PALLAS
CAPITAL ADVISORS

PCA Monthly Commentary

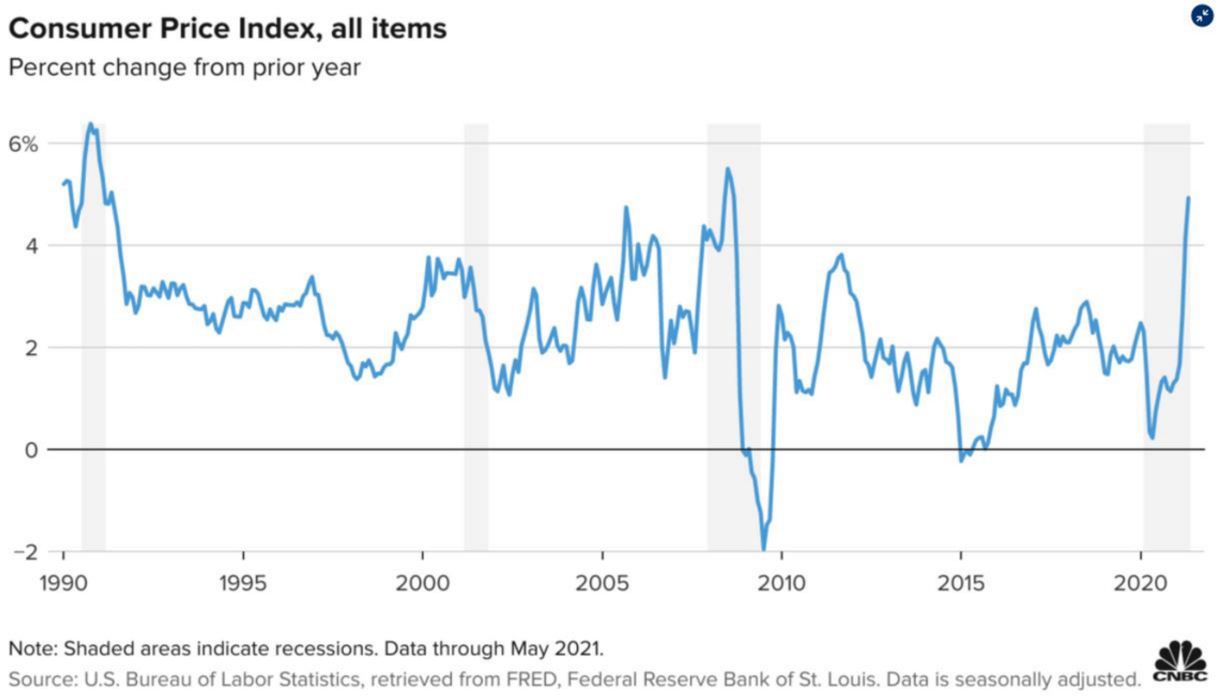
June 2021

Inflation Interpretation: Temporary or Permanent?

Markets generally moved higher in May 2021 led by cyclical sectors as headline inflation accelerated. Debate continues to swirl as to whether this inflation is temporary or more permanent with markets interpreting the data differently. Global equity markets in May demonstrated an inflationary/pro-cyclical tilt with the S&P 500 +0.7%, NASDAQ -1.4%, EAFE +3.6%, and Emerging Markets +1.1%. Fixed income performance was also positive as interest rates drifted lower with the Bloomberg Barclays US Aggregate +0.3% and US high yield +0.2%. Cyclical commodities reacted to the increased inflation by rallying with oil +4.4% and gold +7.6%.

