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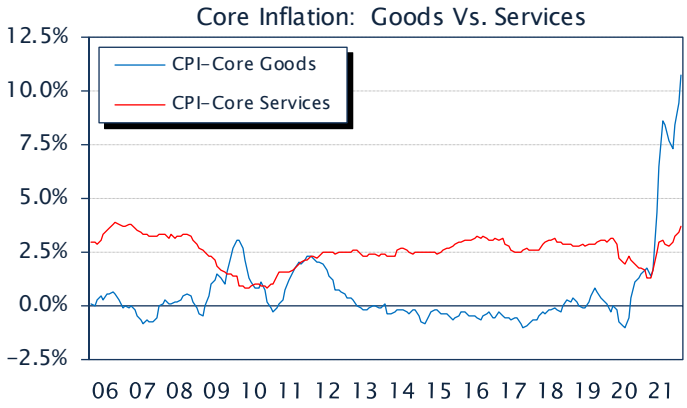
# INVESTMENT UPDATE

We've witnessed a big about-face from the Federal Reserve over the past few weeks. As recently as November, the Fed was still using the term "transitory" to describe the factors influencing inflation. That is, the ongoing supply chain disruptions affecting global trade—factory closings, shortages of containers and workers at ports, and other transportation snafus—were expected to subside in short order.

As we now know, neither those disruptions, nor the strong demand for manufactured goods keeping pressure on the suppliers of those goods, have eased very much over the past couple of months. As a result, the Fed has been scrambling to protect its legacy, built up over the past four decades, that it has the tools and know-how to keep inflation under control. But, as bond investors, we're less concerned about the Fed's reputation than the difficulties the Fed now faces in taming inflation without doing significant damage to economic growth. The risks to the bond market from a "policy error" are significant. Let's take a dive into this topic.




First, we need to go back to August of 2020. The initial wave of COVID infection was easing in the US, but the Fed chose to conduct its annual Jackson Hole Symposium virtually rather than in Wyoming. Nevertheless, this was a pivotal meeting for the Fed, as a new framework for monetary policy was announced by Chair Jerome Powell. The Fed had been grappling with a stubbornly low level of inflation since the financial crisis, and was desperate to avoid bouncing along the "zero lower bound" (i.e., a 0% Fed funds rate) in times of future economic weakness. The new policy aimed to boost core inflation to an average rate of 2% over a complete business cycle by keeping the Fed on the sidelines longer, allowing the US economy to run hot. The Fed would rely less on econometric models that called for tighter policies at the first sign of rising inflation expectations, and instead would keep expansive policies in place until it saw clear signs of full employment, even if that meant allowing inflation to overshoot at times.

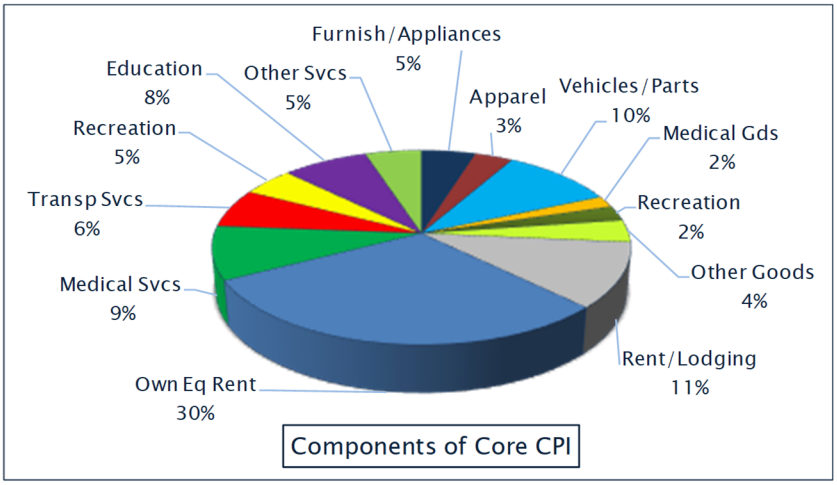
If the Fed was hoping for an overshoot with this new policy, it got more than it was counting on, with core inflation rising in late 2021 to a 30-year high, and nominal inflation hitting its highest level in nearly 40 years, dating back to 1982. By December the Fed realized that its expansionary monetary policies needed to change, and change quickly. Over the past two months, the Fed has announced an end to new asset purchases (they'll end next month), while clearing the way for multiple rate hikes in the Fed funds rate in 2022. The bond market is currently pricing in six rate hikes of 25 basis points (0.25%), which would be the most aggressive sequence of rate increases by the Fed since 2005.

