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America's Risky Experiment: Will the Inflation Genie Escape?

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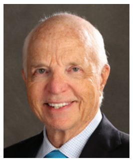

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- Today's combination of a generous Treasury, a tolerant Fed and a reopening economy has put America in treacherous territory.
- For equity investors, secular inflation is a devastating force; policymakers should ensure the inflation genie is kept securely in the bottle.
- Although inflation risks are at a four-decade high, the starting point for "Bidenomics" is one of sizable slack. As a result, our base-case scenario assumes only a brief period of above-target inflation.
- The key upside risk to inflation is that MMT is explicitly embraced as the new policy orthodoxy, implying Bidenomics would deliver an awful lot more stimulus than we currently anticipate.
- Embracing MMT would also involve the Fed throwing out the lessons from the Great Inflation of 1965-82, working even more closely with the Treasury, and prioritizing employment over inflation.
- Given these risks, it is crucial to monitor wage growth. Once inflation expectations become embedded into wages, it typically leads to a vicious cycle entangling consumer prices and labor costs. Breaking such an expectations spiral inevitably requires a severe policy-induced recession.
- Regardless, investors should brace themselves for more inflation scares, which will likely remain a key driver of market volatility into 2022 and possibly well beyond.

"There are slippery slopes, and once you start a process of accelerating inflation there are precious few examples of where inflation has been brought back down without very substantial economic disruption and without enormous disruption to financial markets."

—Larry Summers, Harvard

Massive fiscal stimulus, immense pent-up savings and excessively loose financial conditions risk pushing demand well above potential GDP and driving inflation markedly higher. Bidenomics has been excoriated by Larry Summers of Harvard as "the least responsible economic policy in 40 years!" The former U.S. Treasury

Secretary accuses the Fed of "dangerous complacency," warning, "The odds are better-than-even that inflation will exceed 3% over the next five years." Although such exhortations might sound shrill, they may not be too far off the mark, with investors pricing in a 40% chance of such an occurrence (**Figure 1**).

While Summers has been the most strident critic of Bidenomics, he has emboldened a strong supporting cast. For example, hedge fund legend Stanley Druckenmiller has stressed "I can't find any period in history where monetary and fiscal policy were this out of step with the economic circumstances." Both Janet Yellen, the current Treasury Secretary, and Fed chair, Jerome Powell, are preternaturally cautious, but together have embraced the "go big or go home" doctrine enveloping D.C. This has prompted investors to wonder if a change in regime, from a deflationary era to an inflationary one, is underway. And, if so, how aggressively will the Fed respond once it recognizes inflationary pressures are burgeoning across the economy?

> "Keeping emergency settings after the emergency has passed carries bigger risks for the Fed than missing its inflation target by a few decimal points."
>
> *—Stanley Druckenmiller*

The right-wing cognoscente has also leapt into the fray. Robert Barro of Harvard asserts, "Unfortunately, the reputational capital that Volcker bequeathed is now being threatened by reckless monetary and fiscal policies." Similarly, John Cochrane of Stanford asks, rhetorically, "So when do expectations become unanchored? Simple: When people decide that our government will not take the swift and painful fiscal and monetary actions needed to control inflation." They speculate there has been a stealth policy regime shift, questioning if the Fed is genuinely committed to its

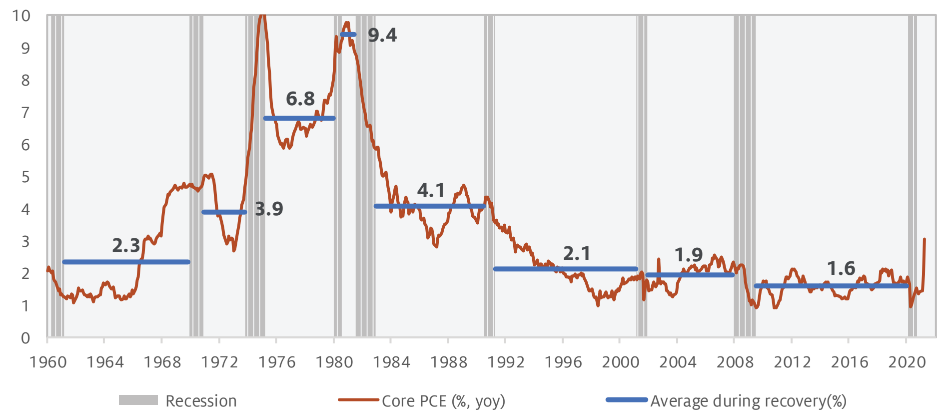
We are in the midst of the biggest inflation scare in four decades

Figure 1: The market suggests it is 40% likely CPI will exceed 3% over the next five years

Source: Bloomberg, Minneapolis Federal Reserve

Inflation expectations soared during the late-1960s/1970s, were then walloped by the Volcker recessions, and have been remarkably stable over the last three decades

Figure 2: There have been three distinct inflation regimes during the last six decades



Source: Bloomberg, NBER, Epoch Investment Partners

2% inflation target (**Figure 2**). Since Volcker, the market has trusted the Fed would do "whatever it takes" (i.e., induce a long, painful recession to reanchor inflation expectations). While this credibility has lasted through Greenspan, Bernanke, and Yellen, there is growing apprehension that, under Bidenomics, it is now at risk.

While the hawkish counsel from right-wing inflationistas has changed little since the 1980s, the "New Keynesians" have undergone a profound transformation. They were chastened by the harsh lessons of the 1970s stagflation, which taught them to be unduly cautious in their policy ambitions. Forty years later, the economic guard on the left still hasn't seen inflation surge. As Jon Hilsenrath of the Wall Street Journal has emphasized, "The fading of these concerns has opened the floodgates to expansive new government spending programs." In that sense, the growing clamor for an expanded role in the economy is grounded in what hasn't happened over recent decades. Despite multiple periods of QE, zero interest rates, and massive fiscal spending, inflation has remained tame.

