

What We Are Hearing And Seeing

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Mike Wedekind, AVP, Senior Investment Analyst **Inflation's a-Comin', but this isn't a 1970s Redux**

In recent months, the topic of broad based price increases for goods and services, otherwise known as inflation, has divided wonkish opinion and piqued Google search users' interest. Some prominent economists argue that the US Government's unprecedented fiscal stimulus risks overheating the economy and sparking inflation. Others, including powerful policymakers atop the Federal Reserve and Treasury Department, expect inflation to spike at various points this year, but argue these increases will be transitory – in part the result of so-called “base effects” that reflect year-over-year growth from unusually weak price data when the economy ground to a halt in the initial wave of COVID-19.

The most common measure of inflation, the Bureau of Labor Statistics' Consumer Price Index for All Urban Consumers, posted a 2.6% increase year-over-year in March. Gasoline prices were among the most significant constituents pulling this index upward, increasing by 22.5%. However, as Neil Irwin explains in *The Upshot*, some of this increase is indeed due to base effects, but some is attributable to unbalanced supply and demand for oil products. Grocery prices are also increasing, but the index also includes constituent prices that have fallen over the last 12 months, most notably airfare, tickets to sporting events, and hotel rates. As the vaccinated share of the population rises and travel increases, these prices surely will rise as well, but how durable should we expect these changes to be?

As they always do, opinions vary, but most of the managers we cover tend to align with the Fed's view that inflation is likely to be volatile this year, yet mostly tame for the foreseeable future. Shortages of shipping containers, microchips, and restaurant workers will likely combine with base effects to produce unusual top-line inflation figures in the coming months as demand increases and weak data points roll off, but policymakers have clearly indicated that they plan to look through these blips after years of sub-target price increases. While booming growth and the plans of an ambitious Biden Administration present some risk of higher and more sustained inflation, the dominant view at present is that we are not in serious danger of 1970's-style runaway price increases.



Dan Homan, CFA, AVP, Investment Analyst

Emerging Market Equities – A Lesser Known Inflation Hedge?

We have all heard about the building inflationary pressures that are occurring in the US. Whether this narrative is a head fake or not is yet to be seen. Surely, there is considerable pent up demand in some key industries, particularly travel and leisure. The question then becomes, how does an investor protect their portfolio from increasing inflation? There are various evident inflation hedges, such as TIPS (Treasure Inflation Protected Security), real assets, and real estate. Historical return data suggests that emerging markets equities also perform very well during inflationary periods in the US. Is there a causal relationship or purely a spurious correlation? Let's look at the drivers of emerging market equity returns to see how that connection pans out.

US inflation can have a direct impact on emerging market equity returns due to its influence on currencies and exchange rates. When the US experiences higher inflation than the rest of the world, the dollar typically weakens and US investors in emerging markets stand to benefit from EM currency appreciation. This is because a US investor's total return is both the local market price movement of a stock plus any appreciation in the local currency where the stock is domiciled. Domestic inflation aside, there is a bear case to be made for the US dollar. The US has gone through a period of sharp fiscal and monetary expansion, even more so than other developed countries and considerably more than emerging markets countries. After a long bull run for the US dollar, it seems the environment is ripe for a prolonged slide in the greenback. If this were to occur, it would benefit investors in all international stocks, but especially in emerging markets stocks.

Secondarily, emerging markets tend to benefit from inflation spurred by global economic growth. As the global economy recovers and demand picks up, emerging markets' export linkages to developed markets should provide another tailwind to returns. In decades past, this would have played out through emerging markets' commodity exporting businesses and those that support them. However, today those sectors make up a fraction of what they once had, now only comprising about 15% of the MSCI EM Index. Rather, export linkages are likely to occur in sectors like Information Technology, through heavy semiconductor demand. With a spike in remote working, 5G infrastructure buildout, data centers, automation and artificial intelligence, it appears we are in early innings of continued strong global semiconductor demand.

Nevertheless, the asset class is not without its challenges. Many EM equity managers acknowledge that emerging markets equity flows have been strong since late 2020 and into 2021, and earnings multiples have stretched to multi-year highs. In addition, new COVID variants and more limited access to vaccines could prolong domestic demand drag. However, EM multiples relative to the US remain very attractive, and thus far North Asian countries (which account for the preponderance of the index) have been very successful at containing coronavirus outbreaks. All told, emerging markets equities remain a very attractive asset class for US investors, regardless of whether we ultimately see a spike in domestic inflation.



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Small Caps Are Off to a Strong Start in 2021. Will It Last?

In the first four months of 2021, the Russell 2000 Index has returned around 16%, outperforming the S&P 500 Index by more than 3%, helping make up for some of the underperformance of the past few years. This outperformance was not all that surprising given the fact that small caps are known for rebounding strongly after recessions, as highlighted in our earlier 'What We Are Hearing and Seeing' edition. Now, the question on most investors' minds is, is there still room for upside in small cap stocks and how will they be impacted once the Fed eventually starts raising interest rates?

Increasing inflationary pressure is bringing the question of how long the Fed can remain accommodative to the forefront. Historically, small cap stocks have outperformed their large peers in most rising interest rate environments, especially in the early part of the cycle. This has been evident in 2004-05 and in 2016, both occasions in which the Russell 2000 Index outperformed the S&P 500. The theoretical explanation for this phenomenon is that typically central banks hike interest rates when the economy is facing inflationary pressure due to economic expansion. These periods are often good for small cap stocks due to their cyclical nature and higher dependency on economic growth as compared to large cap stocks.

Most small cap managers we speak to believe there is still room for the small cap rally to continue. Even though the market may see temporary setbacks, relative valuations are attractive compared to companies further up the market cap spectrum. Given the fact that the economy is still in the early phases of recovery, our managers believe that it's not too late to invest in small caps and reap the benefits as the economy continues to expand.

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