MIDYEAR MARKET OUTLOOK

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2021 MIDYEAR OUTLOOK

Inflation: Transitory or Here to Stay?

At-a-Glance

Developed economies continue to ride stimulus tailwinds as vaccine distribution peaks.

Inflationary pressures are building, but central banks are largely dismissing above-trend inflation as temporary.

Stock and bond investors seem to agree with central banks and see temporary inflation as a possible benefit for companies to raise profit margins and reduce debt on an inflation-adjusted basis.

Stocks and bonds both seem relatively expensive, but possibly justified by the good economic backdrop.

Volatility could pick up in the second half of the year as investors continue to assess risks, mainly rising inflation.

We continue to recommend diversifying across and within asset classes, along with a focus on long-term objectives and not getting caught up in day-to-day fluctuations and noise.

The economic recovery continues to forge ahead on a path similar to what we described in our annual Outlook late last year. Fueled by government stimulus and low interest rates, the recovery is gaining steam with many local economies fully opening as a result of vaccine distribution efforts. This past quarter may mark the peak in the rate of economic growth for this expansion, apart from the extraordinary bounce-back in the third quarter of last year.

With the economic recovery in full gear, inflation risks are rising. In our second-quarter Outlook, we considered the prospects of higher price levels and now we are seeing this firsthand. Inflation measures are heating up and the question is whether these price pressures will be temporary or more sustained. The U.S. Federal Reserve (the Fed) insists that it expects the effect will be temporary, and it may be. They don't want to slow the recovery prematurely by overreacting to inflation that is temporary and could just be taking a wait-and-see approach.

Equity investors seem to agree with the Fed. Stock indices continue to hit all-time highs and have lofty valuations on top of high earnings expectations. Inflation fears occasionally seem to bubble up for a trading day or two but subside quickly. Consumers have saved money and are looking to spend it, and businesses need to build inventories, both of which support optimism among stock investors.

Inflation increases generally hit bond investors first, and these concerns seemed to be on bondholders' minds as they demanded higher yields for much of this year. That has started to reverse recently, as bond investors seem to agree with equity investors and the Fed that inflation may not run that hot after all. A moderate amount of inflation would be welcome news for corporations looking to raise prices and profit margins and erode some of their debt on an inflation-adjusted basis. As such, corporate bonds are trading at low yields over Treasury bonds right now, so compensation for taking on additional credit risk may be justifiably low.

Overall, 2021 is progressing as many expected. We won't know if inflation will be temporary or longer-term until after the fact, but we will be watching it closely, especially wage inflation, which has started to pick up. We think there will be more volatility in both equity and bond markets in the second half of this year as market participants weigh inflation risks, high equity valuations, and low bond yields.

We continue to recommend being diversified across asset classes, sectors and countries and adhering to long-term risk and return objectives. We remain cautiously optimistic, but risks are increasing and therefore we are more balanced in our outlook. Your financial professional can help you stay on track and keep your sights on your long-term plans.

Global Economy

Strong bullish economic tailwinds are picking up strength as we hit the halfway point in the year. Economic data looks great, helped in part by what economists call base effects, otherwise known as a low starting point, but more importantly, growth is aided by efficient vaccine distribution in the U.S. and increased sales fueled by pent-up demand coupled with high savings rates.

Consumers have more than continued their trajectory for consumption of goods which saw a spike in 2021 that far exceeded previous records. However, let's not forget the U.S. is predominately a service-driven economy with nearly three-quarters of economic output coming from spending on services, which has rebounded dramatically but still has a way to go.