According to the old guard among New Keynesians, the economy typically operates near full employment, which means fiscal stimulus is dangerous as it will crowd out the private sector and spur inflation. This perspective has now been turned on its head, with the new generation positing the economy almost always operates well below full employment, so inflation is a remote risk and certainly less costly than persistent unemployment. As long as inflation remains tame, MMT will reign as the new orthodoxy and its fiscal profligacy will be heartily adopted by whichever party holds the purse strings.

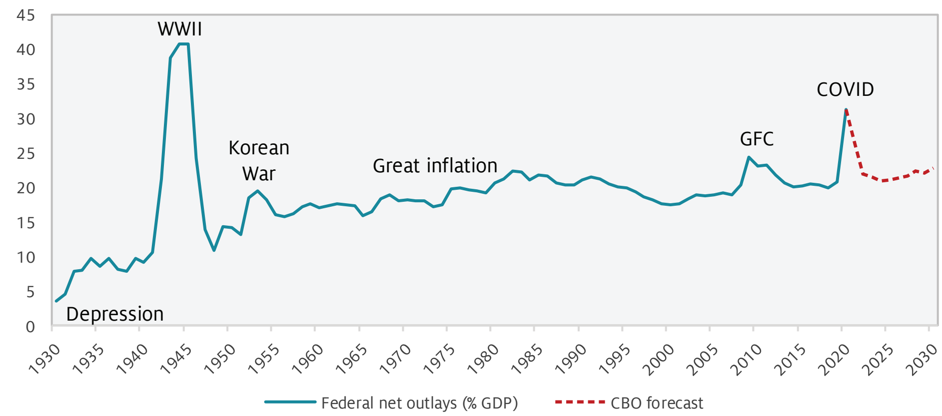
The recent and widespread adoption of MMT is profoundly worrisome. Equally troubling is Fed complacency. After three decades of well anchored expectations, there is ample reason to believe the Fed is overestimating its abilities to fine-tune the economy. Central bankers have mistakenly come to believe they can let the economy run hot, but still hold inflation steady at 2.5% or 3.0% or wherever they deign to draw a line in the sand. However, this is a myth; laser-guided precision is not possible. Once unleashed, the Fed will have a fiendishly difficult time to control inflation without inducing a painful recession. This is as true today as it was in the 1970s.

> "We have the tools and the experience to gently guide inflation back to target."
> *—Lael Brainard, Fed Governor*

With the strongest growth outlook in decades, this note examines whether Bidenomics, abetted by the Fed, will allow the inflation genie to escape from the bottle. We will discuss three recent developments that have triggered fears about secular inflation: massive fiscal expansion, over $2 tn of excess savings, and a Fed that appears alarmingly tolerant of inflation. We then examine "The Great Inflation" of 1965-1982 and the burst of inflation during the Korean War of 1950-1953, arguing the latter offers a better qualitative analogy to today. We then review the current state of the Phillips curve which remains the Fed's (and everyone else's) conceptual framework for understanding inflation. Finally, we explain what an inflationary regime would imply for equity markets and then discuss the key risks to our inflation outlook.

The spending boom associated with COVID has outpaced all previous episodes since WWII

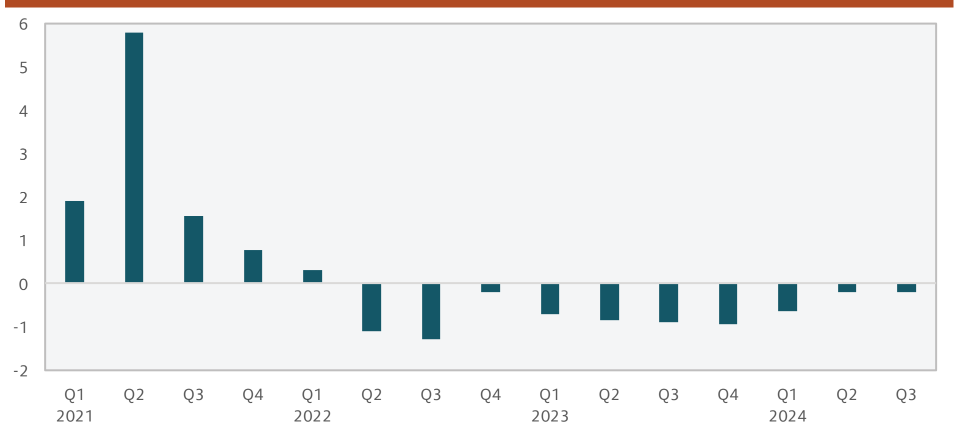
Figure 3: Over the last century there have been six distinct surges in Federal spending



Source: Bloomberg, Congressional Budget Office

In an MMT world, is there an upper limit on fiscal spending? Yes, and that limiting principle is inflation

Figure 4: Contribution of the March 2021 American Rescue Plan to real GDP growth (ppts, saar)



Source: Bloomberg, BEA, CBO, Epoch Investment Partners

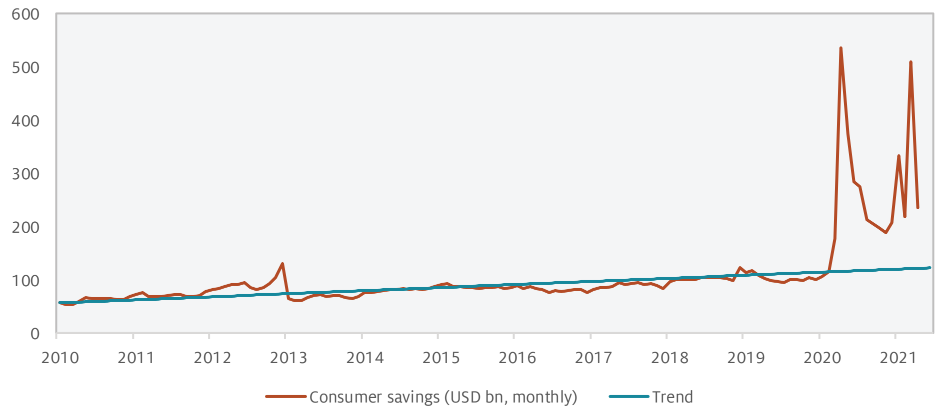
Just a Transitory Blip or Is Secular Inflation on the Horizon?

