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Investment Brief
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COBBLESTONE
CAPITAL ADVISORS

Inflation: Transitory Phenomenon, or Underappreciated Risk?

US and international equities delivered another strong quarter of returns during the April through June period. While US value and small cap stocks lagged, both asset classes continue to perform well on a year-to-date basis. Returns from fixed income were also positive for the quarter, though they remain in negative territory year-to-date.

Global COVID-19 infection rates have generally declined in recent months amid rising vaccination rates, supporting healthy levels of economic activity. With 90% of country-level leading economic indicators indicating expansion, it is safe to say that a global economic recovery is well underway.

As of this writing, 48% of the US population is now fully vaccinated. Business reopenings are ramping up, physical occupancy of US offices is trending higher, and high-frequency mobility indicators such as TSA traveler traffic, US seated diners, and hotel occupancy rates are continuing to recover.

Concurrently, consensus economic forecasts for the US have been steadily revised upward, with the median projection for 2021 real GDP growth now at +6.6%. If this level of growth indeed materializes, it would mark the strongest rate of growth for the US since 1984, when GDP increased +7.3% on the year.

The outlook for 2022 is equally sanguine, with estimates suggesting that above-trend growth (current est. +4.1%) should continue through next year as well.

Though all positive developments, the sharp rebound in activity has created imbalances across large swaths of the economy, with demand rising at a quicker pace than supply. In addition to global supply chain disruptions leading to shortages of everything from automobiles to chicken wings, capacity constraints resulting from labor shortages have also materialized.

It's certainly hard to square 5.9% unemployment with a labor shortage, especially when 9.5 million people remain unemployed and the number of job openings is at a record high of 9.2 million. Even so, despite there being more than enough workers to fill the open positions, employers are reporting that filling them is as difficult as it's ever been. This imbalance can be partially attributed to transitory factors such as enhanced unemployment benefits, childcare constraints, and lingering virus fears. However, fortified personal balance sheets, limited migration, a wave of recent retirements, and mismatches in the labor market—both skill and geography-related—also appear to be playing a role.

We are beginning to see evidence that these imbalances are pushing up wages as employers vie for workers. Employees are also voluntarily leaving their

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Total Return (%), Ending 6/30/2021				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	8.55	15.25	40.79	18.64	17.64	14.83
Russell 2000 (Small-Cap Stocks)	4.29	17.54	62.03	13.49	16.46	12.33
MSCI EAFE (International Stocks)	5.17	8.83	32.35	8.25	10.27	5.89
MSCI EM (Emerging Markets)	5.05	7.45	40.90	11.25	13.02	4.28
Bloomberg Barclays US Aggregate Bond Index	1.83	-1.60	-0.33	5.33	3.02	3.39
Dow Jones US Select REIT	11.76	22.94	39.89	8.08	5.14	8.65
Consumer Price Index (% Chg over Period; One-Month Lag)	2.35	3.35	4.99	2.28	2.30	1.77

jobs at the highest rate on record, suggesting that upward pressure on wages may persist in the months ahead. With wage pressure historically acting as one of the most important drivers of inflation, developments in labor markets over the next several months will be key determinants to the inflation outlook.

Beyond the inflationary pressures resulting from labor market and supply chain imbalances, the release of pent-up demand and a concurrent shift in consumer spending from durable goods to services has led to material price increases across categories such as lodging and transport (see below chart), further stoking runaway inflation fears. It is worth noting that services account for 63% of the US Consumer Price Index (CPI), and prices in the category are generally sticky (i.e., changing relatively infrequently).

