Put Away Your Bell Bottoms: This is Not the 1970s

"Fear of runaway inflation remains at the top of investors' list of concerns—a closer look at the data suggests cooler heads will prevail."

Contributors

Elias Belessakos, PhD
Senior Quantitative Analyst
Multi-Asset Strategies and Solutions

Sanne de Boer, PhD, CFA
Director of Quantitative Equity Research

Kurt Kringelis, CFA, CPA, JD
Head Macro Credit Strategist
Fixed Income

Anuranjan Sharma
Macro Strategist
Fixed Income

Barbara Reinhard, CFA
Head of Asset Allocation
Multi-Asset Strategies and Solutions

Vinay Viralam, CFA
Asset Allocation Strategist
Fixed Income

"Even if inflation runs at 3% for 2021 and 2022, it will not bring the price level to where it would be if inflation had run at 2% since 2010."

The Fed Has Spoken...But Is Anyone Listening?

Last year, when the Fed adjusted its approach for targeting inflation, we noted that investors seemed to pay little attention to the historic change. Instead, headlines at that time focused primarily on fiscal stimulus, vaccines and geopolitical uncertainty. The focus of headlines today remains largely the same with one notable addition to the list of most frequently cited concerns: inflation.

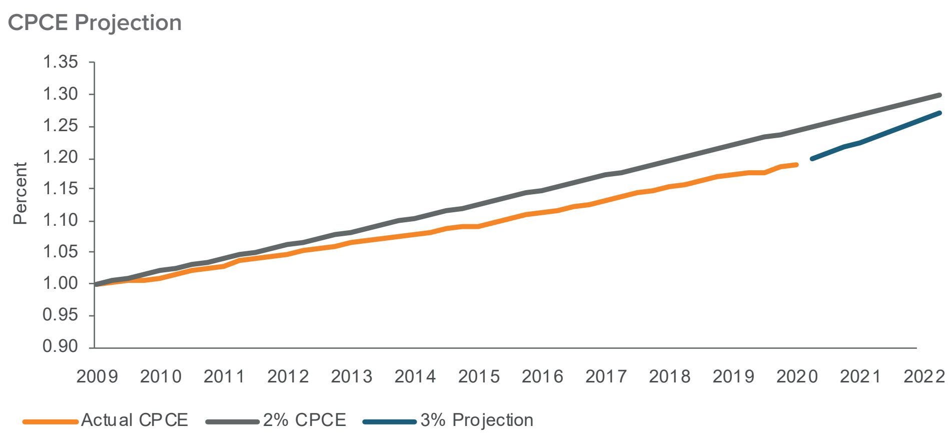
"Most market participants remain unconvinced and fear the worst when it comes to inflation."

Increasingly, the market seems to think that the recent inflation uptick and yield run-up will get out of hand, forcing the Fed to step on the brakes sooner and harder than expected. For its part, the Fed has been very transparent. Fed officials repeatedly said they are in no hurry to change policy until their inflation and labor market goals are realized.

Recall that under the Fed's new inflation targeting approach, after periods of persistently low inflation, the Fed said it would tolerate inflation moderately above 2% "for some time," to allow the economy to solidify a recovery. As we stated in our October outlook last year, we expected that the change in the Fed's framework would lead to higher "cyclical" inflation, i.e. higher inflation in the near term. We also believed at the time, and continue to believe today, that the pickup in near-term inflation will not translate to structural long-term inflation.

For context, even if the core personal consumption expenditures price index (CPCE) runs at 3% for 2021 and 2022, it will not bring the price level to where it would be if CPCE had run at 2% since 2010 (Figure 1). Still, as Figure 2 shows (see next page), most market participants remain unconvinced and fear that inflation will cause the Fed to raise rates much sooner than previously anticipated. On the other hand, as seen in the Fed's dot plot, most FOMC members believe that rate increases are not in our immediate future.

