
# ECONOMIC & INVESTMENT PERSPECTIVES

## SPOTLIGHT: *INFLATION SPIKES*

**Figure 1: 5/31/2021 Returns** (source: Bloomberg)
*Conditional formatting: green (high) to red (low) for each time period*

| Bonds | ETF | Month | YTD | 1YR | Current vs. 52-wk High | Current vs. 52-wk Low |
|---|---|---|---|---|---|---|
| US Aggregate Fixed Income | AGG | 0.2% | -2.5% | -0.7% | -4.3% | 1.2% |
| U.S. Treasury Bonds | GOVT | 0.2% | -2.8% | -3.9% | -6.0% | 1.2% |
| Investment Grade Corp Bonds | LQD | 0.6% | -3.9% | 2.3% | -5.5% | 3.0% |
| Muni Bonds | MUB | 0.3% | 0.4% | 3.6% | -0.8% | 2.5% |
| High Yield | HYG | 0.0% | 1.3% | 10.8% | -0.7% | 8.3% |
| Non-US Corp Bonds | IBND | 1.2% | -2.0% | 13.0% | -3.6% | 12.6% |
| Emerging Markets Bond LC | EMLC | 2.4% | -2.7% | 8.6% | -4.9% | 5.0% |
| **Global Equity** | | | | | | |
| ACWI Global Equity | ACWI | 1.5% | 10.9% | 41.6% | -0.3% | 42.0% |
| United States | VTI | 0.5% | 12.4% | 44.2% | -0.7% | 45.5% |
| International Developed | EFA | 3.5% | 10.8% | 38.8% | -0.4% | 36.7% |
| Emerging Markets | EEM | 1.6% | 6.2% | 47.8% | -5.9% | 44.4% |
| **Global Equity by Region** | | | | | | |
| United States | VTI | 0.5% | 12.4% | 44.2% | -0.7% | 45.5% |
| Europe | IEUR | 4.3% | 15.1% | 44.7% | -0.3% | 42.1% |
| Asia ex-Japan | AAXJ | 0.7% | 5.3% | 47.6% | -7.9% | 44.6% |
| China | MCHI | -0.2% | 1.1% | 35.7% | -16.1% | 33.5% |
| Japan | BBJP | 1.9% | 1.9% | 25.7% | -4.8% | 26.7% |
| Latin America | ILF | 7.9% | 4.4% | 52.7% | -0.8% | 48.8% |
| **US Equity** | | | | | | |
| US S&P 500 | IVV | 0.7% | 12.7% | 40.5% | -0.7% | 42.2% |
| NASDAQ 100 QQQ | QQQ | -1.2% | 6.6% | 44.0% | -2.6% | 44.3% |
| US Large Growth | IWF | -1.4% | 6.4% | 40.0% | -2.7% | 42.0% |
| US Large Value | IWD | 2.3% | 18.3% | 44.2% | -1.4% | 47.9% |
| US Eqwt S&P 500 | RSP | 1.9% | 19.0% | 52.6% | -1.1% | 54.1% |
| US Mid Cap | IJH | 0.3% | 18.9% | 56.9% | -1.8% | 61.1% |
| US Small Cap | VTWO | 0.3% | 15.3% | 64.8% | -3.8% | 69.3% |

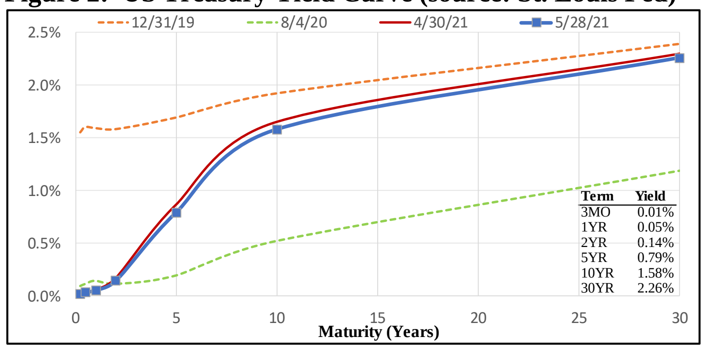
Volatility returned to the markets in May as inflation concerns took center stage. Investors worried about the prospects of future economic growth and debt amid potentially higher interest rates. Even so, equity markets remain near all-time highs. Performance highlights for the month and year-to-date (YTD) are below.