> "They'll be transitory, they carry no implication for the rate of inflation in later periods."
> *—Jerome Powell, Fed Chair (discussing base effects and supply-side bottlenecks during his April press conference in which transitory or temporary was mentioned 15 times)*

The Bloomberg consensus has headline inflation peaking this quarter[1], but then remaining well above target through the remainder of the year. One reason why short-term inflation expectations have catapulted higher is President Biden's spending policies, which are the most aggressive since WWII (**Figure 3**). The stimulus package passed in March is expected to boost 2Q21's growth

1. In April, core CPI printed 3.0%, with core PCE at 3.1%, their highest levels in 25 and 29 years, respectively.

Figure 5: Consumers have $2.2 tn in excess savings, with half from above-trend income (transfer payments in Apr 2020, Jan 2021, and March 2021) and half from below-trend consumption during the pandemic



Source: Bloomberg, Epoch Investment Partners

by an eye-popping 6 ppts, with the fiscal impulse then declining rapidly (**Figure 4**). Further, the President's budget proposes additional spending, but spread out over the next decade. Our base-case is for a bill of about $3.0 tn, with $1.5 tn in tax offsets, to be passed in early 4Q21.

The second reason inflation expectations have escalated is that, since the beginning of the pandemic, U.S. households have cumulated excess savings of $2.2 tn (**Figure 5**), which implies enormous pent-up demand as reopening progresses. 2021 is likely to exhibit the strongest GDP growth since 1984, implying a Roaring Twenties replay, at least for a couple years. Consumers, with their pockets full of cash just want to have fun, suggesting we will experience significant price increases at restaurants, bars, hotels, airlines, car rentals, and so on. Further, with consumer demand returning more quickly than expected, many sectors are experiencing severe supply-side bottlenecks. To illustrate, container ship freight rates are at multi-year highs, semiconductor shortages have caused supply chain disruptions in sectors such as autos, and house prices are rising at the fastest pace since 2005.

The third reason to worry is the Fed has been actively reinterpreting its dual mandate, adopting a novel approach to monetary policy that is alarmingly tolerant of inflation. For a start, in August 2020, the Fed officially embraced average inflation targeting: "To achieve inflation that averages 2% over time … following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time." That is, the Fed intends to let the economy and inflation run somewhat hot during the next couple years. The Fed's belief that such vague guidance won't affect expectations and that the growth-inflation relationship can be fine-tuned to a decimal point has little empirical support and strikes us as hubristic and dangerously complacent.

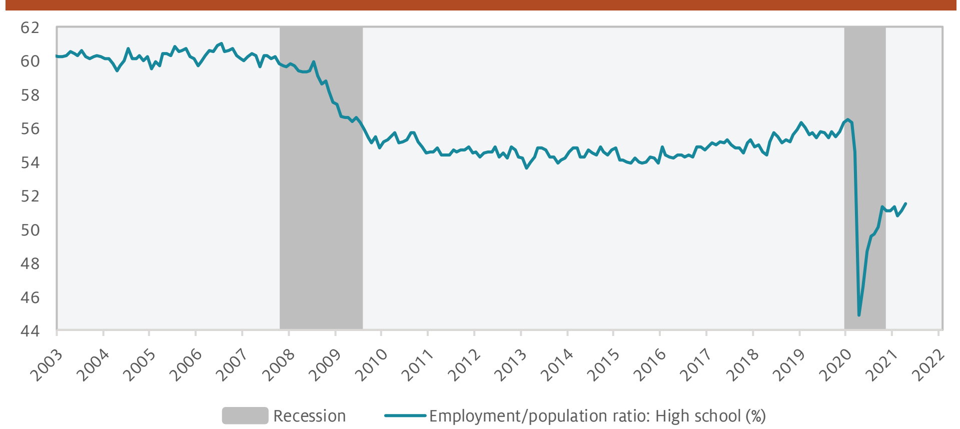
The Key Inflation Clue: Tighter Labor Markets and Faster Wage Growth

> "The Volcker era started the war on inflation. The Powell era starts the war on unemployment and inequality. It is a dramatic change from past policies."
>
> *—Tim Duy, University of Oregon*

The second element of the Fed's reinterpretation is that Powell's FOMC is placing greater emphasis on the "full employment" half of its dual mandate. Last August, the Fed specified that "The maximum level of employment is a broad-based and inclusive goal." That is, Powell is focused on a broader definition of "full employment", underscoring the particular challenges of low-income workers, non-college grads and people of color — something previous Fed chairs seldom mentioned (**Figure 6**). While this should be a critical policy goal for any government, there is only so much monetary policy can do to address long-standing structural impediments. Further, aside from

Biden and Powell don't want to repeat the mistake of a decade ago: Jobs never came back after the GFC for those with a high school education

Figure 6: The Fed's inclusive full employment objective means a greater focus on less educated workers