Figure 1. Inflation Has a Long Way to Go Before It Becomes a Structural Risk

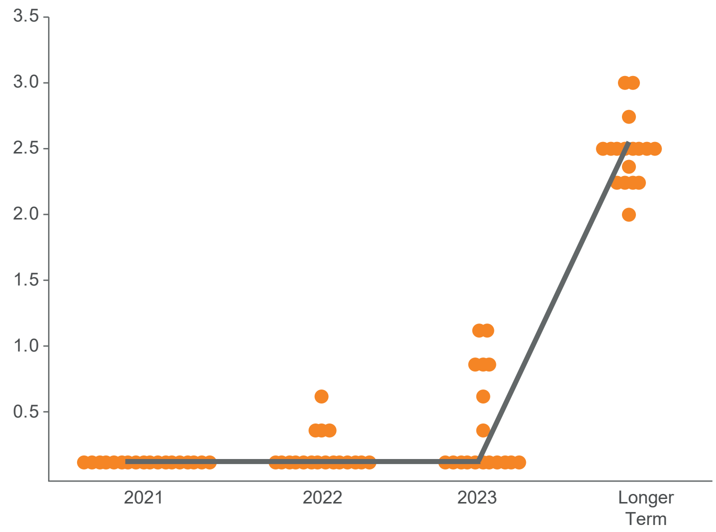


Source: Bloomberg data, analysis by Voya Investment Management.

Figure 2. The Market Expected an Early Rate Hike—the Fed Has Other Ideas

Market Expectations: Months Until First Fed Hike

Federal Reserve Dot Plot: 03/17/21



As of 03/31/21. Source: Morgan Stanley, Federal Reserve and Voya Investment Management.

What About the Output Gap? A Closer Look at this Common Argument for Higher Inflation

The output gap, which is a measure of an economy's actual output versus its potential output, is the most commonly cited reason why most investors fear future inflation. A negative output gap indicates more potential or "slack" in the economy. In the current environment, many expect inflation to firm and accelerate as the negative output gap is absorbed and potentially crosses into positive territory.

However, *potential* output, aka "slack" in the system, is very hard to measure, and the output gap has a long track record of coming up short as a predictive tool. For example, the Congressional Budget Office (CBO) has consistently underestimated potential GDP and the output gap for decades. As a result, economic growth has run below trend far more often than above trend, which is deflationary and helps explain the undershoot of inflation. Ideally, the output gap should average zero over time — unfortunately, it averages 0.6% since 1970. This may not seem like a lot but it means GDP has been 0.6% lower than potential per year.

Of course, to understand how an economy might reach full capacity, it's better to focus on the factors that can close the gap rather than the measure of the gap itself.

What is Structurally "Bad" Inflation?

Structurally "bad" inflation is defined by rapidly increasing input costs that cannot be passed on to consumers, a dynamic that helps feed a vicious feedback loop of higher unemployment and declining nominal GDP. In the U.S., this type of "stagflation" was last experienced in the 1960s and 1970s, the latter of which is the decade most often cited in today's media frenzy about potential inflation doomsday scenarios looming on the horizon.

"In an economy that was already facing high unemployment, corporations could not pass these higher prices to consumers, and inflation contributed to the overall economic malaise."

In the 1960s, policymakers mistakenly believed that high unemployment reflected inadequate demand rather than festering labor market rigidities. Second, they incorrectly assumed that there was a permanent trade-off between lower unemployment and higher inflation. Finally, and perhaps most damaging, policymakers increasingly came to see monetary tightening as an ineffective tool in the fight against inflation.