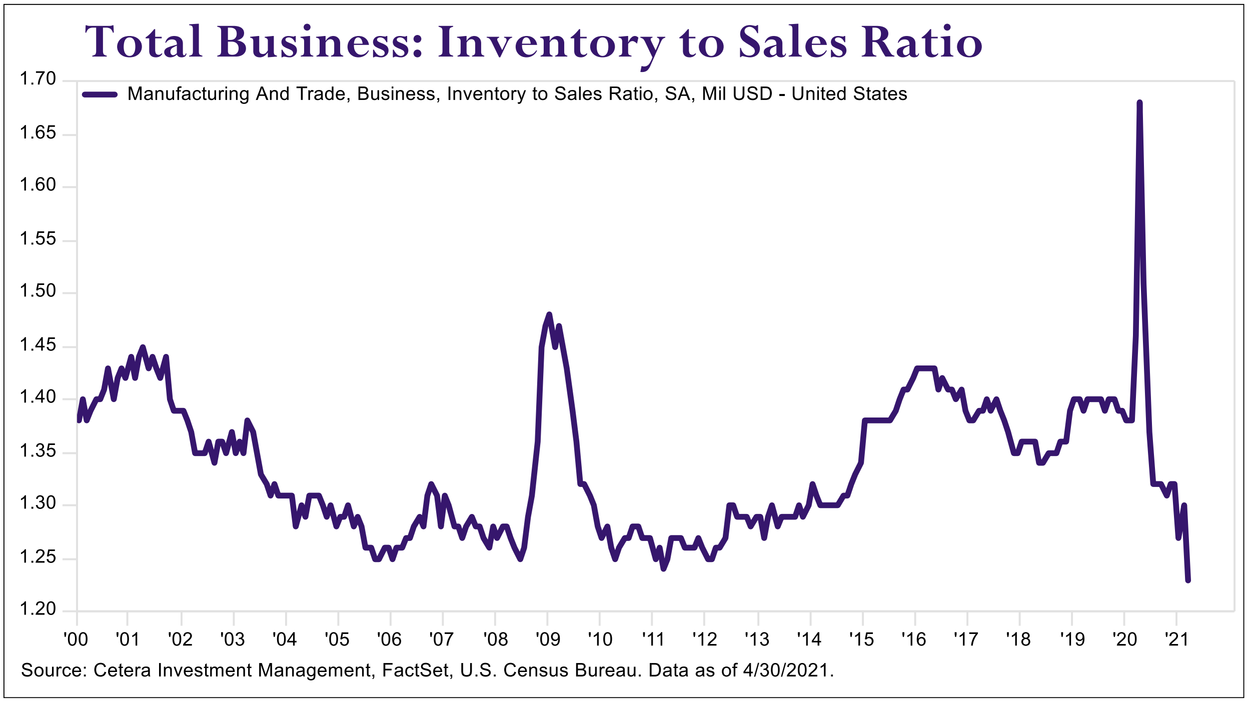
Looking at vaccination data, the outlook for reopening is very promising, however, the U.S. far outpaced other countries in vaccine doses.

- As of the end of May, over 50% of the U.S. population had already received at least one dose. By comparison, Europe was under 40% and Asia under 10%.
- Real GDP, which measures total economic output, is estimated to be over 9% in the second quarter of 2021 in the U.S.
- As more people get vaccinated, consumer movement becomes less restricted, and many have money to spend. Personal savings rates have climbed to record highs with trillions of dollars of fiscal stimulus pumped into the economy. Savings rates initially spiked to all-time highs during the onset of the pandemic, and are still elevated at around 15%, compared to around 8% before the pandemic.

The unprecedented fiscal and monetary stimulus should further augment these figures. We expect that with further reopening, some of this savings will begin to be spent.

While consumers have a lot of savings, corporations are low on inventories. Many corporations were waiting to see how the pandemic played out before buying inventories and planning for the future. Now that the future looks bright, they are playing catch-up. **Figure 1** shows that amidst a backdrop of skyrocketing retail sales, many companies lack the inventories to keep up with demand, with the ratio of sales to inventories is extremely low. Companies will have to spend money to build up inventories which will add to economic growth, doing so at perhaps an inopportune time, as inflation is picking up and input costs are rising.

