KayneInsights

Inflation Concerns?

No Long-Term Inflation Concerns, Only Transitory Inflation from Pent-Up Demand

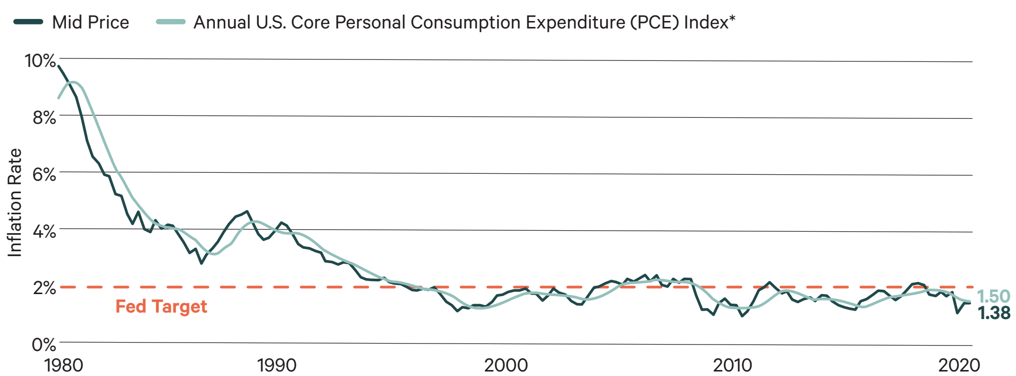
"I've spent many years studying inflation and worrying about inflation, and I can tell you, we have the tools to deal with that risk if it materializes."

Janet Yellen
Treasury Secretary

Talk of higher inflation continues to be a topic of intense debate among everyone from Wall Street to Main Street. Much of the frenzy is triggered by the government's $2 trillion COVID-19 relief package combined with the re-opening of the economy. The worry is that pent-up demand from U.S. households will drive break-neck growth that will spike inflation and move interest rates higher. While it is extremely likely we will see a burst of inflation in a post-pandemic recovery, we believe this will prove to be a temporary phenomenon, described by economists as "transitory," and should not create long-term inflation concerns for investors.

Federal Reserve Chairman Jerome Powell has repeatedly played down the risks of inflation by saying that the Fed is in no hurry to change its easy money policy of ultra-low interest rates. He has reiterated that the U.S. economic recovery remains far from complete despite recent improvements and signs of strengthening, which he expects to continue. In regard to the new stimulus, Powell recently told lawmakers the effect on inflation from government spending will likely "be neither particularly large nor persistent."[1] Treasury Secretary Janet Yellen also weighed in with lawmakers saying, "I've spent many years studying inflation and worrying about inflation, and I can tell you, we have the tools to deal with that risk if it materializes." In other words, Yellen believes inflation is a solvable problem.[2]

FIGURE 1: ECONOMISTS EXPECT INFLATION TO STAY SUBDUED
Inflation vs. Fed Target



**The PCE price index, released each month in the Personal Income and Outlays report, reflects changes in the prices of goods and services purchased by consumers in the United States.*
Data presented is as of December 31, 2020. Data is obtained from Bloomberg and is assumed to be reliable.
Past performance is no guarantee of future results.

Kim Friedricks
Managing Director,
Fixed Income

Don't Fear "Transitory" Inflation

The Fed does indeed have the tools to keep inflation under control. In fact, the Fed and banks around the globe have learned from the past 50 years how to control and contain inflation with interest rates. So, we believe any inflation coming out of the pandemic will be "transitory," – not something that will continue to drive prices persistently higher and higher. We expect that as the economy re-opens and as supply has an opportunity to catch up with demand, prices should level off and normalize. Importantly, the Fed has stated it will be patient and allow the economy to run hot and let growth and recovery take hold and that it will not be influenced by this *expected* transitory inflation.

With newly vaccinated Americans excited to resume life, one example of transitory inflation that may arise this summer is a hike in the cost of travel and lodging. After sheltering in place for much of 2020, U.S. households may prioritize taking a vacation or traveling to visit family. Travelers should expect a jump in the cost of airfare and hotels as these companies seize the opportunity to make up for last year's heavy losses and incentivized travel discounts. While we expect prices to go up across many sectors of the economy until industries recover and stabilize, we don't expect prices to continue escalating to levels that would require substantive interest rate intervention to tame rapidly successive price increases.