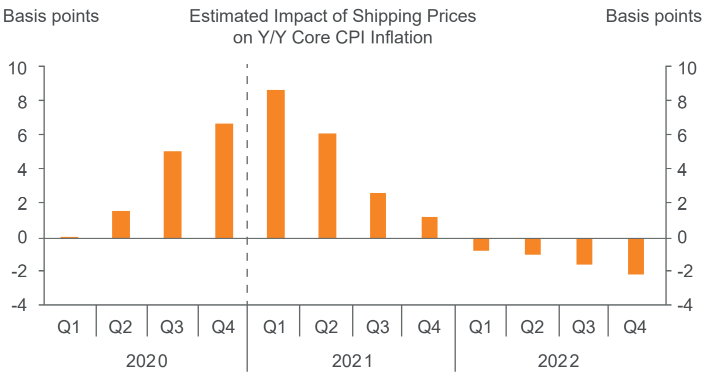
Then in the early 1970s, geopolitical events caused a sudden and unexpected disruption to the supply of oil, which sent prices sharply higher in a short period of time. In an economy that was already facing high unemployment, corporations could not pass these higher prices to consumers, and inflation contributed to the overall economic malaise.

What Are the Risks? Analyzing the Factors that Could Cause Inflation to Surprise on the Upside

When you look at today's environment next to the market backdrop of the 1960s and 1970s, you quickly see that there is little to compare. Some investors have pointed to the recent rise in input costs as an omen for "stagflation" ahead. While it's true that supply chain disruptions are causing input costs to rise broadly across industries, the impact is expected to be temporary and minimal (Figure 3).

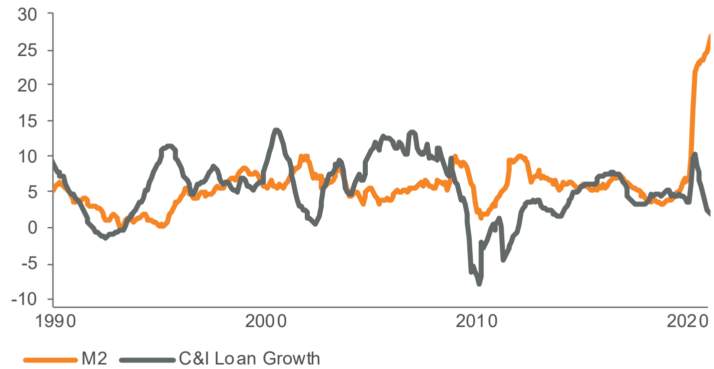
In addition, corporate profits have yet to see any real impact as consumer demand has been more than enough to offset rising input costs. Homebuilders are a great example of an industry that is prospering despite strong input cost inflation. Lumber prices have surged, yet homebuilder margins are expanding because of strong home sale pricing power and robust consumer demand.

Figure 3. Supply Chain Disruption is Expected to Have a Minimal Impact on Inflation over the Long Term



As of 03/31/21. Source: Goldman Sachs.

Figure 4. Loan Growth and Money Supply Must Grow in Tandem for Structural Inflation to Take Hold



As of 02/28/21. Source: Federal Reserve and Voya Investment Management.

"The most important aspect of this market backdrop to remember is that the increase in government spending is intended to fill the gap left by the absence of private sector demand."

With the Biden administration's $1.9 trillion stimulus package and ongoing vaccinations creating a bridge to a fully reopened economy, other investors are viewing inflation through the lens of what's to come. In most market commentary regarding inflation fears, the logic goes something like this. Consumers, flush with inflated bank accounts from stimulus checks will unleash a purchasing frenzy that will lead to higher prices, i.e. inflation. However, for inflation to be persistently high, there has to be strong demand for funds. Even though the system is flush with liquidity, both supply side and demand side forces have led to much slower loan growth in the previous 12 years than in the 50 years before the 2008 financial crisis (Figure 4).

Since the 2008 crisis, stricter regulatory requirements have been imposed on banks. In order to increase holdings of "risky" assets such as mortgages or business loans, banks have to hold not only sufficient deposits and reserves to fund the loans, but also sufficient capital and liquidity to be able to survive potential defaults on these loans. In addition, corporations raised significant amounts of precautionary cash and consumers are flush with over $1.5 tn in excess savings from reduced consumption and fiscal stimulus. In the near-term, it is likely that these cash balances will also constrain loan demand.

