

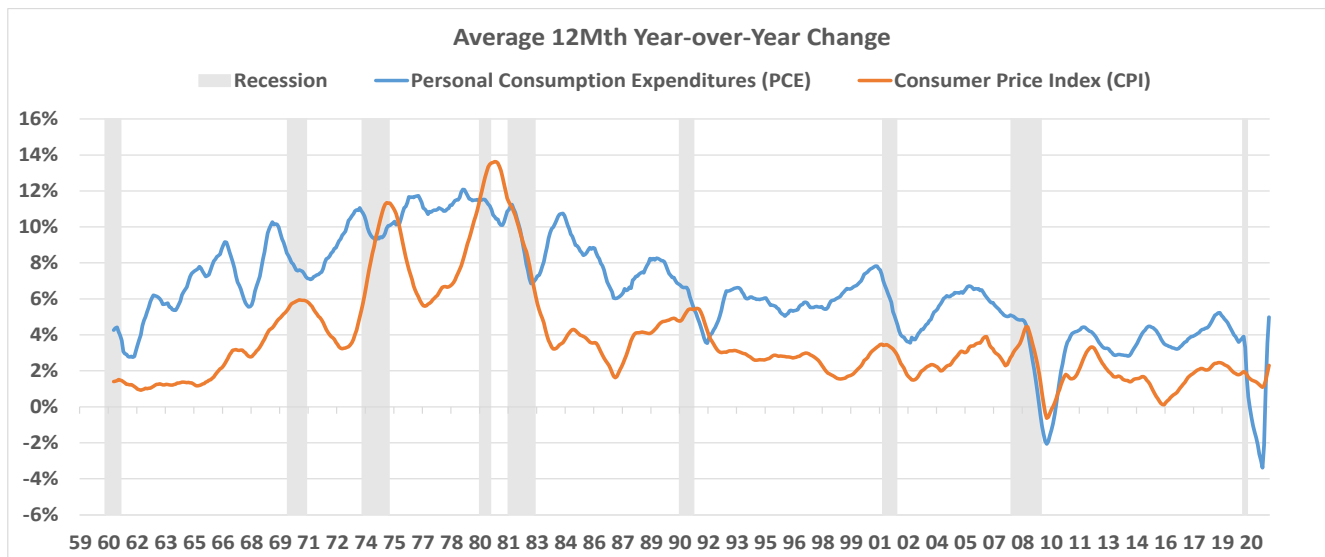
Inflation: Past Present & Future

August, 2021

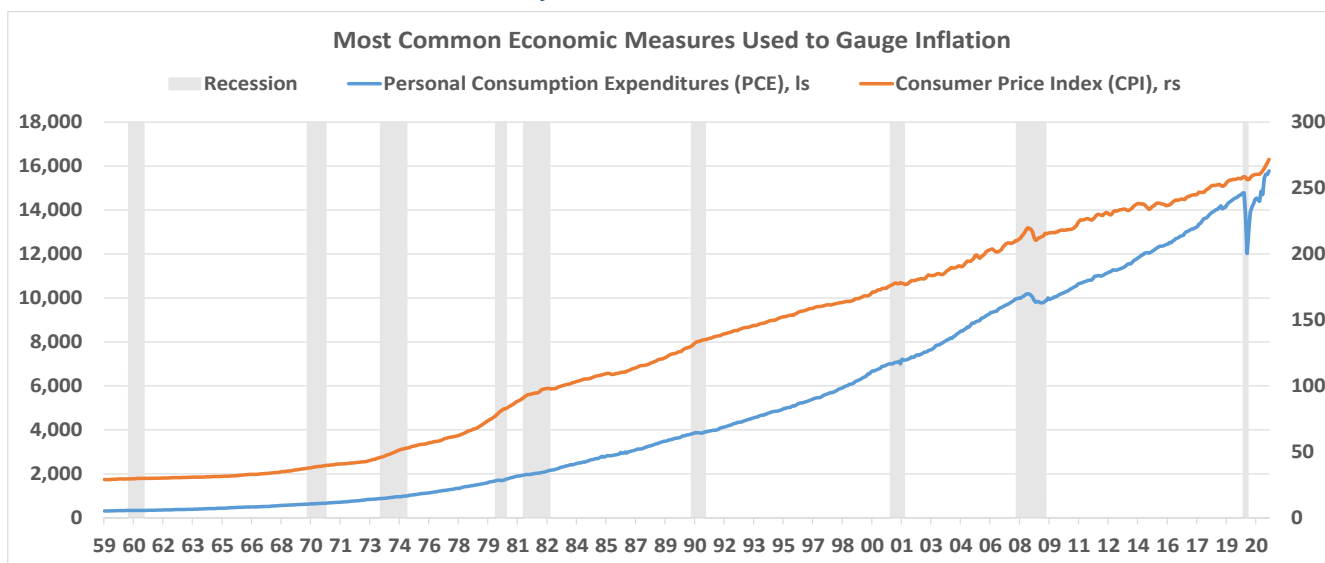


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Below we chart the Consumer Price Index (CPI) and Personal Consumption Expenditure (PCE) Component of Gross Domestic Product (GDP) dating back to 1959 (grey shaded areas indicate recession). The following chart represents the year over year change in these two data sets and are the most common used measures to gauge the level of price changes in the economy (or inflation/deflation).

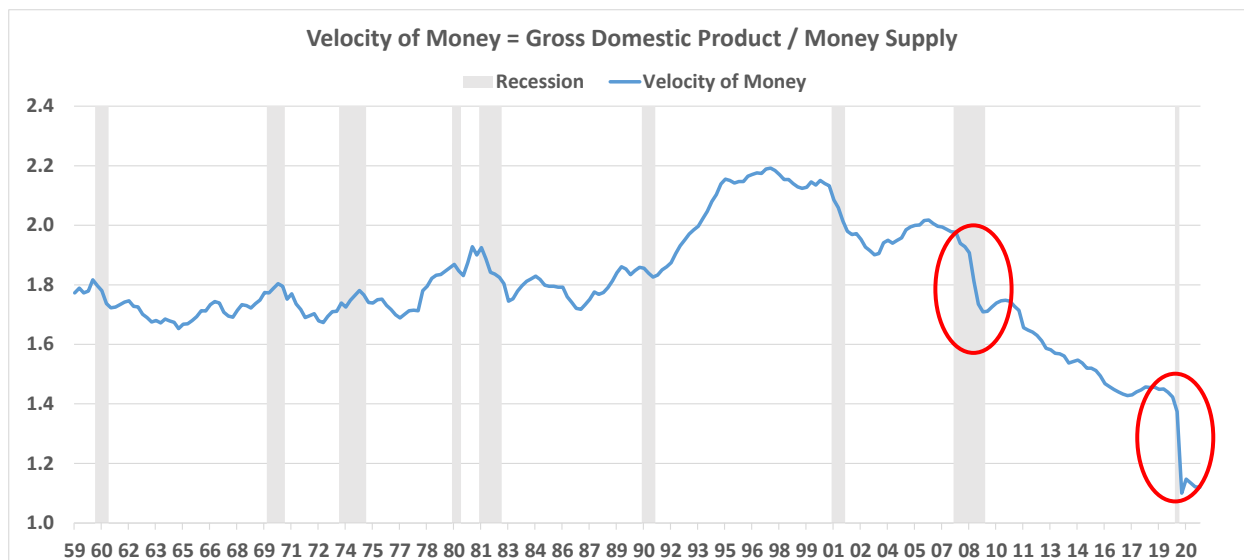


Source: [U.S. Bureau of Labor Statistics](#); As of June 30th, 2021



Source: [U.S. Bureau of Labor Statistics](#); As of June 30th, 2021

The velocity of money is another metric that can help to determine inflationary or deflationary pressures. This simple equation is the ratio of the United States' GDP over the amount money circulating in the economy. The ratio has been on a steady decline since 2001. Measures taken by the Federal Reserve to offset recessionary pressures has increased the supply of money at a faster pace than the growth in GDP. This is most evident in the severe drop coming out of the 2008 credit crisis and 2020 COVID pandemic.



Source: Federal Reserve Bank of St. Louis; As of June 30th, 2021

We break down the past five decades into three stages starting with the 1970s which is the most well-known period of inflationary pressures. The first chart on the next page is the year-over-year change in CPI and PCE while the second is a chart of the 10 year rate.

The decade of the 1970s (#1) resembled more of a stagflationary environment (rising prices with falling GDP) as it started and ended with a recession. Nixon going off the gold standard, oil shocks, government deficits and rising wages due to social unrest all contributed to the inflationary pressures felt during that period. Interest rates rose dramatically as the Federal Reserve Chairman at that time, Paul Volcker, raised rates to stymie the effects of inflation. The rate increases worked, but it came at a cost of three recessions.