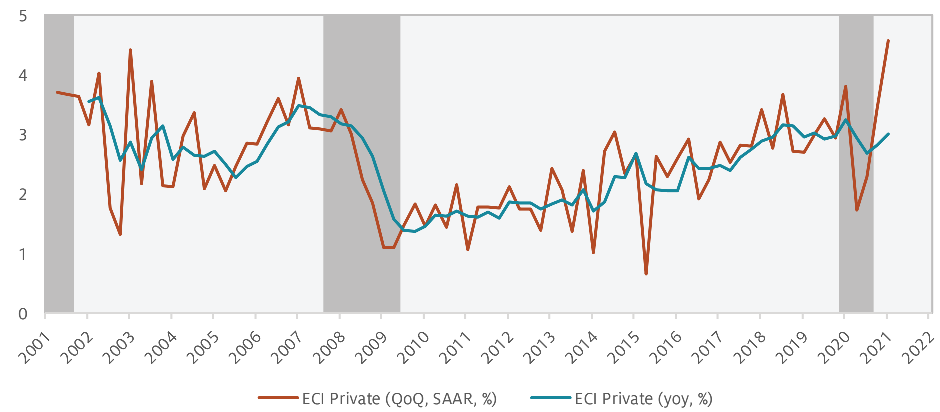


Source: Bloomberg, NBER

adding a dovish tilt, it isn't at all clear how a more inclusive interpretation gets weighed and calibrated into the Fed's policy decisions. Unfortunately, as the Fed's policy objectives become ever more vague and convoluted, household inflation expectations will necessarily become less firmly anchored.

The ECI and Atlanta Fed's wage series are most important as they control for compositional changes

Figure 7: The Q1 increase in the Employment Cost Index raises concerns about wage inflation



Source: Bloomberg, NBER

The third novel feature of the Fed's mandate is a focus on outcomes rather than outlook. That is, the Fed wants to see hard, realized data points rather relying on forecasts (from either its own staff or the street). This revision raises issues though. For example, in judging labor market strength, the Fed typically looks at several time-series for wages. However, only two adjust for compositional effects (e.g., during 2Q21 the bulk of new hires are coming in lower wage sectors, such as leisure and hospitality), namely the employment cost index (ECI) and the Atlanta Fed's series. The ECI is worrisome. In Q1, it printed 4.6% (on a SAAR basis), the fastest pace in 20+ years (**Figure 7**). Still, the ECI's yoy % change is less worrisome, and the Atlanta Fed's series show no sign of acceleration, at least so far. Overall, we expect an extraordinarily strong labor market for at least three more quarters, with wage growth increasing solidly, but not escalating as it did in the 1970s.

While we believe several of the factors currently pushing inflation higher are transitory and likely to fade after a couple quarters, we do acknowledge the possibility of a more permanent and insidious dynamic. A secular rise in inflation is especially probable if wages begin to accelerate and the Fed remains accommodative. Once inflation expectations become imbedded into wages, it can lead to a vicious cycle entangling consumer prices and labor costs. At that point inflation expectations typically become untethered, with severe economic consequences. To better understand how that might happen, we now examine the last time inflation was "public enemy number one."

The Great Inflation: 1965-1982

"We're all familiar, at the Fed, with the history of the 1960s and '70s."

—Jerome Powell, Fed Chair (April 2021 press conference)

A newly-elected president promises to tackle racial injustice and build a better, more inclusive economy. A Fed chair who wants to keep monetary policy steady on its current course despite vocal critics. An accelerating economy that's enjoyed sub-2% inflation for well over a decade. That certainly sounds like 2021, but it also describes 1965, a year that marked the beginning of the Great Inflation and could, according to Larry Summers and other critics, provide a qualitative analogy to today.

According to the Fed's history site , inflation had been tame from 1953 to 1965, averaging 1.3%, but then several epochal events occurred. The first was President Johnson's Economic Opportunity Act of 1964, which was part of the War on Poverty and brought about a broad array of spending programs. While the legislation was commendable on many fronts, it turbo-charged an already overheating economy, with the output gap soaring to a record 4.3% in both 1965 and 1966. [2] Moreover, the fiscal situation was already being strained by the Vietnam War, particularly from 1965 with the beginning of the American ground campaign, and by 1968 the federal deficit had tripled to 2.7% of GDP (a post-WWII high, even if it sounds mild by today's standards).

The Fed now recognizes it should have acted more aggressively in the late-1960s to tame the inflationary threat and keep expectations well anchored. However, due to a combination of theoretical and practical/political reasons (belief in a short-term Phillips curve, the prioritization of employment over inflation, and a conviction that price pressures were temporary) they chose to keep policy excessively accommodative. This set the stage for act two of the Great Inflation.

The next critical events were the energy crises of 1973 and 1979. The first resulted from the Yom Kippur War and OPEC embargo (targeted at nations perceived as supporting Israel), with WTI almost tripling from $3.50 in July 1973 to $10.10 in Mach 1974. This aggravated a surge in inflation that was already very much underway. Next,

2. The output gap, which has been published since 1950, refers to the excess of actual vs potential GDP, with 4.3% remaining the record high.

with the Iranian Revolution in 1978-79, oil prices took another leg-up, with WTI soaring from $14.85 in Jan 1979 to $39.50 in May 1980. As a direct consequence, inflation in America rocketed into double-digit territory.

The Fed mistakenly accommodated both supply-side shocks, believing their effects would be temporary. However, expanding the money supply, in a misguided attempt to keep unemployment from increasing even more, resulted in "cost-push" inflation becoming entrenched. Surging crude prices were passed through the supply-chain and into higher retail prices. This in turn beget further wage increases, inflation expectations became unanchored, and so the vicious cycle took hold.

"The Fed chairmen who did the most talking about transitory factors were the Fed chairmen we had in the mid-70's and that's when inflation was accelerating very rapidly."

