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INVESTMENT MANAGEMENT®

After the Deluge: Inflationary Impulses in a Post-Covid World

Though the policy response to the global financial crisis of 2008–09 was of a magnitude never before seen, concerns about the potential negative impacts of huge federal debt balances appeared to serve as a constraint on governments and central banks across the developed world, limiting the size of bailout packages, encouraging austerity measures and, in some estimations, undercutting the effectiveness of their efforts. Presented with another chance at crisis-solving with the outbreak of Covid-19, policymakers unleashed waves of monetary stimulus and fiscal support that already have dwarfed the accommodations of the 2010s—and appear to be far from complete.

With the initial market and macroeconomic disruptions of the Covid-19 pandemic now more than a year behind us, the rapid dissemination of vaccines has buoyed hopes for a return to something akin to normalcy in the near term. While pent-up consumer demand, a reopening economy, large base effects from last year's low inflation and large-scale fiscal spending seem like a can't-miss recipe for higher prices in 2021, a transitory burst of post-Covid inflation would represent little more than a bit of noise in the midst of 40 years of moderation. Of greater concern, if lesser probability, is that such a surge—amid a backdrop of massive indebtedness, significant and ongoing fiscal stimulus, and a Federal Reserve determined to drive inflation higher—may awaken long-dormant structural inflationary impulses and lead to a durable shift higher in the pricing environment.

Key Takeaways

- Massive fiscal and monetary intervention in the US along with the ongoing rollout of vaccines should allow the economy to fully recover from the dislocations of the pandemic and outperform earlier expectations. In contrast, most other economies, with the notable exception of China, seem likely to experience some degree of permanent scarring from Covid-19.
- Inflation is likely to accelerate. While the initial move higher may be merely the byproduct of base effects and price distortions that arise as the economy reopens, a more durable shift may emerge as a result of a large positive output gap and the uncertainties associated with the Fed's new flexible average inflation-targeting policy framework.
- We believe even more pernicious levels of inflation could result from a fiscal regime shift toward permanent accommodation combined with a Fed unwilling or unable to adjust policy to tame price increases. While such fiscal dominance does not seem likely given the Fed's independent status, very high government debt levels raise the risk of policy alignment.
- Regardless of the inflation environment that emerges following this extraordinary episode in economic history, First Eagle will remain focused on building all-weather portfolios that seek to mitigate risk and to help prevent the permanent impairment of capital.

Massive Fiscal and Monetary Stimulus Has the Economy Back on Track

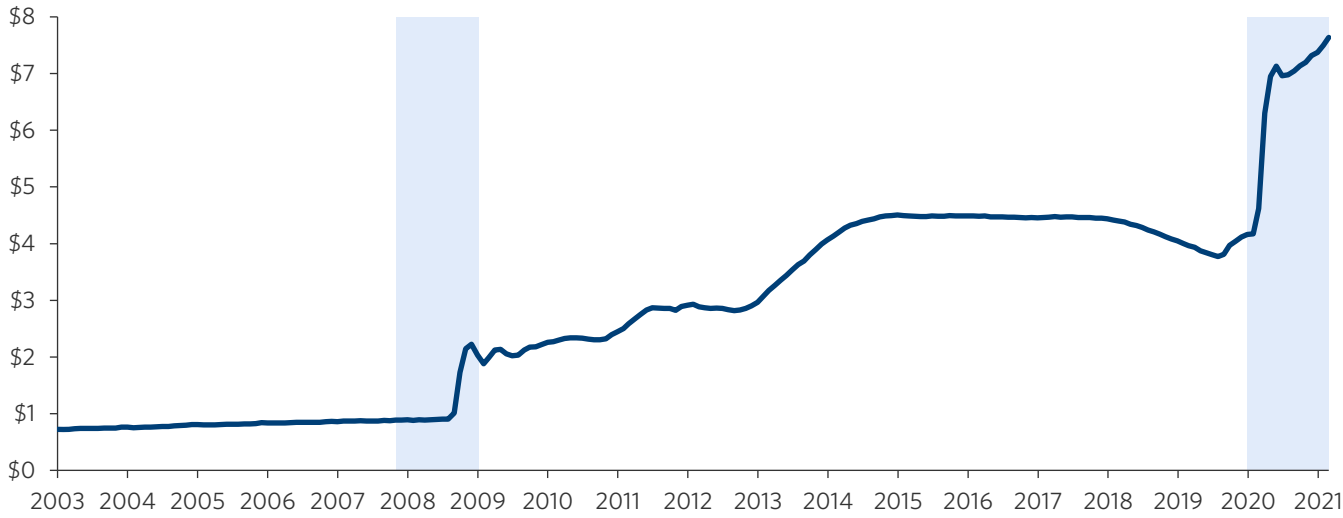
With policy rates already at or near their effective lower bound in most advanced economies, central banks looked to asset purchases and lending facilities to carry the load when the pandemic hit.

