PORTFOLIO MANAGER INSIGHTS

WEEKLY INVESTOR COMMENTARY | MAY 19, 2021

Investment Committee

The central issue for many investors continues to be inflation. Prices are rising for some everyday goods and services as well as for important commodities. The fastest increases in decades could threaten growth in certain sectors, impact household spending, and affect the value of savings and investments. These concerns will only grow as the economy returns to pre-pandemic levels. What perspective should long-term investors have on inflation as business activity accelerates?

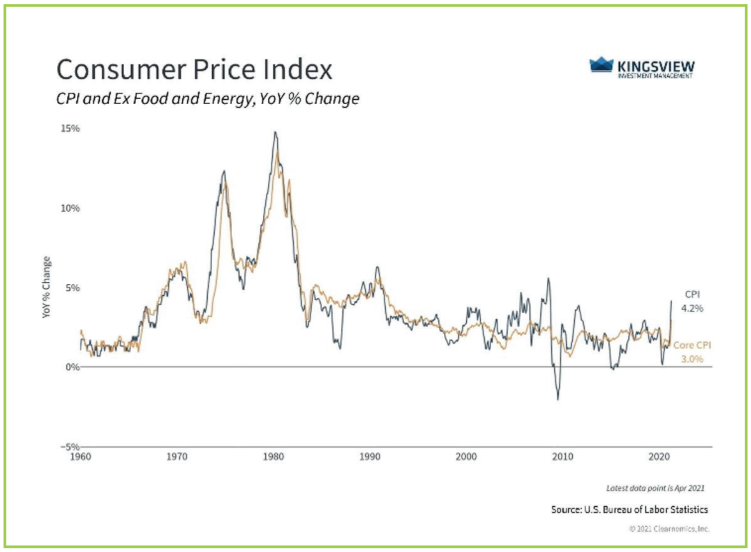
In everyday language, we often talk about any price increase as "inflation." However, it is important to distinguish between three factors at play during this post-pandemic recovery. Understanding the differences can help investors to stay balanced and be properly positioned in the years to come.

First, some prices are simply bouncing-back from historically low levels. Oil, for instance, plummeted at the onset of the nationwide lockdown last year, with the front-month contract falling into negative territory for the first time in history. Even with no changes to the oil industry,

it would be expected for prices to rebound as the economy reopens. The fact that these price increases are large on a percentage basis is due to the low starting points last year. Economists often refer to this phenomenon as "base effects" - i.e., prices coming off a low base.

Second, there are supply and demand imbalances in certain industries that are causing prices to soar. This is true in semiconductors, housing construction, agriculture, gasoline and many more areas. In most cases, this is what captures the attention of news headlines and the general public.

MANY MEASURES OF INFLATION ARE ACCELERATING



KEY TAKEAWAY:

1. **Many measures of inflation including CPI and PPI have increased in recent months. In some cases, prices are simply jumping off last year's pandemic lows. These base effects should be expected to fade over time.**

Each industry has its own supply and demand story. For instance, semiconductors are facing shortages due to strong demand for work-from-home technology, graphics cards for cryptocurrency mining, increased car-buying, and more. There are also supply factors such as disruptions to the global supply chain and droughts that threaten water-intensive chip manufacturing.

In most of these cases, the supply and demand imbalances should resolve themselves over time. And while this may be "inflationary" if it affects a wide variety of goods at the same time, this is not usually what investors worry about when they think of that term, even if it does affect consumers in the short run. After all, the skyrocketing price of toilet paper during the pandemic was not referred to as inflation, since it was understood to be temporary.

Thus, the third factor is a broad rise in prices across the economy due to monetary and fiscal stimulus. This is textbook inflation caused by increases in the money supply and/or the velocity of money - i.e., the pace at which money is spent. Unlike an energy pipeline disruption, the effects of this type of inflation are theoretical and can be harder to see.

Monetary inflation is not a universal concern among economists today. Although loose monetary policy was one reason for the inflation of the 1970s and early 1980s, Fed stimulus after the 2008 financial crisis did not result in the inflationary pressures many expected. Additionally, there have been strong deflationary forces over the past several decades as prices fall due to globalization, technology and other trends.