Figure 1: Low Inventories Amidst Rising Sales

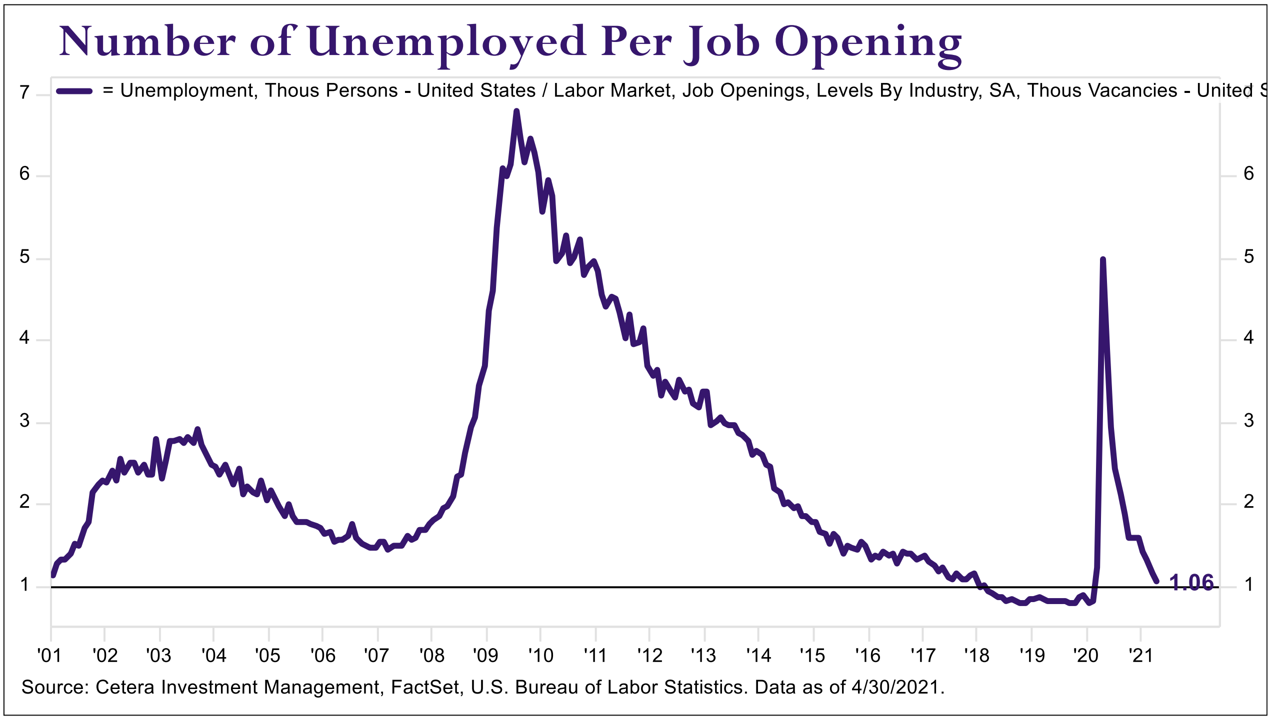


Inflation is the topic du jour among economists and consumers alike right now, so we'll dissect this in more detail, starting with input costs followed by labor markets.

Input costs—prices of metals and goods used in production—have increased dramatically. For instance, the price of copper has gone up from a low of $2.17 per pound to near $5 per pound at its peak in the second quarter. Not only are goods needed for production increasing, so are shipping costs. With companies seemingly all needing to build inventories at the same time, China and other emerging-market nations are scrambling to make parts and ship them to the U.S. and Europe, which even created log jams at many shipping ports. While this is concerning for companies and consumers, these factors would be what the Fed has been referring to as "transitory." Supply chains and shipping logistics will normalize, and prices should come back down. For sustained inflation that is not transitory, typically we need to see persistent wage inflation.

For wage inflation to happen, we generally need to see a tight labor market. Of the 23 million jobs lost during the pandemic, about 15 million have been recovered and the unemployment rate is back under 6%. So, while there is slack in the labor force, it is improving. In fact, the number of job seekers relative to job openings is near a ratio of one-to-one as seen in **Figure 2**. This means there is competition among businesses to find workers, which should drive up wages and that is exactly what we are seeing.

Figure 2: Job Seekers vs. Job Openings



Many of the job openings and much of the wage growth are concentrated in the service industries, which tends to employ workers with lower-paying jobs. These service companies are competing against additional unemployment benefits, which allow some workers to make more being unemployed than working at a job. To compete with these benefits (which expire in September), companies are offering sign-on bonuses to new employees. These sign-on bonuses show up in wage data, but since they are only one-time payments, will drop off. That means there's a case that wage growth will also be transitory—but that might not be the complete picture.