The second phase covered the early 80s to the late 90s (#2). This stage was characterized by two juggernaut themes: globalization and a technological revolution. Despite spurts of rising money supply to offset exogenous shocks and climbing government deficits, these two themes created overcapacity in the manufacturing sector and higher productivity in the services industry keeping a lid on inflationary pressures.

The final phase (#3) started with the tech bubble which perpetuated a cycle of lower rates that accelerated during the credit crisis as the Federal Reserve kept rates near zero and culminated with real rates (or inflation adjusted rates) going negative during the COVID pandemic.

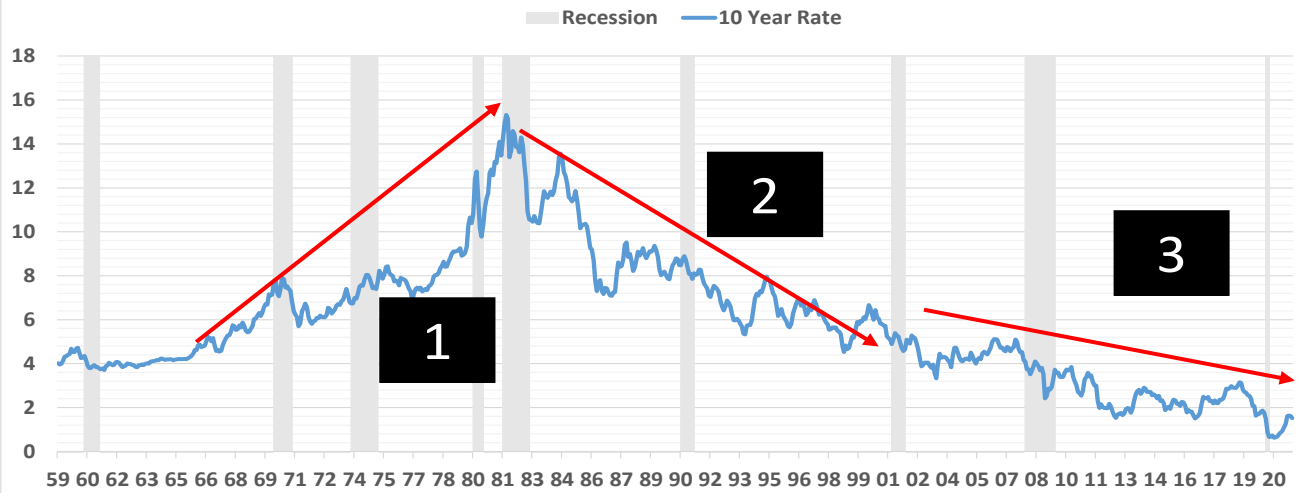
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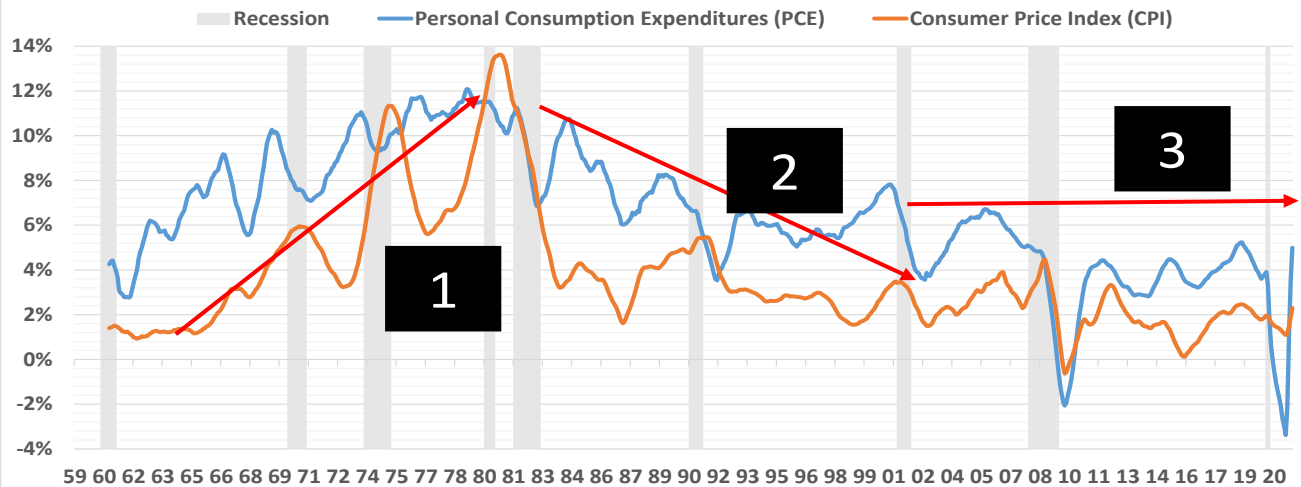
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The 10YR Peaked in the Early 80s and Started a Structural Decline Ending Close to Zero in 2020



