by DOUG SANDLER, CFA

THE RIVERFRONT WRITING TEAM

REBECCA FELTON
Senior Market Strategist

CHRIS KONSTANTINOS, CFA
Director of Investments |
Chief Investment Strategist

KEVIN NICHOLSON, CFA
Global Fixed Income Co-CIO |
Co-Head of Investment Committee

DOUG SANDLER, CFA
Head of Global Strategy

ROD SMYTH
Chairman of the Board of Directors

SUMMARY

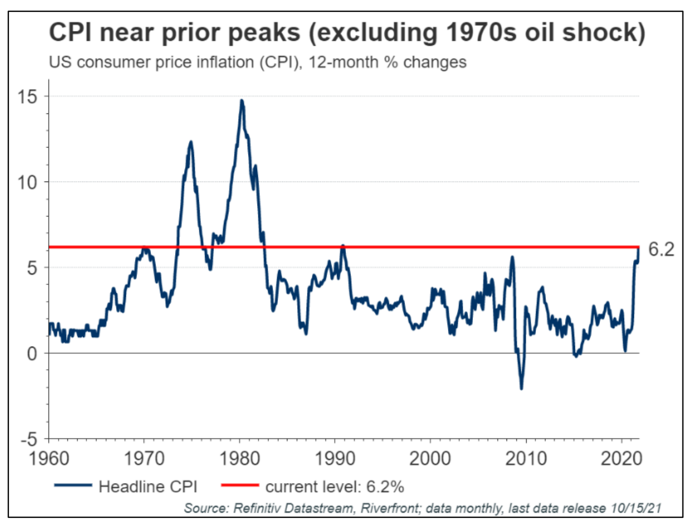
- Global supply chains are currently clogged-up.
- We think it will be mid-to-late 2022 before things return to normal.
- Because we think inflation will be transitory, we remain overweight stocks.

11.15.2021

Inflation's Return is Not Surprising

Whether It's Structural or Transitory Remains the Million-Dollar Question

That 1968 Chevrolet Chevelle convertible in the picture used to be mine. I say 'used to' because owning it was a headache. Because I used it rarely, every time I went to take it for a spin, it would either not start or leave me stranded a long way from home. At first, I thought it was just 1968 engineering and that old engines were not as technologically advanced and reliable as they are today. However, that thesis was quickly disproven when I had the same issue with a brand-new 2015 motorcycle. The simple fact is that machines are 'born to run' and regular usage keeps their many parts lubricated and in working condition.



Shown for illustrative purposes. Not indicative of RiverFront portfolio performance.

Global economies and global supply chains are far more complicated and fragile machines. Therefore, we should expect some difficulty restarting them after leaving them dormant for 18+ months. Complications will occur and disruptions should be anticipated. It is natural to assume such issues will multiply if those machines are immediately placed under stress before having ample time to 'warm up'. This is exactly what has happened across the world over the last 6 months. Just as producers were trying to get restarted and warmed up, consumers were leaving their COVID-19 quarantines with pockets full of savings and a desire to spend. This intersection of depleted supplies and torrential demand has caused prices to rise quickly and has stoked inflation fears. October's reading of the Consumer Price Index (CPI), released last week, noted that prices have risen by 6.2% over the past year, which was the highest annual inflation rate since August 1991 (see chart above).

STRUCTURAL OR TRANSITORY?

The stakes are high regarding the answer to that question since structural inflation could severely damage investment values. Unfortunately, we do not believe that there is enough data to definitively answer that question yet. Complicating matters is the uniqueness of the COVID-19 shutdown making comparisons with other inflationary periods (especially the 1970's) problematic. For this reason, it is probably not appropriate to project today's difficulties into the future and assume that world economies are destined for 'stagflation' (low or no growth along with high inflation).