—Larry Summers, Harvard

The policy response in the decade to 1979 was inept. The Fed erroneously believed in a stable and exploitable short-term Phillips Curve, a notion that became popular in the 1960s but was ignominiously discarded by the late-1970s. Arthur Burns, who was Fed Chair from 1970 to 1978, later explained that full employment was the first priority in the minds of the government and voters, with inflation a distant second. In reflecting on the failures of his leadership, Burns confessed, "In a rapidly changing world the opportunities for making mistakes are legion."

Even worse were the policies adopted by politicians, who concocted schemes they hoped would control inflation, but without the costly side effect of higher unemployment. The Nixon administration introduced wage and price controls over three phases between 1971 and 1974. However, rather than taming inflation, their main impact was to exacerbate supply shortages, particularly for food and energy. The Ford administration fared no better, despite declaring inflation "public enemy number one." In 1974 President Ford introduced the Whip Inflation Now (WIN) program (**Figure 8**), which consisted of voluntary measures to encourage thrift. It was a thorough and utter failure.

By the late 1970s, the public was suffering from a "crisis of confidence" and the media adopted the portmanteau, stagflation. Moreover, business investment slowed, productivity faltered, and equity markets plummeted (**Figure 9**). Vision and resolve were required to escape the economic malaise, but such leadership had been sorely lacking for well over a decade.

Catchy slogans and inspirational buttons failed to whip inflation

Figure 8: WIN button from the Ford Administration, 1974

Source: Wikipedia

"The inflation tax has a fantastic ability to simply consume capital ... If you feel you can dance in and out of securities in a way that defeats the inflation tax, I would like to be your broker — but not your partner."

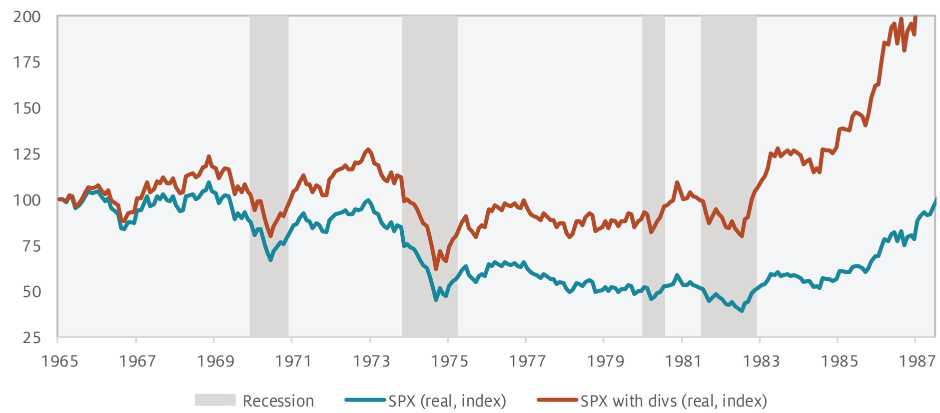
—Warren Buffett, 1977

The Inevitable Cure for Inflation: Painful "Shock Therapy"

The good news finally arrived when Paul Volcker was appointed Fed chair in August 1979. As he took office, headline inflation was running above 11% and a consensus finally emerged that the Fed's focus had to be on fighting inflation even if it meant excruciatingly high unemployment. Shortly thereafter the effective Fed Funds Rate (FFR) was hiked to almost 20% and two painful recessions ensued. And critically, the message was explicit: The Fed is unambiguously committed to implement painful policies if that is what's necessary to vanquish inflation. By late-1982 the Great

The SPX, in real terms, languished for over two decades, but dividends helped enormously

Figure 9: Equity investors took a beating during the Great Inflation of 1965-82



Source: Bloomberg, NBER

Inflation was history (**Figure 10**) and what followed was a long-term decline in trend inflation.

The key to Volcker's legacy was the anchoring of long-term inflation expectations, eventually at 2%. Over the next four decades this provided the Fed with a great deal of policy leeway: it could adjust the FFR and money supply without jeopardizing its long-run credibility. This included multiple periods where it kept rates close to zero and vastly expanded its balance sheet.

From the above discussion we can characterize the Great Inflation as having four key features:

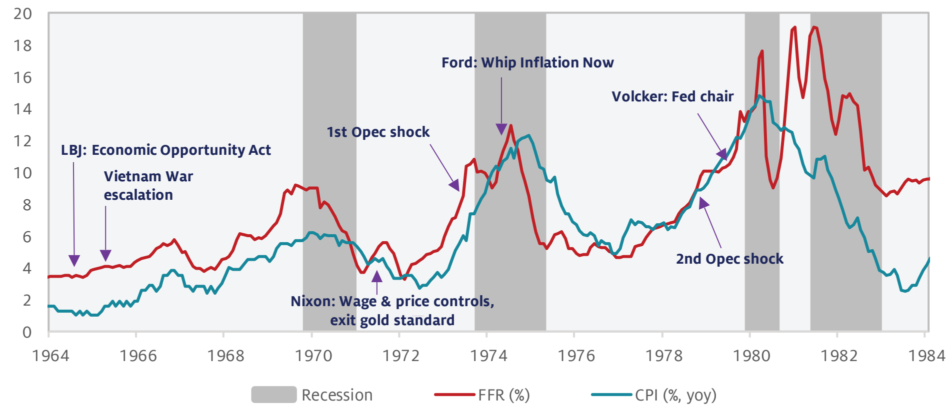
1. Complacency, which followed a long period of benign inflation (1953-65)
2. Accelerated government spending (from 1964)
3. A Fed that prioritized employment over inflation (until 1979)
4. Supply shocks (energy crises of 1973 & 1979) that were mistakenly expected to have only a temporary impact on inflation and consequently, were accommodated

It is also worth emphasizing that inflation expectations didn't become unmoored quickly, in the span of a few quarters or even a few years. It took an extended period, requiring multiple catalysts and numerous policy errors.