Source: Federal Reserve Bank of St. Louis; As of June 30th, 2021

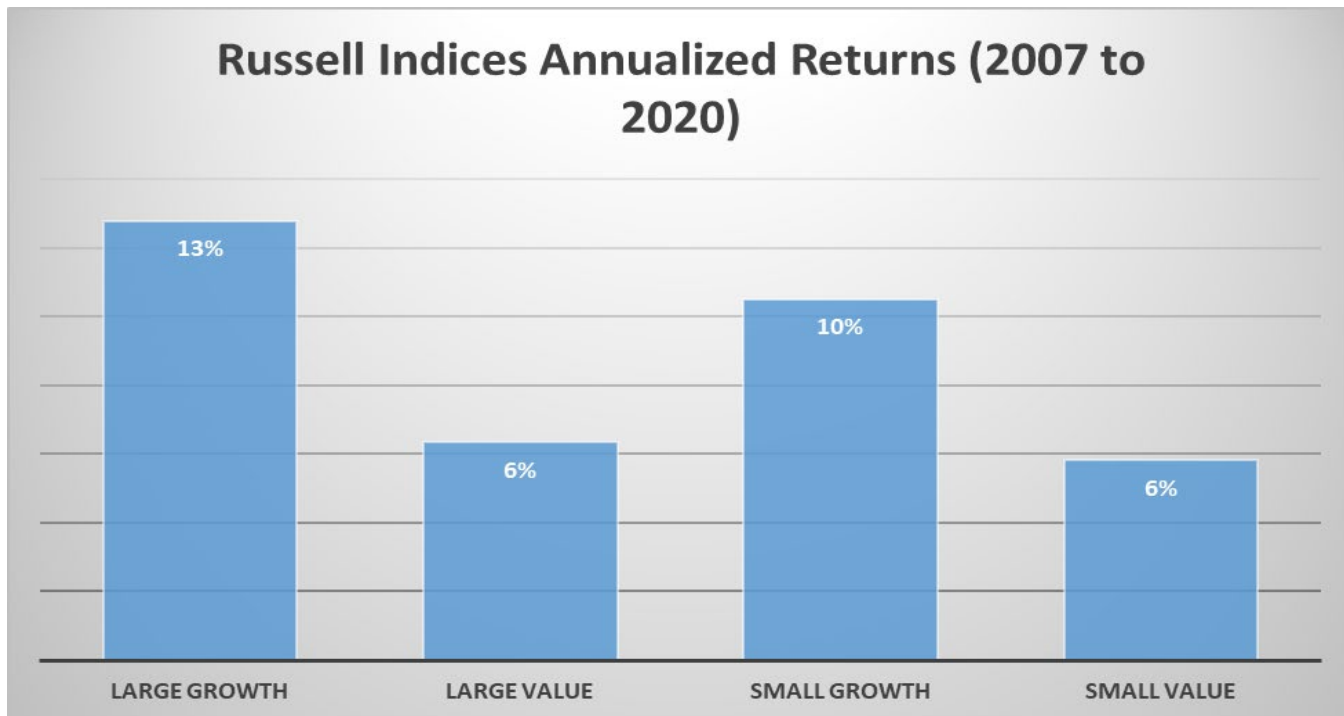
Average 12Mth Year-over-Year Change



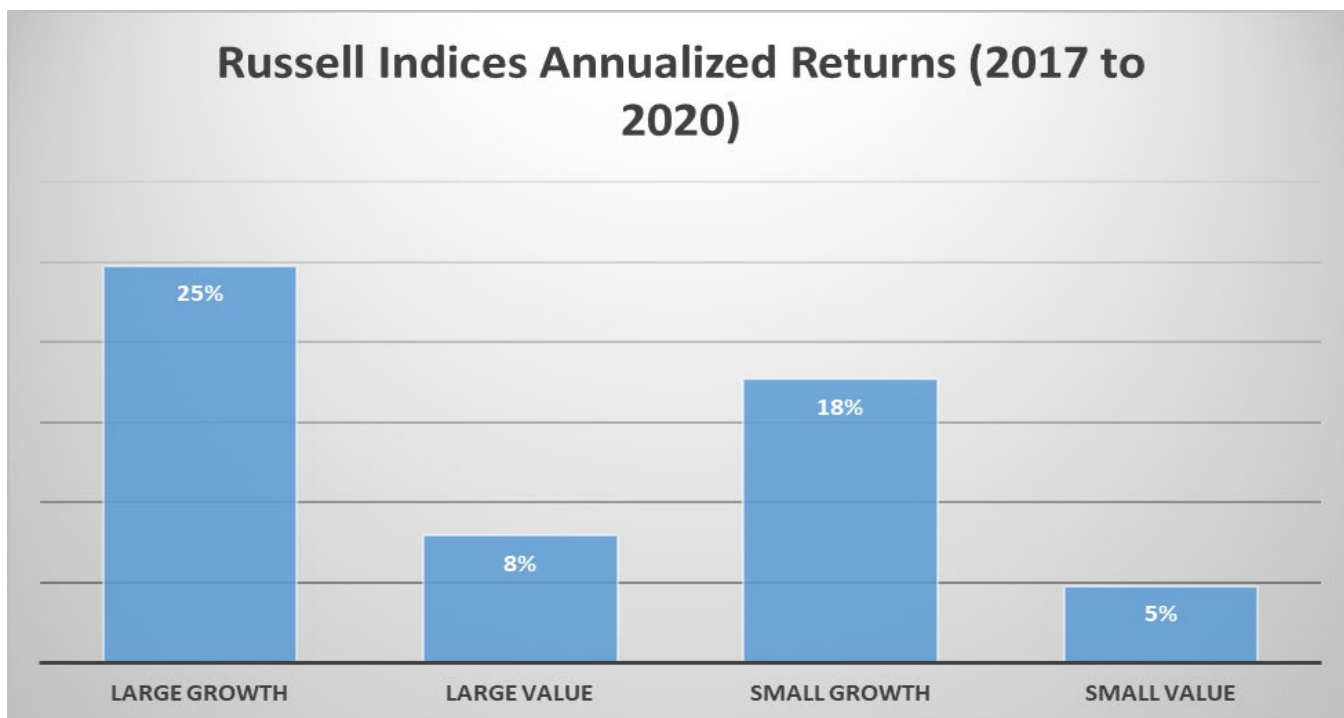
Source: Federal Reserve Bank of St. Louis; As of June 30th, 2021

The Federal Reserve has implemented a zero interest rate policy for a better part of the last 20 years, particularly since the credit crisis. From an investment standpoint, long duration assets (i.e. negative earners and new entrants) and compounders (i.e. accelerating profitability and earnings growth stocks) have performed the best in this environment. The laggards over this period were incumbent companies in low growth industries with profitable mature businesses that generated considerable cash flow but topline growth was capped. For simplistic purposes we tend to boil down this relationship by looking at growth vs value and large vs small.

As the chart below illustrates, large cap growth stocks were the best performing style and market capitalization since the end of 2006. This dynamic accelerated in the second half of the past decade as investors started to bid up valuations on several large cap and growth stocks (see following chart).



Source: [FTSE Russell Index](#); As of December 31st, 2020



Source: [FTSE Russell Index](#); As of December 31st, 2020

This shift in large outperforming small and growth outperforming value that has occurred since the credit crisis has ultimately unseated a multi-period relationship where each decade since the 1930s witnessed small and value outpace large and growth (see chart below). Begging the question: Is this the start of a new multi-decade trend or an aberration in the time series?

Decade	<u>Large Growth</u>	<u>Large Value</u>	<u>Small Value</u>
30s	2%	-2%	15%
40s	8%	18%	27%
50s	16%	22%	20%
60s	8%	12%	19%
70s	3%	13%	18%
80s	16%	21%	21%
90s	17%	16%	22%
00s	2%	7%	14%
10s	15%	11%	11%

Source: Copyright 2016 Kenneth R. French; As of December 31st, 2020

While it is too early to tell, we are seeing slight shifts in the current landscape that portend a potential change in the current inflation and interest rate environment. A near-term period of rising rates, inflation expectations and more widespread growth could lead to a period of time of value outperformance.



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