Diving deeper into employment reports, looking at data that goes back over 20 years, the number of workers voluntarily leaving their jobs is at an all-time high. Since workers generally don't leave their jobs without the prospect of more money or stability, this is a sign that workers feel confident they can make more money and are willing to take a risk with a new job.

So, while there is a case to be made that inflation will be temporary, there are also signs that it may be somewhat sustained. This is important because the Fed is watching inflation closely. There is an adage that bull markets don't die of old age, but instead are killed by the Fed. The Fed has a dual mandate to keep inflation in check *and* maximize employment. If inflation gets too hot, the Fed may be forced to raise interest rates to cool the economy down by creating higher borrowing costs. The Fed does not want to kill this fledgling recovery though and seems to be willing to underestimate inflation for the time being. If a lot of these inflationary pressures are indeed temporary, that is the right approach. It would be a mistake to put the brakes on economic growth when the proverbial "foot on the gas pedal" is also about to lift.

We currently think the truth is probably in the middle, that inflation will probably pick up and settle at a reasonable, slightly elevated rate that would not be categorized as runaway inflation like the U.S. saw in the 1970s. We expect the Fed to buy time and focus on “broad and inclusive” employment goals and ignore inflation for as long as it can.

Outside of the U.S., a lot of these same themes still apply. Where each country is in the recovery cycle generally depends on how well they were able to contain the virus or distribute a vaccine.

China is behind on vaccine distribution, but they were able to combat the virus more quickly due to strict lockdowns. China also benefited from a pandemic-induced surge in global demand for goods rather than services. While China is also seeing inflation, its central bank is already acting to take liquidity out of the market and tighten lending standards to cool its economy.

By contrast, **Europe** is behind the U.S. on vaccine distribution, and countries like Italy and Poland were hit hard by the virus. Estonia and the Czech Republic also saw rising cases as recently as this past spring. Hence, Europe’s economic recovery is lagging that of the U.S. Even so, Europe is seeing inflationary pressures starting to build. The International Monetary Fund (IMF) estimates U.S. GDP in 2021 to be 6.4%, and the Eurozone’s to be 4.4%. Europe is expected to edge out the U.S. in growth in 2022 as it plays catch-up.

Equity Markets

Investors are left grappling with strong economic data, high valuations, and the prospects of above-trend inflation. Positive economic data is no surprise, as expectations for corporate earnings are high even while inflation risks continue to grow. Share prices relative to expected earnings are at levels not seen since the dotcom bubble in the early 2000s. Valuations, such as price-to-earnings (P/E) ratios, can remain elevated for long periods of time, so trying to time corrections in these type of ratios often proves difficult. But it’s worth noting, stocks are relatively expensive now, and as a result volatility may be on the rise.

Equity investors seem to believe the Fed’s view that inflation will be transitory. The reason inflation is a concern to stock investors is that not all increases in prices can be passed on to consumers, and then these increased input costs start to eat into corporate earnings. Also, maybe more concerning is that if inflation is too hot, the Fed will raise rates and start to taper bond purchases, which will drive up borrowing costs. This is also troublesome for technology investors because future earnings must be discounted more.

With continued high valuations and mounting inflation risks, our outlook on equities is little changed. We believe that the recovery will continue to broaden and benefit value-oriented and smaller companies. Year-to-date this has been the case, so there could be some profit-taking at some point leading to growth stocks outperforming for periods of time, but we expect this trend to eventually continue longer term. As seen in **Figure 3**, correlations between growth and value stocks have been falling—a trend we saw before the reversal and subsequent decade of value stock outperformance in the 2000s.