One takeaway from the post-financial crisis period is how quickly the extraordinary can become commonplace. While the United States, unlike many of its developed market peers, had embarked upon a slow road back from the ultra-low policy rates it introduced in the aftermath of the 2007–09 crisis, progress toward normalcy was minimal and typically met with stiff resistance from financial markets. The target federal funds rate, which had been pegged near zero from 2008 until the Fed began a cautious hiking cycle in 2015, peaked at only 2.5% in December 2018 before the central bank was forced to pause and ultimately reverse course. Similarly, the unwind of the central bank's balance sheet, which began in late 2017, had trimmed only about 15% from its $4.5 trillion balance sheet before the bond runoff was discontinued, leaving it several multiples above its pre-crisis levels.[1]

The policy measures that seemed so novel in the 2010s established a new baseline for crisis response and helped ensure that central banks worldwide were prepared to respond to a global pandemic whose economic impact was likely to be rapid and forceful. With policy rates already at or near their effective lower bound in most advanced economies, central banks looked to asset purchases and lending facilities to carry the load when the pandemic hit. The Fed, for example, rolled out all the facilities it implemented to fight the global financial crisis—including very large-scale purchases of Treasuries and mortgage-backed securities—as well as new programs to support the corporate and municipal bond markets, small and medium-sized enterprises and nonprofit organizations. By the end of March 2021, the Fed balance sheet stood at a record $7.6 trillion, as shown in Exhibit 1.

Exhibit 1. Already-Large Fed Balance Sheet Ballooned in Response to Pandemic

Total Assets of the Federal Reserve (Less Eliminations from Consolidations) in Trillions of Dollars, January 2003 through March 2021



Source: Federal Reserve; data as of April 5, 2021.

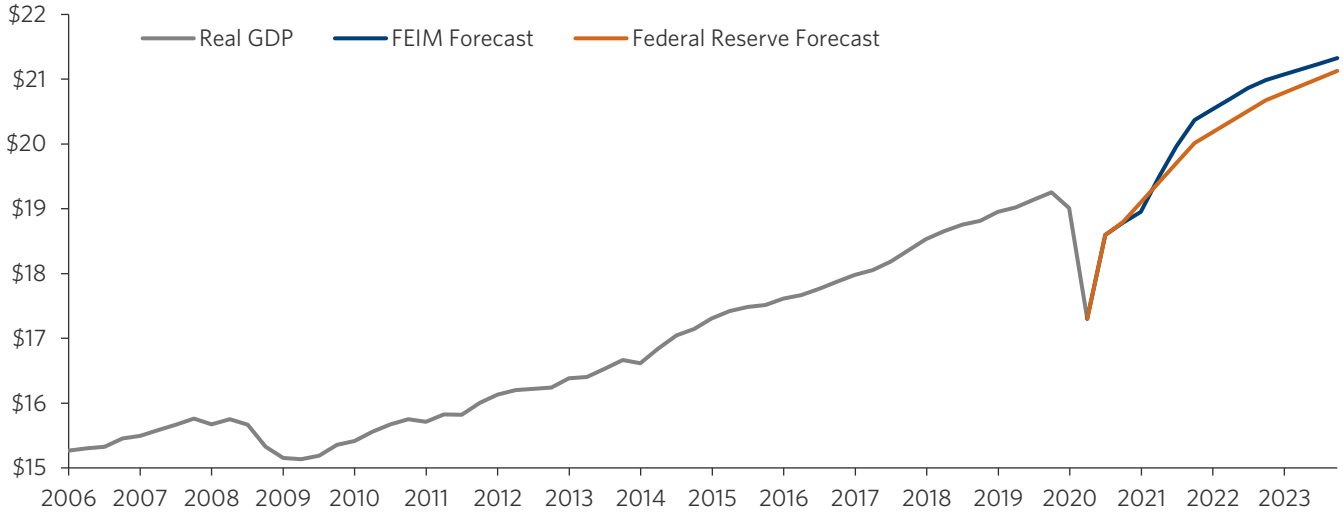
The good news is that these measures appear to have had their desired effects. The Fed's interest rate cuts, quantitative easing and deployment of various facilities to restore market functioning soothed jittery investors and enabled risk assets to mount an astonishing comeback from their initial selloff in February and March 2020. Meanwhile, the swift development and so-far successful rollout of vaccines combined with the introduction of multiple fiscal spending packages have significantly brightened economic outlooks for 2021. The March edition of the Fed's forecast called for 2021 US GDP growth of 6.5% (up from its December 2020 estimate of 4.2%) and