How fitting is the Great Inflation as a qualitative analogy for today? We can certainly tick-off the first three boxes without too much debate. However, that alone is not sufficient for an untethering. Rather, it would take more extensive supply shocks than we are experiencing today and a considerably longer time period to convince Americans the Fed no longer possesses the vision and resolve required to keep inflation in check. For these reasons we don't think the Great Inflation is the correct analogy, at least not yet. Rather we believe the Korean War period is a more apt comparison.

Shock therapy: There is only one way to slay inflation once expectations become unanchored

Figure 10: Key events during the Great Inflation of 1965-82



Source: Bloomberg, NBER

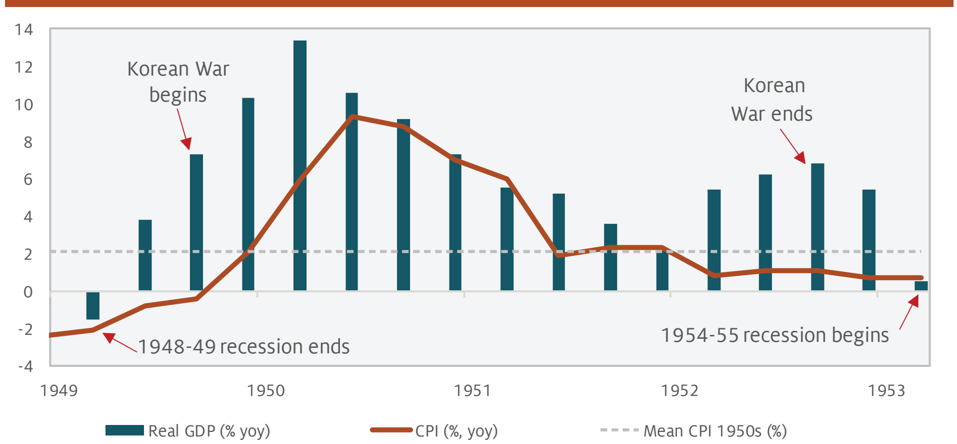
The Korean War of 1950-1953: A Temporary Surge in Spending and Inflation

The debate over Bidenomics has drawn attention to past cases of inflation spurred by big government spending. We believe the best template is offered by the Korean War, which started when North Korea invaded South Korea in June 1950 and ended with an armistice in mid-1953.[3] As the economy ramped up in preparation for war, nominal GDP soared by 18.2% in 1950 and 11.3% in 1951 (by contrast, growth during the remainder of the decade averaged 5.0%). Further, the output gap remained over 3% for three consecutive years (1950-1952), the only time this has occurred in the entire post-WWII period.

Reflecting the war-induced spending boom, US inflation soared in late 1950 but returned to around 2% in 1952 and 1% in 1953 (**Figure 11**). The surge in inflation was temporary and did not pose any lasting damage to the US economy. Further, the SPX rose just

A better historical analogy to today is the temporary surge in inflation related to the Korean War

Figure 11: U.S. GDP growth soared in 1950 and 1951 as Korean War spending ramped up, leading to a transitory burst of inflation



Source: Bloomberg, NBER

3. See "Inflation Fears and the Biden Stimulus: Look to the Korean War, not Vietnam," by J. Gagnon of the Peterson Institute.

over 36% during the three years of hostilities, producing solid real returns for investors. This suggests the market views a transitory burst of inflation quite differently than the secular inflation that took hold from the mid-1960s. We believe this should provide some encouragement to investors today.

The Phillips Curve: Still the Fed's Framework for Forecasting Inflation

"When it comes to the economy we're building, rising wages aren't a bug; they're a feature."

—President Biden

We are now going to change gears, moving on from the two historical analogies to a discussion of the Phillips curve and what it means for the inflation outlook.[4] The Fed has become obsessed with inflation because it believes it understands what drives inflation and possesses the tools to control it. Although the empirical evidence supporting these claims is weak, in the Fed's conceptual model interest rates affect consumption which in turn drives employment and wage growth (**Figure 12**). While there is a lot of slippage along this chain of reasoning, one empirical regularity is that a pick-up in wage growth typically precedes a secular rise in inflation.

Proponents of Bidenomics argue that even if substantial overheating occurs, it won't lead to markedly higher inflation and thus won't require the Fed to bring forward its hiking plans. Indeed, as we'll now show, current estimates of the output gap and Phillips curve do not yield overly worrisome results.[5]

The U.S. output gap for this cycle is likely to peak next year at around 1.5% (according to the IMF and other forecasters). However, as a thought experiment to grasp how high cyclical

In the Fed's simplified model, stronger wage growth is the most likely precursor of an enduring rise in inflation

Figure 12: The consumption-employment-wages nexus leaves a lot of slippage between Fed policy and inflation

Source: San Francisco Federal Reserve

factors could conceivably push inflation, let's imagine Biden's stimulus plans produce a massive output gap, say of 4%, just below the record set in 1965. To estimate the likely impact on unemployment and inflation, we can start with Okun's law which implies a 1% increase in output leads to a decrease in the unemployment rate of roughly 0.5%. That is, an output gap of 4% would imply an unemployment rate about 2% points below the natural rate, which we assume to be 4%. This logic suggests an unemployment rate of 2.0% which is well below the pre-COVID cyclical low of 3.5%.

To assess the impact on inflation, we bring in the Phillips curve, and assume a slope of 0.5 (this is significantly steeper than most estimates, which are typically in a 0.2 to 0.3 range). That is, inflation increases by 0.5 ppts for every 1 ppt decrease in the unemployment rate. Given the sharp fall in unemployment discussed above, this suggests Bidenomics could increase inflation by roughly 1.0 ppt above baseline. Core PCE was 1.8% when Biden's March stimulus was signed, so our arithmetic implies a core inflation rate of 2.8% could be sustained. While not a catastrophic increase and nowhere close to the experience during the Great Inflation, it is well above both the consensus and the Fed's own projections and indicates much earlier tightening than conveyed by the Fed's dot plot.