We continue to believe that inflation will prove to be transitory. Importantly, however, we do not define transitory as 'quick'. Instead, we believe that inflation aftershocks will continue to reverberate into 2022. Our benign longer-term view is due to the following factors:

INFLATION MITIGATORS

For inflation to prove transitory, there must be mitigators to combat rising prices. Fortunately, there are a few which we are watching:

1. **Supply:**

    - **Labor:** According to the Bureau of Labor Statistics' latest report, there are 7.4 million unemployed workers in the US. This means there are 1.7 million more unemployed workers than the number that existed prior to COVID-19 (February 2020). Getting those workers back to work will be a key in lessening supply constraints on the services sector. Rising wages for low-cost workers and the expiration of Federal enhanced unemployment benefits appear to be having a positive impact. For example, October's payroll gain of 531,000 jobs was well-above economist's forecasts and reversed a two-month trend of disappointing job growth numbers.

    - **Automation:** Unfortunately, getting the unemployment rate back to pre-COVID-19 levels may not be enough to completely reduce labor pressures. This is because roughly 2.3 million workers left the US workforce during the pandemic and are currently not seeking re-employment. Given that necessity is the mother of invention, the automation of labor-intensive tasks may be a solution. For example, according to Progressive Grocer, the delivery of self-checkout terminals surged by 25% in 2020 and can now be found in many non-grocery retailers, like drug and discount stores. Similarly, 'labor-light' solutions are beginning to be utilized throughout the economy in areas like food service (mobile ordering and check-out) and healthcare (wearable monitors and the utilization of robotic assistants).

    - **Logistics:** By now most of us have either heard of the logistical bottlenecks plaguing the recovery or have experienced it first-hand. Like many of the issues affecting the supply-chain there is no 'magic bullet'. However, a combination of several efforts should eventually ease some of these obstacles. One such effort is President Biden's October announcement that US ports would expand their operating hours to 24/7. The transportation industry is also attempting to address the trucker shortage by accelerating their testing of self-driving trucks. For example, Wal-Mart, the country's largest retailer announced last week that they were now operating two driverless box trucks near their Bentonville headquarters. While regulatory approval and full adoption is likely several years away, we are encouraged by the rising valuations and recent IPOs of companies that manufacture electric/autonomous vehicles. We think this influx of capital should provide the funds and the motivation to accelerate this timetable.

2. **Demand:** Inflation is often defined as 'too much money (demand) chasing too few goods (supply)', therefore, one inflation mitigator would be a decrease in demand. We can see this happening a couple of ways. First, as the economy fully re-opens, consumers will be able to increasingly spend on services, like travel and entertainment, which should alleviate some of the pressure on the supply-chain for goods. Second, we think pent-up savings from the economic shutdown will eventually be exhausted, returning spending to more normal levels.

DIFFERENT MESSAGES FOR DIFFERENT INVESTORS

Distribute & Sustain Investors: Inflation is called the 'thief in the night', because it can rob investors without detection. It goes undetected because it robs purchasing power, which generally is not noticed until it is too late. To put it into perspective, when inflation is at 2%, a portfolio would have to grow by 49% over 20 years to maintain purchasing power. If inflation rises to 6%, that same portfolio would have to grow more than 4 times faster (221%) to keep up. Generating faster growth can be difficult given that distribute and sustain investors tend to have portfolios laden with bonds and little prospects for growth. **Our view on a potential remedy is to increase stock allocations, and to adopt a total return mindset where spending needs are met from portfolio income and systematic withdrawals of principal.** The degree of that adjustment and the appropriate balance of spending from income and/or principal is best determined by your financial advisor. **RiverFront's balanced portfolios remain significantly underweight fixed income and moderately overweight equities relative to their benchmarks.**

Accumulate Investors: Inflation can reduce the value of stocks and real-estate, especially if it is structural and significant. Furthermore, inflation can have an exaggerated effect on the growth stocks that accumulate investors tend to favor. This is because growth stocks tend to generate their earnings far into the future, and future earnings are less valuable when inflation is high. **Therefore, in our Advantage portfolios we have gradually added more cyclical stocks, whose earnings can be expected to benefit from inflationary trends, to complement the growth stocks we already own.**