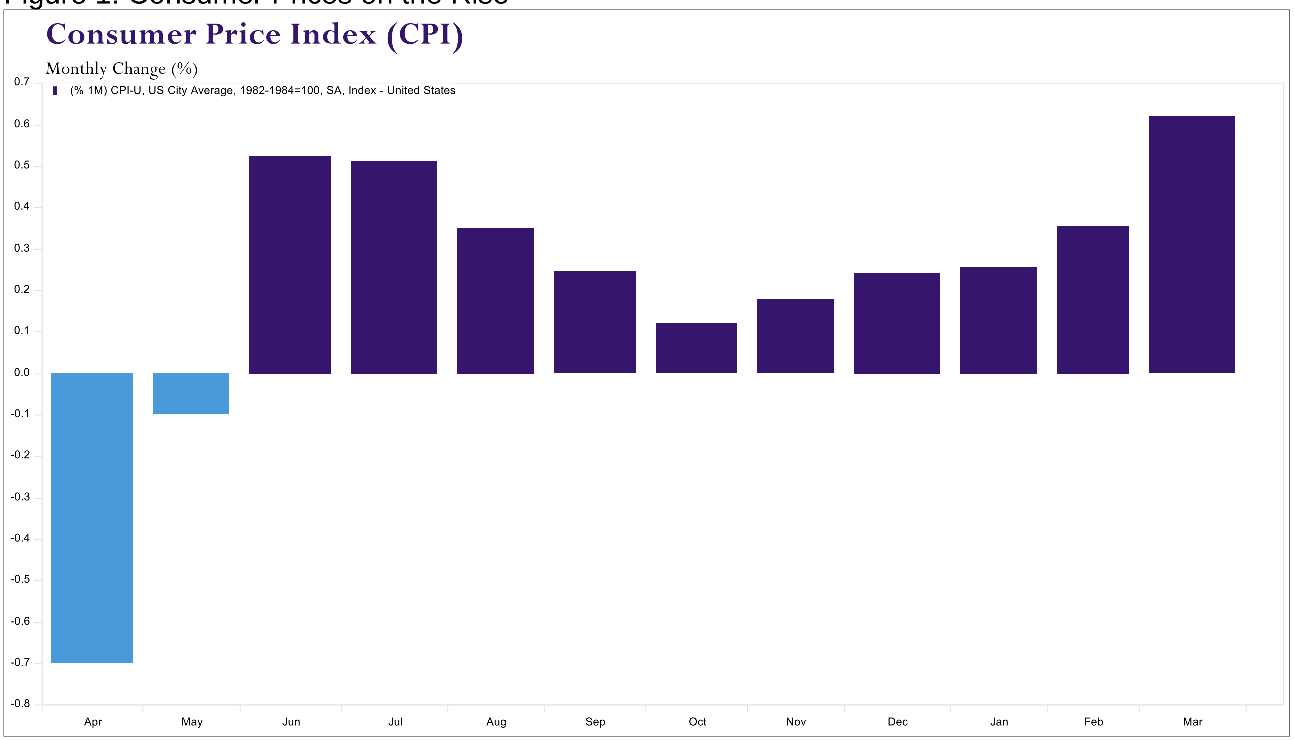
04/15/2021

Inflationary Pressures Build

- Inflation is rising as evidenced by a recent economic report.
- Expectations were for a rise in the price of goods, but services rose more.
- While inflation may continue to rise, we expect the rise in inflation to be temporary.

The most recent economic release from the U.S. Bureau of Labor Statistics confirmed expectations that inflation is indeed rising. The 0.6% increase in consumer prices in March was the largest monthly increase since August 2012 and represented a 2.6% jump on a 12-month basis. The biggest gains in the Consumer Price Index (CPI) were related to energy, as gasoline spiked 9.1%, the fourth straight month of increases over 5%. This is worrisome because inflation erodes purchasing power. It makes money worth less as goods and services become more expensive.

Figure 1: Consumer Prices on the Rise



Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics. @CeteraIM. Data as of 3/31/2021.

Supply disruptions and increasing prices of commodities like copper, steel and aluminum were already apparent in producer prices and business surveys. The economic reopening in developed economies is gaining momentum. Companies are scrambling to order parts from emerging markets, mainly China, and there is congestion in shipping ports. With ships already backed up at the ports, the Suez Canal became blocked for nearly a week after a giant ship got stranded, further stressing supply chains. The increased demand for supplies is also in turn driving up shipping costs and most of all these costs will likely be passed on to consumers as companies increase the prices of their final products. With many consumers also recently receiving stimulus checks and the ensuing increase in demand for goods and services, this only added to expectations for a big jump in the prices.

However, core goods prices, which exclude food and energy, only rose by 0.1%, being overshadowed by the service sector, which was the most impacted by the pandemic. Hotel prices rose by 4.4% for the month and car rentals rose 11.7% (7.4% in February), while auto insurance prices rose 3.3%. Though airline prices remained somewhat muted, it seems the price of a vacation is on the rise as "work-from-home"-weary consumers focus less on goods and more on services this year. This was a theme that we highlighted in our 2021 Market Outlook. As the economy continues to reopen, the economic recovery will broaden away from large technology companies and the recovery will make its way to more value, small cap and service sector companies. We have seen this already in the first quarter of the year as these areas of the stock market have outperformed.

The bigger question still unanswered is where will inflation go from here, and will it be temporary? The one-year inflation is expected to jump due to what economists call base effects. All this means is that inflation is going to jump because the starting point is going to be low due to inflation plummeting in mid-April of 2020. We could see headline annual inflation get close to 4% next month and core inflation, which excludes food and energy, could surpass 2.5%. We anticipate that inflation will rise but not to a level that would require the Federal Reserve (Fed) to increase short-term interest rates. Wage inflation is what generally drives longer-term inflation and we have yet to see a jump in average hourly earnings with the slack left in the labor force. Also, productivity gains should help mitigate some of this potential wage pressure. We believe the spike in inflation will be temporary and this is also the view of the Fed. However, as the unemployment rate drops and workers go back to work, we will be watching for wage inflation carefully. Longer-term, we are also skeptical that inflation will surge as technology and globalization continue to act as a headwind to it. With that said, a significant further weakening of the dollar, which could make imported goods more expensive, might push inflation expectations higher so we are carefully monitoring that scenario.

In the event our base case scenario on inflation doesn't come to fruition, how does one hedge a rise in inflation? If there is a modest rise in inflation, equities should benefit as companies could pass on increasing costs to consumers. However, a sharp rise in inflation pressures profit margins and corporate earnings as it's more difficult for companies to pass on significant price increases to consumers. If inflation rises dramatically, some possible ways to help mitigate this in portfolios include commodities, inflation-protected bonds, and alternative investment asset classes. Trying to protect a portfolio against inflation is difficult, especially in today's environment where many of these traditional inflation hedges are relatively expensive. Therefore, it is important to work with your Cetera financial professional to help navigate these ever-changing financial markets.

Markets continue to follow our 2021 blueprint that includes a broadening economic recovery. In these times, your financial professional can help you stay focused on your long-term risk and return goals and help you with your personalized investment objectives.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter.

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