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Issue 1 – Inflation vs. Deflation

Bayshore's Chief Investment Officer shares his thoughts on current events and topics.

Last month, when October's inflation numbers showed that consumer prices rose 6.2% year-over-year, our favorite daily market newsletter called it "worse than the worst fears." Last Friday's November reading at 6.8% was more stoically received by observers who had enough time to adjust their expectations. Yet, the last 30 days tipped the debate on whether inflation is "transitory" or "persistent" firmly in favor of Team Persistent.

Financial markets are moved by narratives; currently, the top narrative is resurging inflation. The direction of inflation has material consequences for portfolio management, particularly regarding fixed income (i.e., bond) allocations. We will dedicate the first issue of ***Views From the Top*** to this debate, explaining the key issues and provide our opinions.

Why is inflation bad for fixed income investments?

There are two problems with fixed income in an inflationary environment:

1. **Real loss**: When an investor buys $100 of a fixed income asset (a bond), her return is "fixed" in nominal dollars. If the bond has a 5% coupon, she will receive $5 in interest per year for the lifetime of the bond, and the original investment ($100) plus the final coupon at maturity. Inflation eats away at the real value of the nominal fixed dollar payments. In this example, if inflation is 10%, the investor "loses" 5% of real value per year.[1]

2. **Mark-to-market loss**: When inflation accelerates, central banks are often forced to raise interest rates to reign in inflationary pressures (most central banks' official mandate is to provide full employment and price stability). When market interest rates rise, the prices of existing bonds must fall to force the yields up and "match" the rise in rates, causing mark-to-market losses for their holders. For a widely owned fixed-income ETF (e.g., iShares Core US Aggregate Bond ETF), this would result in approximately a 6.5% loss for every 1% increase in interest rates.

What are the arguments for transitory versus persistent inflation?

We are closely monitoring this debate, as there are strong arguments on both sides.

Team Transitory argues that a temporary rise in prices is to be expected amid the pandemic shock to the global economy and related shifts in consumer behavior. During normal times, supply and demand for goods and services are broadly in sync. Most finished consumer goods (or parts thereof) are produced in Asia and brought to big consumer markets in Europe and the US via well-oiled supply chains (overseas factories, planes, ports, ships, containers, trucks, rail, barges, etc.). Faced with an unprecedented pandemic lockdown, consumers shifted their spending towards goods (e.g., TVs, sofas, cars, etc.) and away from services (e.g., cruises, theme parks, restaurants, etc.). This led to a relative surge in demand for goods, further fueled by stimulus checks that acted like pay raises in many cases. This structural change in demand for goods would have been challenging to absorb in normal times, but the recurring shutdowns of key supply chain facilities and a shortage of labor willing to work under prevailing conditions slowed the system to a crawl. The result is an ongoing shortage of a range of goods, components, and key labor. This high demand and lack of supply thus results in rising prices.

Energy costs are a large contributor to the current high inflation readings. Energy costs are influenced by a variety of factors, some of which are COVID-related. US oil production has fallen during the pandemic, as many

[1] The same is true for any other future fixed payment, such as an annuity, that one receives in an inflationary environment. An inflationary environment hurts **recipients** of nominally fixed amounts and benefits **payors** of fixed amounts (such as someone making regular, fixed mortgage payments).

rigs were shut and have yet to reopen. The resulting oil production shortage in the US has not (yet) been offset by higher production abroad (for tactical and political reasons). Meanwhile, demand is running hot as the global economy is reopening, leading to an unbalanced oil market and rising prices.

Team Transitory believes that given enough time, these issues will resolve themselves, and trade and energy markets will fall back in sync as the system adapts and prices stabilize, or even fall. Lastly, the transitory camp relies on the adage that "the best cure for high prices is high prices" (i.e., high prices reduce demand for a good, thereby forcing prices to fall). The US Fed and the bond market are on Team Transitory (i.e., thus far, interest rates across the yield curve have not significantly risen despite the higher inflation readings, indicating that the market does not believe that the Fed will be forced to raise rates faster than originally anticipated).

Team Persistent, on the other hand, argues that the current price surges are heavily related to non-transitory factors. For starters, COVID put a gigantic nail in the coffin of globalization, already reputationally damaged after years of political fire from the political anti-establishment. Today's discussion is about re-shoring and bringing (at least) critical infrastructure and manufacturing back, also in the context of the growing conflict with China. This process is unlikely to go smoothly, as we can see now with the current shortage of semiconductors, which partially is a result of incentives created by the trade war with China. Globalization was a key driver of deflation over the last twenty years, and reversing it is almost certain to be inflationary. Second, the global ESG push towards decarbonization will structurally raise energy prices. For years, concerns about public image have curtailed the flow of investment capital towards "dirty" energy sources. Combined with the widespread post-Fukushima exit from nuclear power, the global supply side of energy production looks weak. It will take decades until renewables can pick up the slack. Meanwhile, energy demand is certain to remain strong, given the post-COVID boom and the electrification of everything. Third, the labor market is being hit by the double whammy of demographics and COVID. With the vast post-war generation, the Baby Boomers, in the midst of retiring, the US labor pool is expected to grow a meager 5.5% between 2020 and 2030[2]. In addition, evidence is growing that millions of workers used the pandemic to reassess their lives, deciding to retire prematurely or otherwise leave the workforce; record high financial markets and the odd bitcoin million have fueled this trend. The short-term result is substantial labor shortages and rising wages, putting more pressure on inflation. Given the underlying demographic trends, pressure on the labor market might be with us for years to come.

There are few short-term fixes for these issues, thus Team Persistent's conviction that inflation is here to stay beyond the post-COVID reopening.

What is Bayshore's view?

We sympathize with the arguments on both sides but choose to go with Team Transitory. Markets and systems tend to rebalance, and this will likely happen with the supply chain issues and the energy market. Technology will play a pivotal role in relieving labor shortages. Western economies are highly levered and can neither tolerate sharp inflation nor rising interest rates without triggering a deflationary rebalancing (i.e., a recession). Inflation readings may remain choppy for years, though. We expect that inflation will average out just low enough for the Fed to not have to materially raise rates for years. With real rates solidly negative, the US government will be happy to see its debt melt in the inflationary sun.

[2] Employment Projections 2020-2030 (bls.gov)

REQUIRED DISCLOSURES