It's fair to ask at this point where inflation is coming from, and what the Fed can do to slow it down. As the chart on this page shows, we see that the biggest increases in core CPI are, unsurprisingly, coming from core goods (what the Bureau of Labor Statistics calls "commodities excluding food and energy"), which is currently more than 10% higher than its level from 12 months ago. Included in this group are household furnishings, apparel, vehicles, and other household goods. Many of these items have the unfortunate combination of being in high demand while being difficult to source and transport. The stimulus funds that flooded the economy over the past couple of years, combined with reductions in household spending on things like vacations and restaurant meals, meant that people had money to spend on longer-lasting goods. In many industries, that extra demand placed pressure on suppliers and manufacturers who were already struggling with rolling COVID outbreaks. The result has been huge price increases in a series that (as the chart shows) has barely shown any inflation at all over the past few years.

This core goods component, while important, is relatively small—only comprising a little more than 20% of CPI, and approximately ¼ of core CPI. The US economy is dominated by services, and that is reflected in the fact that nearly three-quarters of core CPI is in the core services side of the ledger. Included in core services are housing costs, medical services, education expenses, transportation services, and recreation. In contrast to goods, there has been relatively little upward pressure on prices in the services category, which has kept the overall inflation numbers from spiking even higher.

If you're an optimist, you can find good news in this data. The stimulus money from the past couple of years is drying up, and with it the spending spree on manufactured goods, while supply chain issues appear to be easing. Together, we expect to see normalization of the supply-demand imbalance that's led to outsized increases in things like building supplies and automobiles (not to mention non-core items like gasoline [+50% year-over-year] and meat [+15%], which have pushed the total CPI 1.5% higher than core CPI). As these pressures ease, more moderate increases in the monthly data will be compared to the high levels from 2021, making prospective year-over-year CPI changes much more favorable in the coming months.

But there's also cause for concern. While goods inflation is expected to moderate (it's hard to imagine it going higher!) in the coming months, we have no such expectations for the service sector. The chart on this page details the share of goods (beginning at the top, with furnishings/appliances and moving clockwise in the chart) and services (starting with rent/lodging). As mentioned, services comprise nearly 75% of core CPI, with just four components—rents, owners' equivalent rent, medical, and education—comprising 58% of core CPI. What happens to these components over the next year will determine whether inflation settles back close to its former baseline, or whether we see a new, higher baseline established for core consumer prices.




As you may have noticed, the CPI calculations don't directly measure home price costs, but instead put the costs of housing for renters and homeowners on equal footing by estimating what it would cost for homeowners to rent their homes; this is "owners' equivalent rent" (OER) which makes up almost one-third of core CPI. OER is far more stable than directly measuring home price swings, which means that it's currently lagging (up only 3.9% YOY) the huge increase in home prices we've seen over recent months (+ 19% YOY). Likewise, increases in two other large components of "core services"—medical and education expenses—have been remarkably subdued, rising only 2.2% and 1.6%, respectively, over the past year. Our expectation is that most, if not all, of these service-related components will be accelerating over the next few quarters.

Ordinarily, we'd expect upward pressure on service prices at this point in any business cycle; in the current environment, it's reasonable to assume those pressures will be even more pronounced. In addition to the lagged effects from housing costs feeding back into rent and owners' equivalent rents, we know that energy prices will filter into core services costs as well. But the biggest cost pressures are likely to come from a source that's nowhere to be found in the inflation data: labor costs.

As has been widely reported, labor costs remained remarkably stable during the previous cycle, even after the US moved to very low levels of unemployment in 2017-2019. As with many other statistics, however, things have changed in the labor market since COVID first hit. Unemployment has dropped to the point that the Fed can now reasonably assert that the US economy is at "full employment," yet at the same time there are approximately three million fewer people in the US labor force than pre-COVID, and more than five million job openings unfilled. For various reasons, there are millions of people who dropped out of the labor market and are in no hurry to return. While many are sidelined due to closures and reduced capacity of restaurants, hotels, and entertainment establishments, that doesn't account for all the job losses. As an example, even with the dire need for medical services since the pandemic began, there are fewer people employed in this industry today than in February of 2020.

How much wages increase in the coming months as a result of the economic and societal challenges of the past two years is perhaps the most important consideration for future inflation. In our service-heavy economy, labor costs represent the biggest expense line for many organizations, and a cost that employers and owners will try to pass through at the checkout line. If organizations find, over the coming months, that the only way to fill job openings is via significantly higher wages, that could set in motion a period of inflation which could prove hard to tame, particularly if labor shortages persist and wage demands remain sticky.

What we've seen over the past few months has been a series of price increases, most of which stem from supply and demand imbalances which will be resolved in the short- to medium-term. The Fed's ability to rein in inflation is more vulnerable to an increase in the cost of human capital than any other factor, and if higher wages become embedded in employees' expectations, it is almost certain to boost the baseline for inflation in coming years. The Fed can and will do what it can to tame wage inflation by raising rates and tamping down demand, but that comes at the risk of sowing the seeds of the next recession. There are no easy choices at this point.