The most important aspect of this market backdrop to remember is that the increase in government spending is intended to fill the gap left by the absence of private sector demand. The response to the pandemic caused massive unemployment that resulted in lost wages and lower consumer spending. Fiscal stimulus aimed at consumers and small businesses is intended to temporarily bridge the gap until the economy fully reopens and replace what was lost during the lockdowns.

Positioning Portfolios for Different Inflation Scenarios: Value Shows Signs of Life

Broadly speaking, we believe that inflation will prove to be temporary and/or limited to certain areas of the economy. Monitoring inflation risk requires context for the uniqueness of the economic environment created by the measures to contain the spread of COVID-19. For example, the strength in areas like airfare is related to a recovery of demand from very depressed levels. In other areas like household and recreation items, the higher pricing is likely more permanent, as recent strength is due less to a recovery of demand and more from increased demand relative to pre-COVID levels.

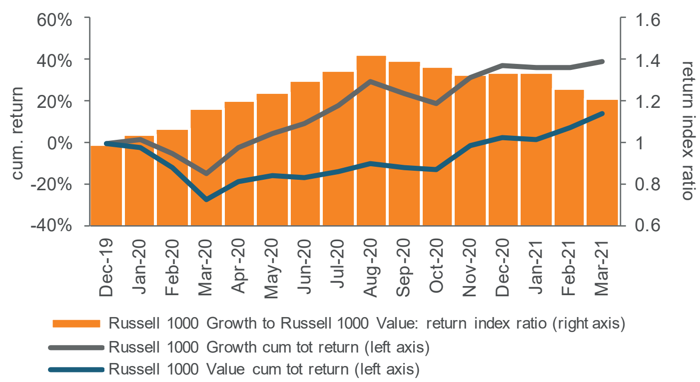
This market environment reinforces the important "K-shaped" dynamic of the economic recovery. It has been our view since last year that the pandemic led to a "two-speed" recovery that created winners and losers with broad strokes across the economy. Against this backdrop, selectivity is key. Last year's equity market returns were largely driven by defensive, pandemic protected businesses and earnings multiple expansion. This year, we anticipate higher corporate profits, particularly from the cyclical areas of the market, which should benefit from reopening and deployment of large amounts of cash on the sidelines. We believe this transition to a more stable macro environment will continue to benefit our preferred asset classes: U.S. small cap and emerging market equities.

From a style perspective, we highlighted the past inflation regimes where value had thrived, showing the historical outperformance of value in periods when real rates came off their lows and inflation was expected to pick up. Because of this relationship and our expectation for near-term cyclical inflation, we suggested that value could add a layer of diversification in investors' portfolios. Since that time, value has indeed thrived, finally chipping into the long-standing leadership of growth stocks (Figure 5). As the economy reopens and additional stimulus takes hold, we believe that value stocks will continue to close this gap in the near term.

From a fixed income perspective, given our view that inflation will ultimately moderate and not become a structural risk, we are overweight corporate credit, non-agency RMBS and CMBS, and underweight TIPS and agency RMBS.

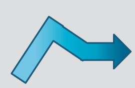
Figure 5. Value Closes the Gap on Growth

Russell 1000 Growth versus Russell 1000 Value index performance (12/31/2019 through 3/31/2021)



As of 03/31/21. Source: Voya Investment Management and FTSE Russell.

Figure 6. How Inflation Expectations Influence Fixed Income Portfolio Positioning

	After up-tick in inflation	Sectors to Overweight	Sectors to Underweight
	Continued momentum, with increasing inflation. Fed raises rates sooner	■ TIPS ■ CMBS ■ CLOs/Bank Loans	■ Treasuries ■ Agency MBS
	Moderating inflation Fed hikes as suggested in DOT plot	■ Non-Agency MBS ■ Corp Credit (IG/HY) ■ CBMS	■ TIPS ■ Agency MBS
	Return to sub-2% inflation. Fed rate hikes delayed	■ Treasuries ■ IG Corporates ■ Agency RMBS	■ TIPS ■ Subordinated CMBS

As of 03/31/21. Source: Voya Investment Management.

Disclosures