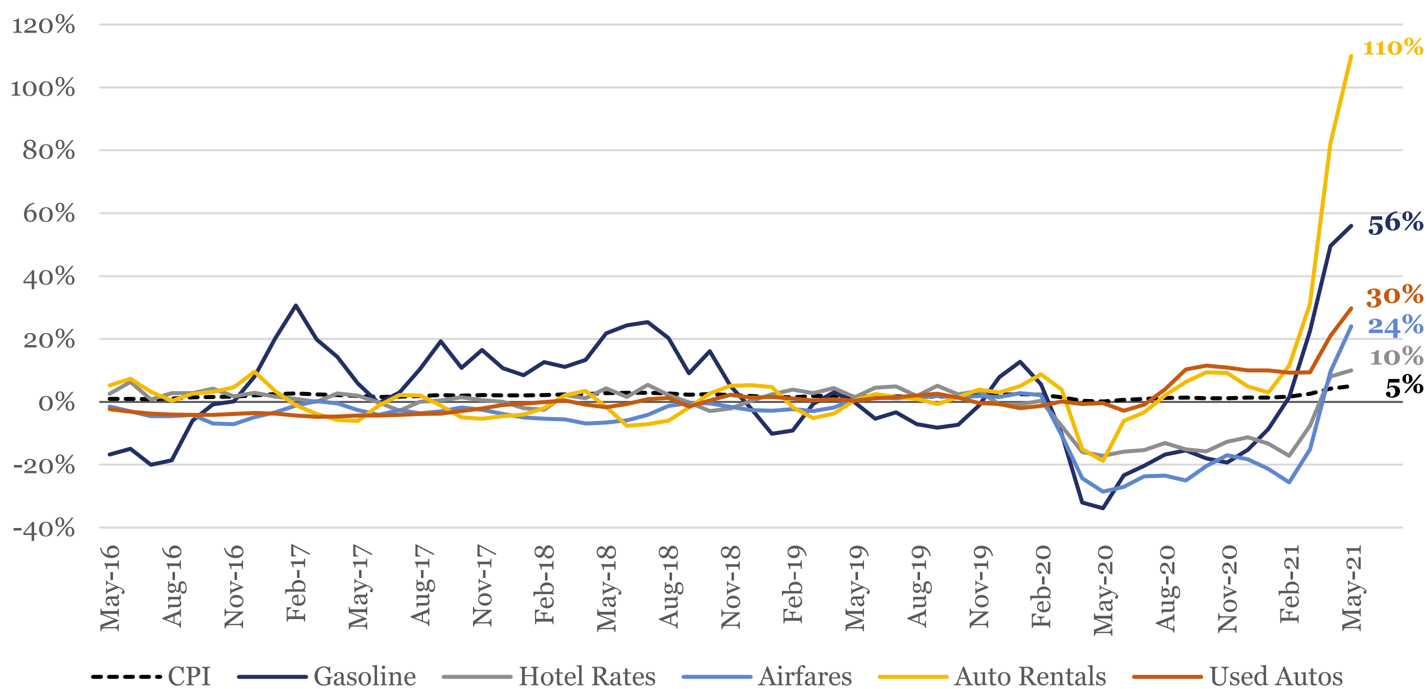
As the economy continues to reopen, the trend in prices for services will be another important monitoring point due to the impact on headline inflation. This is especially true when considering the level of recovery thus far across goods and services. Whereas goods spending has already surpassed pre-COVID levels, spending on services has yet to catch up, leaving a runway for spending growth to continue. And with households sitting on a stockpile of savings and wages beginning to rise, there should be plenty of support for services spending going forward.

What does all of this mean for inflation? Will it prove transitory or more persistent?

Sharply rising prices across several categories are due in large part to considerably lower prices and collapsing supply that materialized following the onset of the pandemic. The lower base prices in the year-over-year comparisons naturally elevate the current inflation measures. Once these "base effects" roll off and capacity comes back online, we expect inflation across the affected categories to normalize.

Markets apparently share this same view. Measures of inflation expectations have increased in recent months, but indicate inflation over the next five years running below 2.5%—hardly the runaway inflation that many investors fear. And with Treasury yields steadily pulling back from their post-pandemic highs reached in March (the 10-year currently sits at 1.3%), the bond market is signaling waning concern about the prospect of lasting inflation.

Nonetheless, being prepared for either outcome is the prudent approach. A well-diversified portfolio with exposure to global equities and alternative asset classes (including private investments) such as real estate and other real assets (e.g., timberland, farmland, and infrastructure) can help investors effectively hedge against inflation risk in the event that inflation proves more persistent than anticipated.



Source: US Bureau of Labor Statistics, Bloomberg. Utilizes most recent data available as of July 12, 2021.

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