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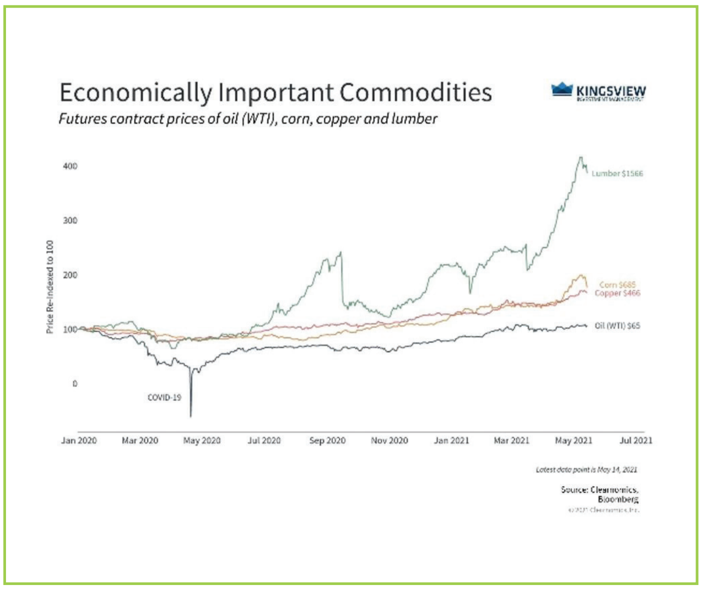
For investors, these factors can affect portfolios in very different ways. Base effects are by their very nature temporary and should generally not cause investors to drift from their long-term plans. In contrast, supply and demand shocks can lend themselves to sector positioning and tilts within portfolios. This depends on the nature of the shocks, whether supply will recover quickly, and whether high prices are tolerated by customers.

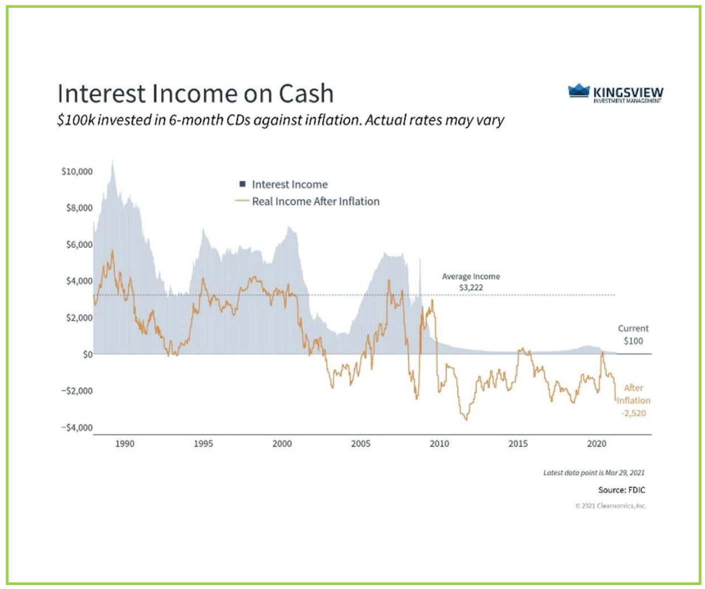
MANY COMMODITY PRICES ARE RISING TOO



KEY TAKEAWAYS:

1. **In certain industries, significant demand coupled with constrained supply have resulted in price spikes.**
2. **Lumber, for instance, is at record levels due to strong demand for new homes and limited capacity at sawmills.**

ASSET CLASSES THAT PROTECT PURCHASING POWER ARE INCREASINGLY IMPORTANT



KEY TAKEAWAYS:

1. **Rising inflation has already eaten into the purchasing-power of investor cash savings.**
2. **This is one reason that investments such as stocks, which can benefit from higher prices, are preferred in rising-inflation environments.**

Finally, monetary inflation is often what investors worry about when they seek inflation protection. TIPS, for instance, can help protect investors from broad and steady increases in prices as measured by the Consumer Price Index. Persistent, steady inflation is often what drives interest rates higher and impacts stock market valuations. This is one reason that staying invested in inflation-resistant asset classes, including stocks, is often better than holding cash whose purchasing power is slowly and quietly eroded.

How investors deal with "inflation" depends on what is truly driving prices higher. Effects that are more temporary should not cause investors to lose sight of their financial plans. Even in cases where there may be persistent inflation, portfolio adjustments may be enough to maintain purchasing power. Although inflation is rising, having the right perspective is important for investors to not overreact. Investors ought to protect their portfolios without deviating from their long-term financial plans.