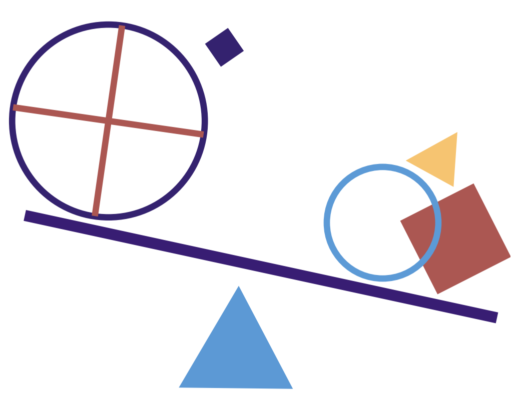
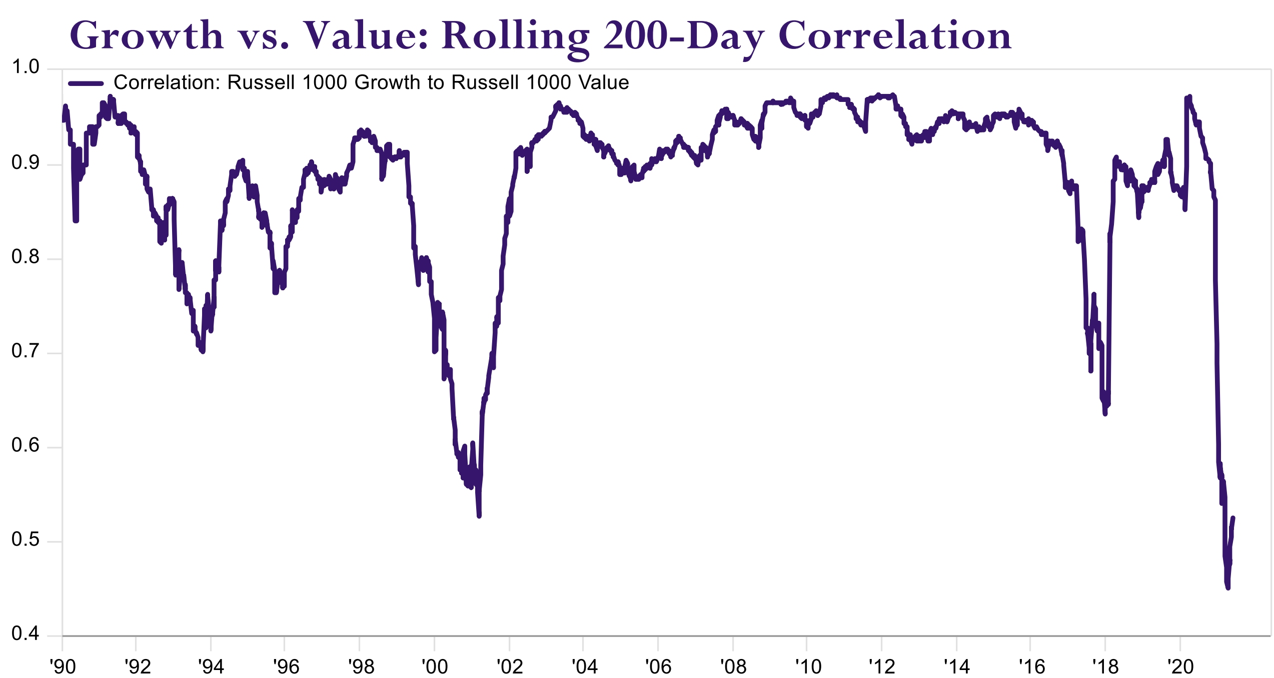


Figure 3: Growth vs. Value Correlation



Source: Cetera Investment Management, FactSet, S&P Global. Data as of 5/31/2021.

Less correlation is good news as it relates to diversification. We are expecting more volatility in equity prices around inflation fears. Investors and economists will not know if inflation is transitory until after the fact, but consumers and investors know we are going to see an increase in prices. The real question is when prices will stabilize or slow. A little bit of inflation would be welcomed news for many companies which haven't had the opportunity to raise prices in years. Raising prices could expand profit margins, but too much inflation would eat into profits and catch the attention of the Fed.

Internationally, if the weakening dollar trend continues, this could help U.S. investors and companies investing abroad. When investors or companies earn money abroad or have foreign investments, they are earned or bought in that foreign currency. A weakening dollar would cause foreign currencies to appreciate relative to the dollar, thus increasing the profits of international investing. After a decade of U.S. dollar strengthening, we think this trend could also continue. U.S. markets have outperformed international markets for over a decade, so this also may be a good opportunity to diversify.