- Bonds: The US Aggregate index (AGG) rose 0.2% this month (-2.5% YTD) as interest rates moderated. High yield (HYG) was flat (+1.3% YTD), while non-US bonds (IBND) gained 1.2% (-2.0% YTD) as the dollar weakened during the month.
- Global equity (ACWI): +1.5% this month (+10.9% YTD).
- US Equity: The broad market (VTI) rose 0.5% in May (+12.4% YTD), while the S&P 500 (IVV) was +0.7% (+12.7% YTD). Small caps (VTWO) were +0.3% this month, under-performing large stocks, but lead YTD (+15.3%). Growth stocks (high earnings growth and valuations) under-performed value stocks (lower growth and valuations, higher dividends) for the month amid rising inflation concerns; the growth ETF (IWF) fell 1.4% (+6.4% YTD) while its value counterpart (IWD) gained 2.3% for the month (+18.3% YTD). Value now leads growth over the last 12 months (+44.2% vs. +40.0%).
- Non-US Equity: Developed market equities (EFA) were +3.5% in May (+10.8% YTD), led higher by European stocks (IEUR +4.3%). Emerging markets (EEM) were +1.6% (+6.2% YTD), with 8-10% gains in Russia, Latin America and India offsetting slightly negative returns in Chinese stocks.

## Interest Rates and the Economy

Interest rates have risen significantly since pandemic fear-related lows in August but declined slightly this month despite rising inflation concerns. Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Short-term yields remain near zero while long-term rates have moved back toward pre-pandemic levels. The US 10-year bond yield fell from 1.65% to 1.58% in May as the Federal Reserve (Fed) reiterated its accommodative policy but suggested the they will begin to discuss plans to taper aggressive bond buying, which has kept long-term rates from rising more significantly.

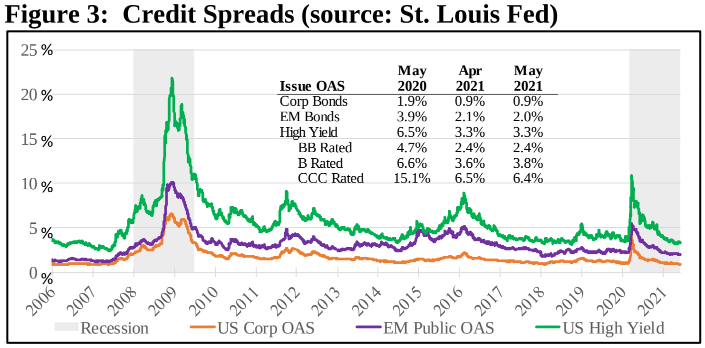
**Figure 2: US Treasury Yield Curve (source: St. Louis Fed)**




For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between yields and US Treasuries of comparable maturities. Low or narrowing spreads signal optimism while high or rising spreads signal fear. Credit spreads spiked on pandemic fears in early 2020 but have tightened steadily since.

- Investment grade corporate bond yields were stable last month at just 0.9% over Treasuries versus 1.9% a year ago.
- High yield (non-investment grade) spreads were also stable at +3.3% but are significantly below year-ago spreads of +6.5%. The riskiest bonds (rated CCC & below) yield +6.4% over Treasuries, well below panic levels of +15.1% a year ago.
- Emerging market bond spreads narrowed to +2.0% this month, well below spreads of +3.9% one year ago.

**Figure 3: Credit Spreads (source: St. Louis Fed)**



## Inflation and Interest Rates

Volatility has returned to the markets amid renewed inflation fears. After years of hovering at or below 2%, the Consumer Price Index (CPI) came in at +4.2% for April versus a year ago, the highest inflation reading since 2008. Given the massive fiscal and monetary stimulus undertaken during the pandemic and the resulting increase in debt and the money supply, somewhat higher inflation was inevitable. A sustained rise is the primary risk to the still fragile recovery, potentially forcing the Fed to withdraw accommodative support (low interest rates and money printing) prematurely. A material increase in yields could render massive debt, deficits and high equity valuations unsustainable.

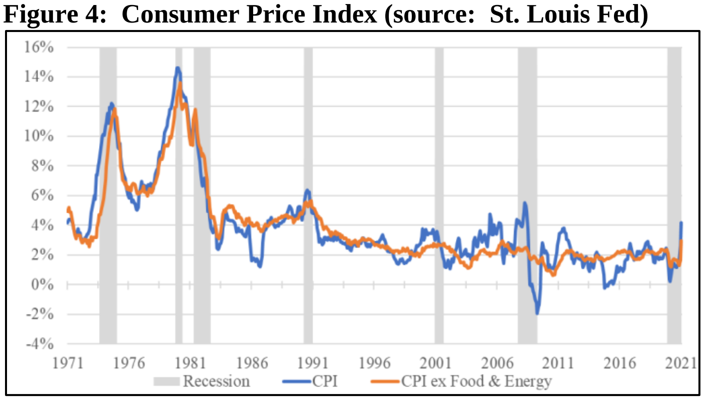
The Fed (and others) saw the inflation spike coming and predicted that it will be transitory, citing pandemic-related causes:

- The "base effect": Comparisons versus a year ago are distorted by depressed economic activity and prices in the early stages of the pandemic and global economic shutdown last spring.
- Re-opening pains: Businesses face temporary problems as the economy restarts, including supply chain disruptions, and shortages of labor and materials (like semiconductors).