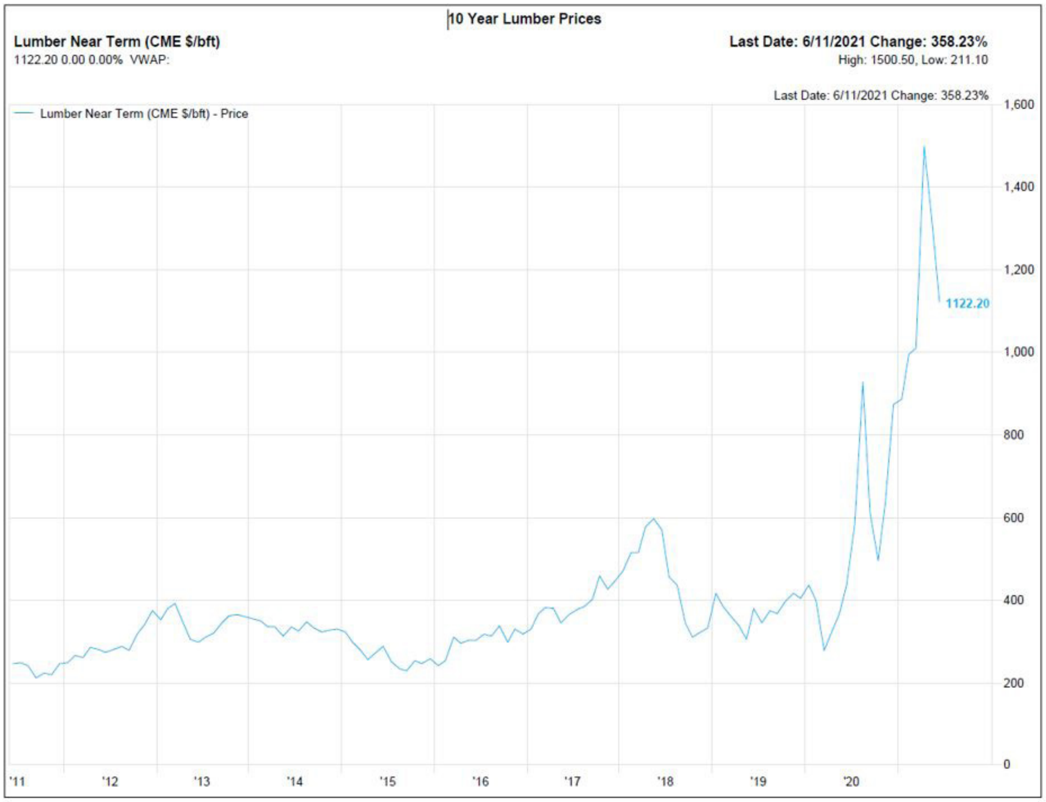
CONSUMER PRICE INDEX JUMPS 5.0% IN MAY

Consumer prices for May accelerated at their fastest pace in nearly 13 years as inflation pressures continued to build in the US economy, the Labor Department reported Thursday. The consumer price index, which represents a basket including food, energy, groceries, housing costs, and sales across a spectrum of goods, rose 5% from a year earlier. Economists surveyed by Dow Jones had been expecting a gain of 4.7%. The reading represented the biggest CPI gain since the 5.3% increase in August 2008, just before the financial crisis sent the US spiraling into the worst recession since the Great Depression. (CNBC)



SOURCE: CNBC

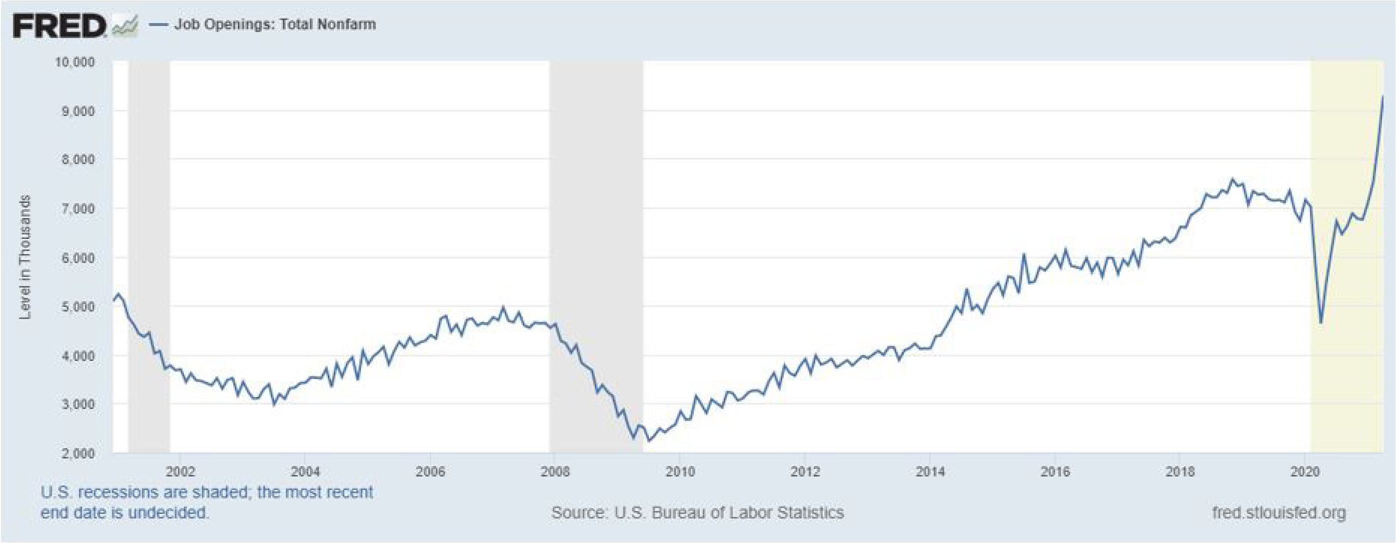
As the broad consumer price index accelerates, an argument exists that certain prices are peaking at this stage of the recovery given the severe and unanticipated impact on many supply chains from the pandemic. An example of this would be lumber prices. Housing demand has soared over the past year with low interest rates and a desire to leave cities during the pandemic. Lumber prices have been squeezed higher by this demand and supply constraints from COVID restrictions. However, Lumber prices may have already peaked as they have dropped 20% over the last few months. (Factset)