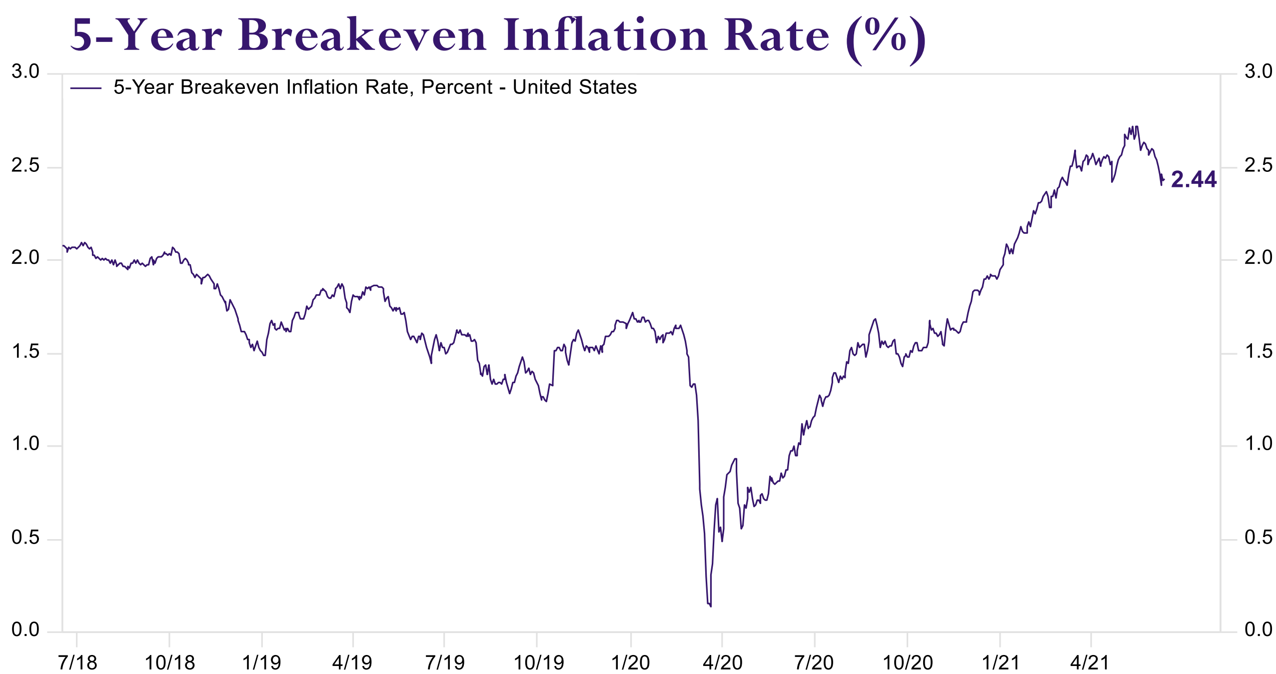
With high valuations and high expectations in stocks, volatility is expected in the second half of this year. Diversification within sectors, countries, and market caps can help reduce volatility.

Fixed Income

Bonds might be the most perplexing place to invest right now. Initially, high-quality bond yields started to rise on the increased prospects of inflation. This is expected as bond investors demand more yield for the increased prospects of inflation, which will erode bondholder returns on an inflation-adjusted basis. The 10-year Treasury yield began the year at 0.93% and climbed to 1.74% by March before pulling back, and as of this writing is around 1.5%.

While yields started falling in the second quarter, inflation expectations were still rising as evidenced by the 10-year breakeven inflation rate, which continued to rise until very recently. This breakeven inflation rate is the rate at which bond investors think inflation will be over the next 10 years. If inflation runs above this rate, Treasury Inflation-Protected securities (TIPS) will do better than Treasuries and vice versa. The 5-year TIPS breakeven inflation rate it is 2.44% as seen in **Figure 4**. Even this rate may seem low, but investors could be thinking inflation will be higher for a few years and cool down after a year or two. In our view, bond investors likely believe the Fed that inflation will be transitory.

