



**HENGEHOLD
FINANCIAL GROUP**



Is Inflation Here to Stay?

We won't soon forget the troubling shortages of personal protective equipment during the early days of the pandemic, or when the first stay-at-home orders spurred panic buying and stress, inducing shortages of toilet paper, cleaning products, and food.

Now, as the economy reopens, we are again experiencing a wide range of shortages. Businesses are having trouble hiring workers as well as acquiring supplies of raw materials and key components needed for manufacturing. Many businesses that shut down or cut back when the economy was closed cannot ramp up quickly enough to meet the flood of demand. The speedy rollout of widespread COVID-19 vaccinations unleashed pent-up demand faster than expected, catching many businesses by surprise. At the same time, the flow of goods ordered from overseas has been hampered by shipping bottlenecks. While many supply constraints will continue to ease in the coming months, some problems, like the current microchip shortage, will take longer to resolve.

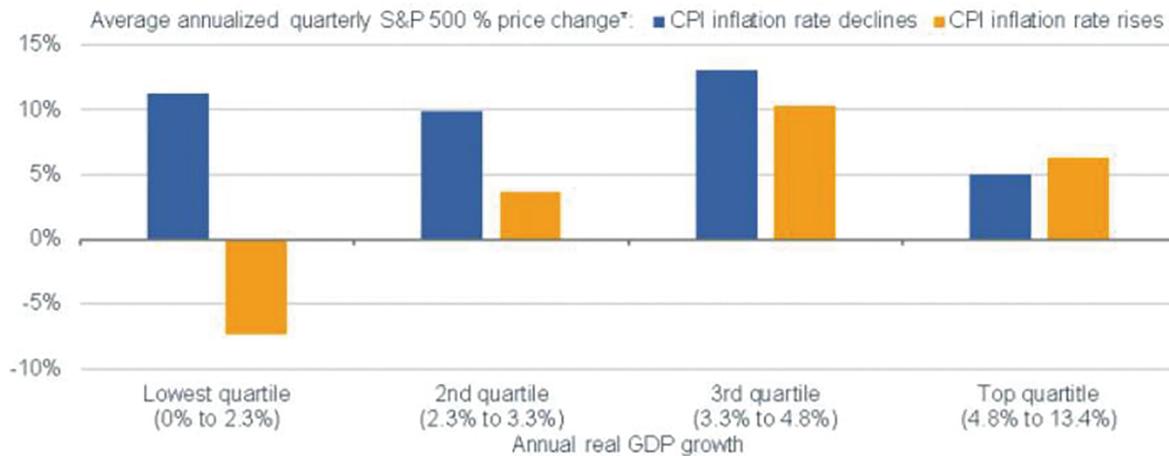
In May, inflation shot up by 5% with consumer prices showing their biggest surge in nearly 13 years (since August 2008). The increase in inflation is being driven in large part by what is believed by many to be temporary mismatches between supply and demand.

All but two of the regional Federal Reserve banks (Dallas and Philadelphia) saw a downtick in prices in June. The Institute for Supply Management prices index declined slightly in May. As the second half of the year unfolds—and assuming employment trends continue to improve and supply shortages are alleviated—a move down in prices should coincide with a relaxation of inflationary pressure. Consult the recent CPI and PPI inflation reports out July 13th and 14th, respectively, for indications as to whether inflation trends are temporary or more persistent.

Regardless, prices rarely fall once they have risen, which means even short-lived bursts of inflation can create long-term pain.

The longer-term path of inflation is still unclear because it depends heavily on economic policy decisions yet to be made. If future inflation readings continue to come in higher than the Fed now expects, we will likely see temporary down drafts in equity prices as investors worry about the Fed's tightening schedule.

While inflation remains in the spotlight, most stock market commentators miss the impact that underlying economic growth has on equity markets as inflation pressures are rising. It is generally true that over the last sixty years stocks have tended to do much better when inflation was falling rather than rising. However, as the following chart shows, equity performance since 1950, even for periods of rising inflation, has been positive during expansionary periods for all but the slowest growing quartiles of GDP.



Source: Charles Schwab, The Leuthold Group, 1950-3/31/2021. *Based only on economic expansions (all quarters when trailing y/y real GDP growth rate was positive). Past performance is no guarantee of future results.

The recently announced bipartisan “skinny” infrastructure deal, should it pass, will provide significant stimulus that will be supportive of growth and should have a positive market impact. While the infrastructure agreement is an optimistic sign, any disruptions in the legislative process could create additional bouts of volatility.

Bond Market’s Message

The temporary nature of the inflation scare has been affirmed by the bond market. While the ten-year Treasury yield did spike from the depths of the pandemic, yields have since retreated and stabilized. The same has been the case for real yields which remain deeply negative.

Much of the selloff in the growth stocks we saw earlier this year was driven by the rise in real rates going into March. Real rates have since retreated and are holding in a tight range. Now that rates have stabilized and the growth stock correction seems to have run its course, HCM has started the process of gradually increasing our growth allocation which we reduced late last year. We believe the back-and-forth trading between value and growth asset classes highlights the importance of bar-belling portfolios with both high-quality growth and value equities.

What Could Go Wrong?

There is always something to worry about. Right now, our list includes:

- Should the delta variant of the Covid-19 virus take hold, we will see more volatility in global markets.
- If inflation does not continue to moderate, fears of future accelerated Fed action will roil the markets.
- If the infrastructure bill collapses in Congress, economic growth estimates will come down, putting the market at risk.
- Labor supply constraints may slow economic growth, putting the market at risk.

In Summary

We think that while inflation will remain a headline risk as the supply chain is normalized, we do not think inflation will get out of hand. We believe that with business coming back and more stimulus on the way, both here and abroad, economic growth will be sufficient to sustain the equity markets through periods of volatility that we will treat as opportunities to add to equities.

Invitation to contact your HCM/HG Advisor

We want to hear from you. If you have experienced any changes in your life that may impact either your financial situation or family's financial goals, be sure to let us know. It's always best to schedule regular conversations so you can stay on top of any changes that may affect your planning, tax, and investment objectives. We would prefer to meet in person, but we are happy to schedule conference calls, video conferences, or whatever works best for you.

If there is someone in your life that might benefit from the type of retirement, tax, and investment assistance we provide, please connect us. We will do everything in our power to help.

We appreciate the opportunity to work with you, and we thank you for your confidence.

Sincerely,

A handwritten signature in black ink, appearing to read "M. Hengehold", with a stylized flourish at the end.

Michael T. Hengehold, CPA/PFS MST RICP®

P.S. Please look for announcements regarding HCM's Monthly Town Hall Live Webinars in your email inbox.