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Weekly Commentary

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By Hubert Marleau

Inflation Is Red Hot, But Not Structural

Submitted May 16, 2021

A Snapshot of the Market for the Week Ended May 14, 2021:

Reports on inflation provided unpleasant surprises. In the first three days, the inflation narrative was in full swing. The media said that worldwide stimulus shock and supply disruptions are producing inflationary pressure everywhere. If one were to look at Google Trends, the search for inflation is at its highest ever and mentions of it on corporate earnings calls were up 800% from a year ago. According to the University of Michigan's consumer sentiment index, it tumbled in early May because year-ahead inflation expectation surged, jumping to 4.6% from 3.4% in April while long term expectation rose to 3.1%. Clearly, workers and businesses are aware of what is going on: the Atlanta Fed's Inflation Expectations survey showed that firms are predicting an overall price increase of 2.8% over the coming year.

The S&P 500 was down 4.0% in the first three days, closing at 4063 on Wednesday. It helped to skim some froth as hyper-growth shares took it on the chin--renewables, innovation, Internet, EVs and biotechs. Nonetheless, investors should take solace. The three-day correction did not kill the reflation trade. Based on similar instances of sudden increases in volatility since 1990, unless we are entering a recession, this week's VIX spike is simply a panic/reset. At this time, the recession risk is very low. Crossing Wall Street's Eddy Elfenbein showed in a recent article in Advisoranalyst.com that stock market performance is negative only when inflation is above 6.0%. The observation is based on data which goes back 1104 months—92 years. At this time, I do not think that we have the sort of inflation that the market should fear.

Rotating into cyclical stocks makes good sense if one believes that there is a 50%+ chance that we are in the early stages of a worldwide cyclical economic recovery. Over time cyclical inflation becomes disinflationary. For the average American household, food, energy, and shelter combined represent roughly 70% of their personal disposable income. Consequently, rising prices for these essential and basic products can reduce demand for

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luxury goods and non-essential items. Counterintuitively, defensive names in the staples, big pharma, and REIT sectors along with monopolistic utilities and telecoms could surprise us to the upside.

In the following two days, the broad market rose 2.7% to finish the week at 4173 because the boom-led recovery is still on track. The Atlanta Fed's GDPNow model is predicting a GDP annualized growth factor of 10.5% for Q/2. Goldman's David Kostin wrote late Friday that we are in the middle of an economic renaissance. The combination of global reopening, elevated consumer savings, and strong corporate operating leverage will drive sharp recoveries in both economic and earnings growth. He raised his 2021 S&P 500 EPS forecast to $193 and lifted the 2022 estimate to $202, 2023 to $212, and 2024 to $223. Interestingly, analysts' bottom-up EPS estimates for Q2-Q4 2021, 2022 and 2023 have been revised up and are far more optimistic than Kostin's bullish projections. His S&P 500 forecast is 4400 by year end. And, that target is without any expansion of the p/e multiple.

Nearly $26 billion flowed into global equities last week of which $9.1billion went into U.S. stocks. In the latest edition of the BofA's popular weekly "Flow Show", Michael Harnett pointed out, "inflows to global stocks are annualizing at a remarkable $1.3 trillion". The reason for this bullishness is related to the belief that the Fed will not raise rates, even if inflation were to exceed the 2% target over the next two years. Fed Governor Waller said, "I would be only concerned with inflation if I were to see 4% month in, month out, month in, month out". A Reuter poll of economists concluded that the Fed's preferred inflation measure, the core PCE, would have to hit a high of 2.8% to discomfit policy makers, and stay at that rate for several months before they would act. In April, the core PCE rose 1.8% y/y.

Inflation Is Red Hot, But Not Structural:

The consumer, producer and import price indices were up sharply in April and considerably above consensus. Thus, inflation was on the mind of traders and investors alike throughout the week. They wondered if the current increase in the inflation rate was either transient, cyclical or structural.

Unfortunately, I'm not very good at making macro-economic forecasts. To make matters worse, we have a weird business cycle, an abnormal market and a new monetary and fiscal regime. We have no empirical evidence nor valid theories to explain the ongoing skewed relationships between these crucial variables. For example, there are millions of unemployed people and it's almost impossible to hire them. There are 8.1 million job openings. Where are they?

Because of my inability to make accurate predictions about the basic components (employment, productivity and inflation) of the economy which determine stock market returns, I rely on the rational machinery of the bond

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market, the shock absorbing capability of the foreign exchange market, and the sensitivity of the commodity markets to build probable scenarios. In this regard, inflation appears to be partially transient but mostly cyclical in nature.

For as long as the idea that the "excess savings" of households will cause demand to rise, even in the face of rising prices, the potential for an inflation psychology will persist. Nevertheless, the stimulating effect of fiscal and monetary policies will fade in 2022. Thus, the structural forces are not anchored. In this connection, I do not anticipate a 1965-1985 style hyper-inflation psychosis. Interestingly, the bond market is not convinced that real-world prices are about to permanently shape inflation expectation. Yield curve derivatives are predicting that the rate of inflation will be about 2.7% for the next five years and decline to 2.2% in the following five years. Put simply, the bond market is either suggesting that over time cyclical price increases will eventually give way to lower economic growth and price inflation and/or the current buy-in-advance mentality is fleeting.

Yet, the housing sector is an exception. It's one area where structural inflation is visible. It reflects the connected dynamics of easy monetary policy, changing demographics, fiscal policy largeness, supply-chain disruptions and transforming consumer preferences. It's a rhythm that could last for a long time. Ben Carlson wrote: "There were 17 million homes finished in the 1970s, 15 million in the 1980s, 13 million in the 1990s, 16 million in the 2000s and just 10 million in the 2010s. Yet, there were roughly on average 210 million people in the U.S. in the 1970s and they were building more than 2 million houses a year. There are now 330 million people and last year there were less than 1.3 million houses completed".

Last week, I gave a 25% chance that the current pace of inflation was transitory—50% attributable to cyclical factors and 25% to structural forces. More or less, I still hold these probabilities. However, based on several idiosyncrasies in the consumer price index, new details about the production pipeline, the changing content of imports, softer retail sales and the apparently stubborn preference for out-of-town residences, I tweaked the probabilities a bit to 30%, 50% and 20%.

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