Figure 4: Breakeven Inflation Rate



Source: Cetera Investment Management, FactSet, Federal Reserve. Data as of 6/14/2021.

Overall, bond yields remain at low levels for a couple of reasons. In stocks, the acronym TINA (There Is No Alternative) is often used, but it may also apply to bonds. For investors looking to diversify risks in equity markets where many indices are near all-time highs and trading at high valuations, there are few options that have the negative correlations to stocks that bonds have. International investors also like U.S. Treasury bonds. 10-year government bond yields in Germany, Switzerland, and Japan are either negative or close to zero. Even after hedging for currency risks, it's still attractive for many foreign investors to invest in U.S. Treasury bonds. These investors may also believe the Fed that inflation will prove transitory.

Beyond government bonds, both high-rated and low-rated corporate bond spreads are low on a relative basis. Corporate bond investors are not demanding a lot of additional compensation for taking on the added risks of corporate bonds, which are susceptible to downgrades by a credit-rating agency and/or default. This may make sense though. Corporations have been borrowing at and locking in low interest rates. If inflation rises modestly, the debt corporations owe will become worthless on an inflation-adjusted basis and become easier to pay back in the future. Inflation may help borrowers that have a lot of debt as long as it doesn't impact their business operations and ability to generate profits. With the economy expected to do well, this could bode well for high-yield issuers. We mentioned high-yield spreads over Treasuries being relatively low, but the absolute yield level for high-yield indexes is at all-time lows. Fundamentals in corporate bonds look pretty good, but they could be priced accordingly.

While we discussed bonds issued by the federal government and corporations, what about bonds issued by local and state municipalities? With a new administration in the White House, coupled with record amounts of government aid and stimulus adding to the Federal deficit, taxes are expected to rise. This has led to record inflows in municipal bonds, driving up the price for such bonds and thus driving down yields. Credit fundamentals have also improved due to federal aid to local and state governments. Tax revenues which support many of these bonds are also expected to rise with the great economic prospects on the horizon. Municipal bonds could make sense to tax-sensitive investors but are relatively expensive compared to Treasury bonds right now, and this suggests the case for shorter maturity municipal bonds may be stronger.

Bonds, like equities, carry increased risks right now. Treasury bonds may not be fully pricing in prospects of inflation. Additionally, the duration of many bond indexes has extended due to the issuance of longer maturity Treasury bonds to finance the record amount of fiscal stimulus. We recommend below-benchmark duration, but still having duration to offset equity volatility. Corporate bonds offer more yield, and while their compensation relative to government bonds is relatively low, this may be warranted by good economic and earnings prospects coupled with modest inflation. For these reasons, we like corporate bonds relative to government bonds. Being diversified in bonds is just as important as it is in equities, so balancing these risks is prudent.

Summary

As we hit the midpoint of the year, expectations are high, and we could be experiencing peak economic growth in the second quarter. Vaccine distribution and stimulus are propelling the pace of growth. The stimulus impact could come with some side effects, mainly higher inflation. It remains to be seen if price pressures will be temporary or more sustained. For the time being, the Fed and market participants are largely dismissing inflation as temporary, and so both stocks and bonds seem to fully price-in the good economic news. Upside economic and earnings surprises may become harder and harder to attain with these high expectations, and this may cause some volatility in the second half of the year.

Volatility can create opportunities, especially with a strong economic backdrop. We continue to recommend being diversified across asset classes, sectors, and countries, while sticking to long-term risk and return objectives. There is a lot to be optimistic about, but also a lot of risks to consider. Your financial professional can help you stay on track and keep your sights on your long-term plans.

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Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

The Russell 1000 index is a stock market index that tracks the top 1,000 stocks by market capitalization in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index. The index, which was launched on January 1, 1984, is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

The Russell 1000 Growth index is a subset of the Russell 1000 as measured by three factors: sales growth, the ratio of earnings change to price, and momentum.

The Russell 1000 Value index is a subset of the Russell 1000 as measured by three factors: the ratios of book value, earnings, and sales to price.