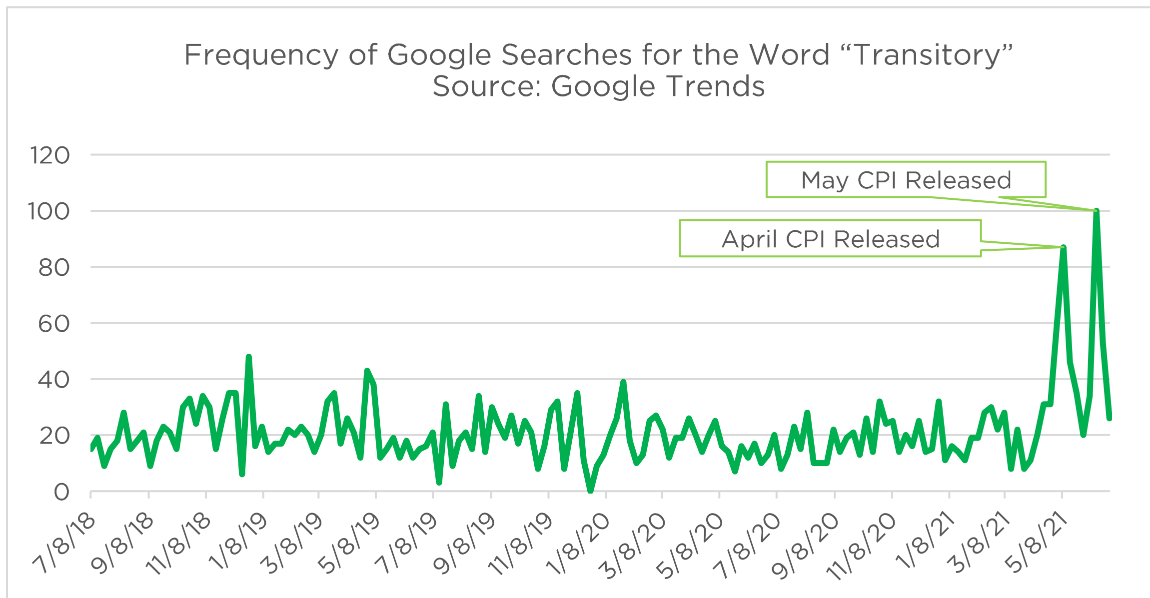
Inflation is a hot topic. Throughout the second quarter, it was the subject of great scrutiny. A new buzzword was ushered into the vocabulary of investors and observers: transitory. Significant increases in consumer prices were widely predicted for the spring months. In both April and May of this year, the CPI rose at the highest annual rate since 2008. June data was nearly double consensus predictions. A spirited debate ensued. Would rising cost of living become the new normal, or would current readings prove to be only a transitory effect of the post-pandemic economic restart?



The importance of the outcome should not be underestimated. Anyone old enough to remember the 1970s knows the corrosive effect that rapidly rising consumer and producer prices can have on both the real economy and financial markets. Ever since the early 1980s, when Paul Volcker broke the back of inflation, the Federal Reserve has been counted on to adjust monetary policy to temper overheating conditions. In the first quarter of this year, interest rates rose as investors worried that the Fed would move too slowly to tame building inflation.

Then things changed.

In the second quarter, while observers debated the potential duration of post-Covid inflation, markets had already begun to signal a winner. Bond investors cast their votes for "transitory."

The yield on the 10-year U.S. Treasury note dropped from 1.75% on March 31, 2021 to 1.45% by June 30, 2021 and is 1.34% as of this writing.

The bond market has begun to reflect the concern that the Fed may start to remove accommodations too soon while the economy continues to require the current level of monetary stimulus. There are several possible explanations for this.

The first, of course, is that current inflationary pressures will subside in the near term as economic growth moderates and various shortages are addressed. One can point to the recent sharp decline in the price of lumber and reduction of shipping delays[i] at major ports as indicators that supply chains are beginning to untangle. The housing market has cooled off noticeably. Labor shortages remain a question mark, but many believe that more of the workers that were laid off during the pandemic will choose to rejoin the labor force after the summer as extra unemployment benefits lapse and children return to school.

Good old-fashioned Washington gridlock may also factor into investor calculations. While there is still the probability of more fiscal stimulus, the size of a potential spending bill is likely to be much smaller than once anticipated.

Some investors are becoming concerned about the impact of the Delta variant. A resurgence of Covid infections could lead to the reinstatement of restrictions, delaying or moderating the economic rebound.