SOURCE: Factset

JOBS AS ANOTHER POTENTIAL SOURCE OF INFLATION

Job openings soared in April to 9.3 million according to the Labor Department's JOLTS report, exceeding expectations of 8.18 million. The economy has opened much faster than employees have been willing or able to get back to work. Reasons for job openings remaining high while unemployment remains above trend include childcare availability issues, COVID hesitancy, and enhanced unemployment benefits.



SOURCE: fred.stlouisfed.org

Wage inflation is closely watched by the Federal Reserve as a key indicator of more permanent inflation. If the job openings persist at this level, wages will have to be raised to entice people back to work. This wage inflation would put pressure on the Fed to begin tapering quantitative easing and/or raising interest rates earlier than expected. The Fed's position has been to wait until the temporary effects of the shutdown work through the economy before making any moves. Interestingly this week, some Fed governors began speaking about the possibility of beginning the tapering of quantitative easing which would be the first signal of tightening policy.

MARKET IMPACTS OF RECENT INFLATION DATA

As the inflation data has come in higher than expected, equity sectors typically exposed to rising prices have performed better such as energy, materials, and real estate. Technology stocks, as represented by NASDAQ, actually fell in the month of May. The bond market, as measured by the 10-year Treasury Bond, has interpreted this inflation data as temporary. The Fed signal that they are thinking of tapering could demonstrate that they are not behind the curve on inflation. The 10-year Treasury rate has fallen to 1.46% as of June 11th.

One example demonstrating the potential temporary nature of inflation is in food prices. Per the chart below, grocery prices spiked at the beginning of the pandemic as supply chains had to adjust to everyone eating every meal at home. Supply chains cannot immediately react and as such grocery prices rose. As the year has progressed, supply chains have adjusted, and prices have fallen.

We are now seeing a spike in prices at restaurants which could be expected as the light switch was flipped on, but supply chains for both labor and goods need to readjust back to efficiently supplying the restaurant channel. Permanent inflation can only be measured after normal economic activity resumes. History has shown that supply and demand will adjust to bring prices back down.

BIPARTISAN INFRASTRUCTURE DEAL MAY BE IN THE WORKS

Members of a bipartisan group of senators said they had reached an agreement on an infrastructure proposal that would be fully paid for without tax increases, pitching the plan to other lawmakers and the White House as they try to craft compromise legislation on the issue (Wall Street Journal). While the group of ten senators did not reveal details of the plan in its statement, people familiar with the agreement said it called for $579 billion above expected future federal spending on infrastructure. The overall proposal would spend $974 billion over five years and $1.2 trillion if it continued over eight years, according to some of the people. The initial agreement comes days after President Biden called off a separate set of negotiations with Senate Republicans over an infrastructure plan, instead pivoting his focus to the talks among the group of five Republicans and five Democrats. A bipartisan deal without tax increases would be positive for equity markets. Bond markets could also benefit as reduced borrowings could take the pressure off increasing long-term rates.

CONCLUSION

Inflation data is reaching levels the US has not seen in a decade as the economy opens back up following the successful vaccination campaign. Job openings are also at a record high as the workforce figures out the most appropriate way to get back to work. The market is taking inflation as a positive sign of recovered activity with the Federal Reserve showing early indications of being ahead of the curve to contain long-run inflation. Pallas Capital will continue to monitor macroeconomic, political, and company news for impacts on the markets.

Sincerely,

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Pallas Capital Advisors