The key upside risk lies in a shift in inflation expectations or a change in the inflation regime.[6] During the history of the Phillips curve there have been two such experiences, one corresponding to 1965-1973 when the Fed allowed inflation to move sharply higher, and the second from 1979-1983 under Volcker's charge, when two policy-induced recessions brought expectations back down to earth. While the Phillips curve has been extremely stable since Volcker helmed the Fed, expectations could well deanchor the curve given the current extraordinary mix of fiscal and monetary policy.

"Today's Fed waxes far too confidently about well-anchored inflation expectations."

—Stephen Roach, Yale (and Fed economist during the 1970s)

The key takeaway is, if investors begin to worry that Bidenomics represents a regime shift similar to what occurred in the late-1960s, the increase in inflation could be much larger than the 100-bps suggested above. In that scenario, a passive or accommodative Fed would invite disaster, in the form of a self-fulfilling inflationary spiral. Fortunately, it is more probable the Fed would respond by tightening policy, perhaps

4. The Phillips curve describes the (inverse) relationship between the unemployment gap (versus the natural rate) and the rate of inflation.
5. Our discussion is based on E. Nakamura (Berkeley), "Is the Phillips Curve Getting Flatter?", 2021; L. Ball (Johns Hopkins), G. Gopinath (Harvard), et al, "US inflation: Set for Take-off?" 2021; and O. Blanchard (MIT, Peterson Institute), "In Defense of Concerns Over the $1.9 Trillion Relief Plan," 2021.
6. Instead of moving up and to the left along a stable Phillips curve, as we did in the previous paragraph, think of a regime change as an upward shift in the curve, so any particular unemployment rate is now associated with higher inflation.

substantially, and running a high risk of inducing a recession. This is why, as the next section demonstrates, although equity markets may welcome a little bit of inflation, they typically sell off sharply as inflation accelerates, fearing secular inflation could take hold.

Inflation and Markets: Gradually, Then Suddenly

> "For those who are quick to dismiss inflation, it is worth remembering that it is a destructive force ... a genie that should be kept in the bottle."
>
> *—Aswath Damodaran, NYU*

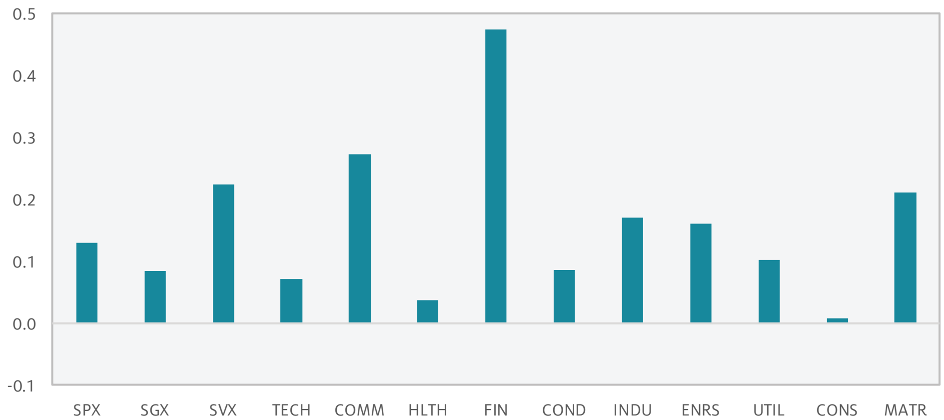
Moving on from a discussion of the Phillips curve, this section examines how equity markets have typically responded to a rise in inflation, first demonstrating the impact of higher breakevens (inflation swaps) and then summarizing how markets have reacted during the eight inflationary regimes experienced over the last century. Beginning with breakevens, the 2-year is currently 2.8%, up from 1.3% in early November (pushed higher by vaccine approvals in the U.S. and the promise of Bidenomics). Markets typically view a rise in short-term breakevens as good news, signaling an improvement in the cyclical outlook (**Figure 13**), and that is roughly consistent with the relative performance we've experienced over the last six months.

Even with the 150-bps rise, the Fed hasn't been overly concerned about short-term breakevens running at 2.8% for two reasons. First, breakevens are based on headline CPI, which could print up to 100 bps higher than core PCE this year (due to different weights on used cars, health insurance, shelter, and others). Second, the longer term 10Y breakeven is only 2.4%, implying the market views inflationary pressures as largely transitory.

This latter point is particularly important as equity markets react to a rise in longer term breakevens very differently than they do to an increase in 2Ys. In fact, 10Y breakevens and 5Y5Y inflation swaps are negatively correlated with all equity sectors with the sole exception of energy (**Figure 14**). This is because they indicate we are now late in the cycle, with inflationary pressures building, so investors start to price in significant Fed tightening and a nasty hangover. The bottom-line for investors is that while higher short-term breakevens might be good news, signaling an improving cyclical outlook, a significant rise in long-term breakevens is unambiguously negative for equities.