Looking at the stock market, its behavior in the spring quarter could almost entirely be explained by a single factor: falling interest rates. Investors returned to the path that worked so well before the economic rebound. Large company stocks outperformed small, and so-called “growth” stocks outpaced more cyclical “value” stocks.

	12/31/2019-11/6/2020	11/6/2020-3/31/2021	3/31/2021-6/30/2021
	2020 Pre-Vaccine	**Since Vaccine**	**Second Quarter**
Interest Rates	Falling	Rising	Falling
S&P 500	8.63	13.21	8.17
S&P 500 Equal Weight	(1.37)	24.33	6.48
Growth Stocks[ii]	30.30	6.02	11.72
Value Stocks[iii]	(9.99)	23.13	4.71
Russell 2000	(1.46)	35.06	4.05
Long Term Treasury Bonds[iv]	19.17	(14.61)	7.02
Investment Grade Corporate Bonds[v]	8.87	(3.71)	3.92
High Yield Corporate Bonds[vi]	0.97	3.84	2.01

It appears that many investors are following an overly simplistic calculus. The formula seems to be buy “growth” index funds when interest rates are falling, then switch to “value” index funds when rates rise and back to “growth” if rates fall again. In our experience, reallocating assets in this manner rarely succeeds for long.

To start, one might reasonably ask what the difference between a “growth” and “value” stock is. A simple answer would be that “value” stocks are cheap by some observable measurement. For instance, stock price to current earnings or total enterprise value (which includes debt) to cash flow. “Growth” stocks are generally more expensive by these measures but are thought to have the potential to increase sales and earnings per share at a faster than average rate. But constructing benchmarks to track market performance is rarely accomplished using simple rules.

Though less influential than the S&P 500, the Russell 1000 is meant to track the performance of large capitalization companies traded on U.S. exchanges. However, when it comes to defining and measuring growth and value investing, Russell indices are the industry standard. There are currently 1024 different stocks in the Russell 1000, from which the Russell 1000 Growth and Russell 1000 Value benchmarks are created. Here is where things get confusing:

Makeup of Russell Growth and Value Indices	
Benchmark	**Number of Stocks**
Russell 1000 Growth	499
Russell 1000 Value	842
Number of Stocks in Both	317

In order to “provide comprehensive and unbiased barometers for the large-cap growth and large-cap value segments,”[vii] all 1024 stocks need to be shoe horned into a category. We get that. But we cannot follow the logic that more than 30% of the companies somehow fall into BOTH.

What we think is most relevant is that there are plenty of companies in the Russell 1000 that are neither cheap nor capable of growing at an above average rate. Having publicly traded stock does not make a company investment-worthy. Segmenting all constituents, good and bad, into clumsily defined categories does nothing to address this flaw. This is just one of many reasons we eschew both index investing and short-term (or “tactical”) asset allocation.

When it comes to the inflation debate, we are not in the business of placing chips on “higher” or “lower,” “transitory” or “persistent,” “growth” or “value.” We prefer to focus on its impact on specific business segments to identify those companies that are best equipped to benefit from changing conditions.

In the longer term, we know that the global labor force is shrinking. Whether near-term wage growth is somewhat faster or marginally slower than currently predicted, companies will invest in software and other technologies to automate tasks and increase efficiency. Beneficiaries of this trend will be found among sellers and buyers of these tools. We invest in both.

Whether due to snarled supply chains or weather events, if commodity prices and other input costs rise, some companies will be in a far better position than others to pass along higher prices to customers. We look for dominant players in businesses with few or weak competitors and high barriers to entry.

If interest rates do rise more than currently expected, countless businesses could be stuck with sharply higher financing costs. The weakest may find themselves unable to raise capital at any price. We favor companies with more than enough free cash flow to finance their own growth.

In the coming months, we believe that much attention will be given to economic data releases. There will be much speculation about the reactions of central bankers, principally Jay Powell, chair of the U.S. Fed. Commentators will likely lean on the most common of forecasting tools: extrapolation. Traders will trade and markets will move in unpredictable ways. It is our belief that all of this noise will produce at least one predictable result: fluctuating sentiment will lead to specific mispriced securities and attractive investment opportunities.

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[i] Logistics and supply chain company Project44 reported that shipping containers are sitting at port, on average, for 13 days, well below the peak of 26 days, but still above the 6-day average pre-pandemic.

[ii] Russell 1000 Growth Index

[iii] Russell 1000 Value Index

[iv] iShares 20+ Year Treasury Bond ETF

[v] iShares iBoxx $ Investment Grade Corporate Bond ETF

[vi] iShares iBoxx $ High Yield Corporate Bond ETF

[vii] FTSE Russell Fact Sheet

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