Most central banks, including the Fed, target 2% inflation. High inflation negatively affects economic and financial decisions and erodes the value of a country's currency. Deflation can be just as bad, as falling prices negatively impact corporate and consumer behavior through decreasing supply and demand of goods and services, resulting in high unemployment, wage cuts, etc. The Fed's goal is to minimize the distraction of prices in corporate decision-making. While 2% is not a firm target, it is generally viewed as a reasonable level where companies' concerns regarding price changes for inputs (labor and capital) are minimized.

The Fed focuses on "core" inflation, excluding the price changes of food and energy, which are more susceptible to temporary shocks. Core inflation is a less volatile measure of the sustainable inflation rate. This is illustrated in Figure 4, which compares total CPI and core CPI changes over the past 50 years.

**Figure 4: Consumer Price Index (source: St. Louis Fed)**

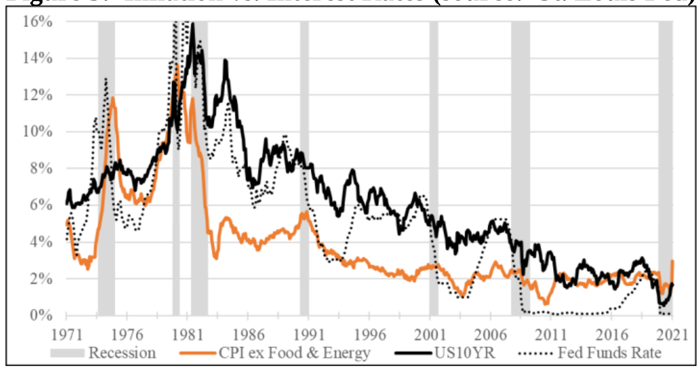



(Note: The Fed's preferred inflation metric is the core Personal Consumption Expenditures price index, but we focus on the more familiar CPI measures here; core PCE and core CPI are similar.)

While April's inflation spike is clear, it is important to note that the most recent core CPI reading was "only" +3.0% versus a year ago. (Note: The Fed's core PCE inflation metric was +3.1%.) While this is still elevated, the Fed has stated on numerous occasions that they will wait to see sustained inflation above their 2% target before taking action (raising interest rates).

The relationship between inflation and interest rates is illustrated in Figure 5, which graphs core inflation (orange line) versus the Federal Funds Rate (dotted line) and 10-year bond yields (black line). The Fed directly impacts interest rates by raising or lowering the Federal Funds Rate, which is the target interest rate at which banks borrow or lend each other excess reserves overnight.

**Figure 5: Inflation vs. Interest Rates (source: St. Louis Fed)**

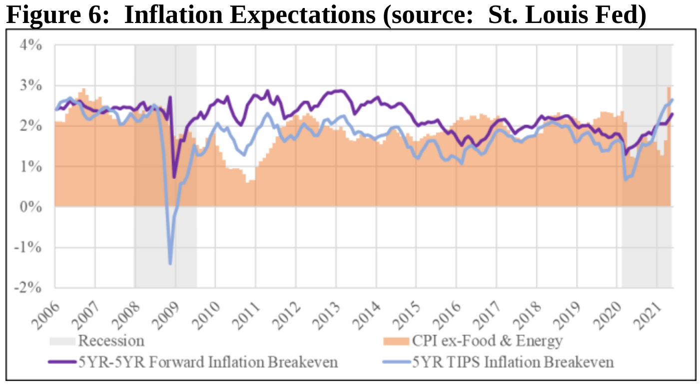



In the 1970s and '80s, the Fed fought high inflation by raising rates dramatically. Since then, they have cut rates in recessionary periods and increased rates in boom times to keep inflation pressures at bay. Longer-term interest rates have generally followed.

## Bottom Line

Higher inflation leads to higher interest rates, and rapidly rising yields could short-circuit economic recovery by increasing the borrowing costs for the government, corporations, and home buyers alike. Higher inflation and yields also impact stock valuations by decreasing the present value of future earnings growth. So far, the markets do not appear to be overly concerned. Stock prices remain near all-time highs on average, and bond market forecasts of future inflation remain low. Figure 6 plots core CPI (orange bars) versus two bond market inflation forecasts derived from Treasury Inflation-Protected Securities (TIPS): the 5-year inflation breakeven (light blue line), and the longer-term inflation breakeven (5YR-5YR Forward, purple line). Inflation expectations for the next 5 years have risen to 2.7% on average, but the breakeven forecast moderates to 2.3% for years 6-10.

**Figure 6: Inflation Expectations (source: St. Louis Fed)**




Interest rates will likely rise from the historically low levels observed in the wake of the global health crisis, but when and how high? Though the Fed has pledged to be patient and hold rates low for an extended period, persistently high inflation could force them to abandon their ultra-accommodative stance, potentially derailing the economic recovery. The Fed's prediction that elevated inflation is transitory seems more likely and is corroborated by the stock and bond markets, but volatility is likely to persist.

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