FIN is the sector most likely to benefit from higher short-term inflation expectations, while underperformers include TECH, HLTH and CONS

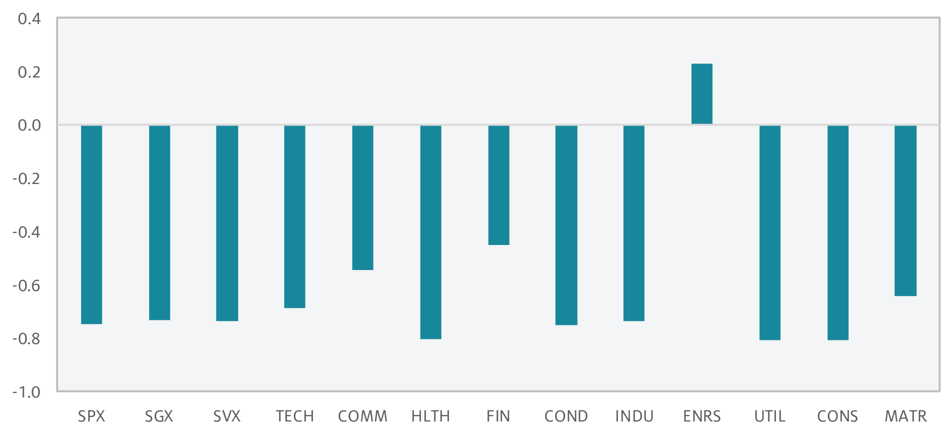
Figure 13: Correlation between the 2Y inflation breakeven and equity sectors since 2005



Source: Bloomberg, Epoch Investment Partners

Equity markets typically tumble when longer-term inflation expectations begin to rise

Figure 14: Correlation between the 5Y5Y inflation swap and equity sectors



Source: Bloomberg, Epoch Investment Partners

What to Expect When You're Not Expecting Inflation: A Century's Worth of Evidence

One problem with using breakevens to assess the impact of higher inflation on equities is that such markets have only been liquid for the last fifteen years. This is particularly limiting given how tame inflation has been over the last three decades. To illustrate, since 1990 inflation vol has averaged just

1.3%, versus 4.8% from 1925-1989. This means investors need to look further back to grasp how to best position their portfolios for an inflationary regime.

A recent note by Cam Harvey of Duke University and co-authors, "The Best Strategies for Inflationary Times," demonstrates the U.S. has experienced eight inflationary regimes (periods when inflation is above 5% and increasing) since 1925. The SPX total return index exhibited negative real returns during six of the eight inflationary regimes (with an average return of -7% vs +10% in non-inflationary periods). The worst performing sectors included consumer durables, financials, and tech (the worst styles were size and value), while the best performing were energy and healthcare (with quality among the best styles). When the next inflationary regime arrives, we believe many of these trends will repeat themselves.

Investment Conclusions: The Ghost of Arthur Burns

> "It is my sense based on talking to academic macroeconomists … about 90%+ think the American Rescue Plan was too large and 70%+ think the Fed is currently too dovish."
>
> *—Jason Furman, Harvard, formerly Chair of President Obama's CEA*

Inflation is determined by three factors: the effect of supply shocks; the size of the output gap; and people's expectations of inflation. The current supply bottlenecks are likely to prove transitory which suggests the following takeaway: If the fiscal expansion is temporary (so the output gap remains below 2%) and if monetary policy remains clearly communicated and decisive (i.e., no change in policy regime), then there is little risk of an inflationary spiral. However, those are two very big ifs.

For equity investors, secular inflation is a devastating force, and policymakers should ensure the genie is kept securely in the bottle. However, today's combination of a generous Treasury, a tolerant Fed and a reopening economy puts America in treacherous territory. Investors should brace themselves for more inflation scares as it will remain a key driver of market volatility into 2022 and possibly well beyond.

Despite this worrisome backdrop, in our base-case scenario we expect only a brief period of above-target inflation. One reason is the starting point for Bidenomics is one of sizable slack (especially on employment-based measures of the output gap) and the fiscal impulse is set to turn negative next year. Further, the Phillips curve is quite flat, suggesting it would take an awful lot more stimulus than we are anticipating to push inflation above 3% (for anything other than a transitory blip, as is occurring this quarter). Additionally, the Fed has changed less than some commentators have asserted. Even though he has loosened the Fed's mandate in three ways, Powell is actually quite conservative (read his speeches carefully, don't just skim the headlines) and very much in line with his four immediate predecessors.

Consequently, we view present conditions as more similar to those in 1950-53 (a temporary surge in inflation reflecting a one-off increase in government spending) and 1965-68 (a sharp increase in the fiscal deficit reflecting LBJ's War on Poverty, as well as Vietnam) than to 1973, when a string of policy errors and severe supply shocks sent inflation skyward. Still, we fully agree with Larry Summers' contention that Biden's aggressive policy program presents significant inflation risks.

In particular, there are two developments that could lead us to become more concerned about upside risks to inflation. The first is that Biden's spending ends up being larger and longer lasting than we currently expect, so the fiscal impulse remains positive through 2022 and beyond, resulting in a 2%+ output gap and accelerating inflationary pressures. This could occur, for example, if the Democratic Party jettisons the filibuster or increases their majorities in the House and Senate next November.

Second, we would become more worried if Powell changes his tone and begins downplaying the costs of higher inflation while emphasizing the benefits of running the economy hot for a sustained period. A Fed that stays too accommodative for too long, risks repeating the errors of the Great Inflation. It is also possible President Biden will choose someone more dovish to replace Powell as Chair (his four-year term expires next February). Further, the term of the Vice Chair, Richard Clarida, expires next January and that of Vice Chair for Supervision, Randy Quarles, ends this October. All three are Republicans appointed by President Trump. The political pressure on President Biden to create a more dovish and Democratic FOMC is already intense and will likely become even more so over the next few quarters.

Given these risks, which are especially pronounced for long-duration equities, what should investors do? Epoch has always believed in focusing on companies that: (a) have an ability to produce free cash flow on a sustainable basis; and (b) possess superior management with a proven track record of allocating capital wisely, including investing today for future value creation. We are confident these companies are the most probable winners and the ones most likely to provide investors with the best returns. In today's challenging investment environment, with heightened risks around the inflation trajectory, we believe these principles are ever more important.

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