Mild Inflation Expected and Essential for Growth

We are prepared to see other examples of transitory inflation across the economy for however long the post-pandemic recovery lasts. Since U.S. households are reported to have $2.8 trillion more in savings, checking and money market accounts than in 2019[3], it's easy to see how pent up demand may surge and create bursts of inflation among sectors of the economy. Producers will need to catch up to demand, so we expect to see elevated pricing across goods and services. Keep in mind this may cause core inflation to appear higher and above the Fed's target range of 2%. Some mild inflation is good for the economy—it encourages consumers to buy sooner versus paying more later, which helps sustain economic growth.

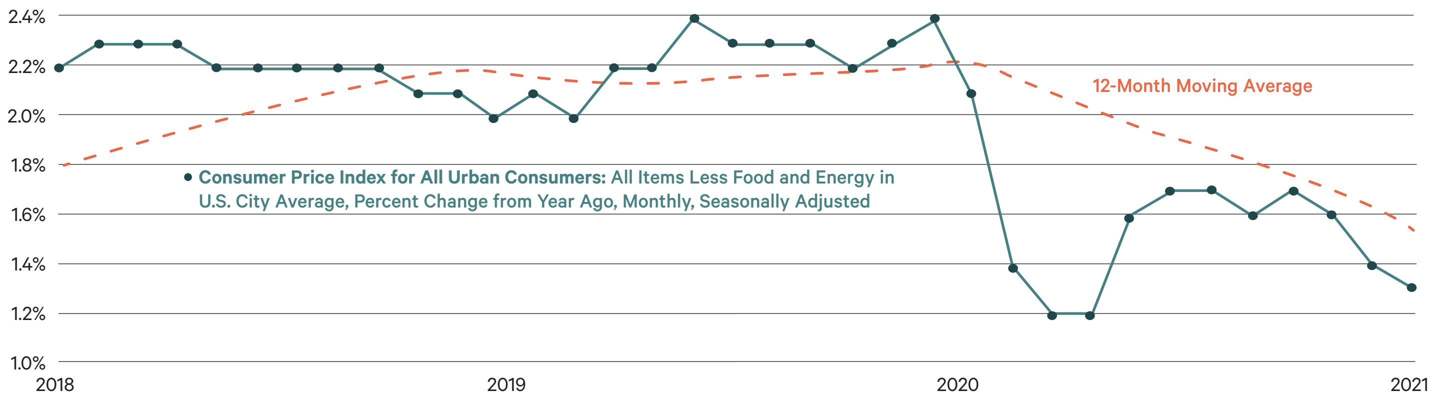
Expect Bond Yields to Flatten

We also view the recent rise in the benchmark 10-year U.S. Treasury yield, used as key measure of interest rates across the economy, as an over-reaction to inflation fears. We believe the forces lifting bond yields, which may go higher before flattening, are optimistically and reflexively priced due to the faster-growth forecasted due to the re-opening of the economy.

As we see it, any surge in inflation is likely to be transitory. We expect a pick up in the inflation rate, but do not see long-term inflation as a sustainable force once the economy fully recovers and emerges from the pandemic.

Lastly, for all the agonizing over inflation, which hasn't existed in the economy for many years due to systemic changes, we believe the real enemy is deflation. When prices fall, people delay spending to see if prices will fall even lower before purchasing. This reduces demand and inventory. With businesses producing less, they tend to need fewer workers, which may reduce the labor force. As businesses continue to lower prices, the effects of deflation magnify making it far more corrosive to the economy than inflation. While we aren't forecasting deflation, it provides perspective to the current "noisy" inflation debate.

FIGURE 2: THE NUMBERS DO NOT SUPPORT INFLATIONARY PRESSURE
Consumer Price Index Less Food and Energy



Data presented is as of March 31, 2021. Data is obtained from Forbes/George Calhoun at the Stevens Institute of Technology and the Federal Reserve and is assumed to be reliable. ***Past performance is no guarantee of future results.***

Kayne Anderson Rudnick is an investment firm specializing in high-quality investment and wealth management strategies. The firm has over a 30-year history serving a diverse client base that includes high-net-worth individuals, corporations, endowments, foundations, public entities, taft-hartley clients, and mutual funds. Kayne Anderson Rudnick is known for its commitment to high-quality investment strategies and business practices. For more information, please visit www.kayne.com.

1 Bond Bulls Charge Ahead, Challenging Consensus on Rising Yields. Wall Street Journal, March 28, 2021.
2 Inflation Debate Heats Up Over Biden Relief Bill. thehill.com, March 4, 2021.
3 Optimistic Forecasts on Economy Might Still Be Too Dismal. Wall Street Journal, March 29, 2021.
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