1. Source: Federal Reserve; data as of April 5, 2021.

a year-end unemployment rate of 4.5% (compared to its previous 5.0% assumption). These positive developments make it likely that the US will avoid a permanent loss of output from the lockdown, as had been widely feared during the pandemic's initial disruptions. As depicted in Exhibit 2, real GDP is on track to exceed its pre-Covid growth rate as soon as this year. The faster-than-expected rebound in the US as well as a strong recovery in China also has bolstered expectations for global growth; the Organization for Economic Cooperation and Development, for example, updated its 2021 forecast for global economic output to 5.5%, up 1% from its December projection, due in part to the improved outlook for the US and the many beneficial spillovers that should accompany it. That said, the unequal nature of the recovery suggests permanent output loss is likely for the global economy, as shown in Exhibit 3, with emerging markets and developing economies bearing the brunt.

Exhibit 2. The US Looks Set to Avoid a Permanent Loss of Output from Covid-19...

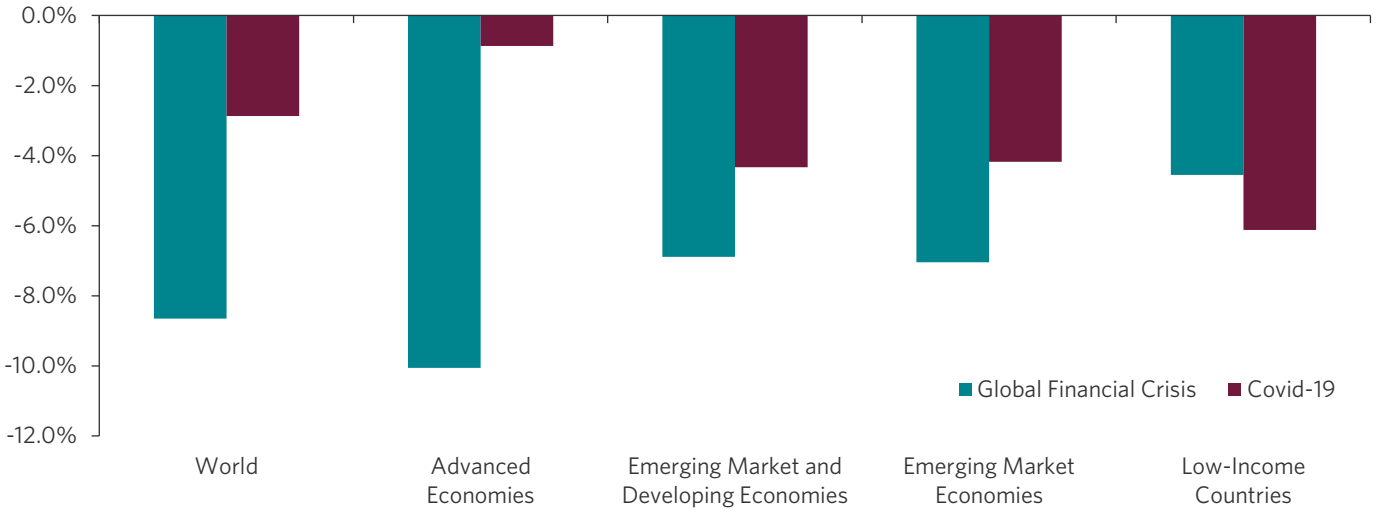
US Real GDP in Trillions of Dollars, Seasonally Adjusted Annual Rate; January 2006 through December 2023



Source: Bureau of Economic Analysis, First Eagle Investment Management; data as of April 12, 2021.

Exhibit 3. ...But Unequal Rates of Recovery Will Dent Global Growth

Percent Difference from Pre-Crisis Forecast



Note: Bars show the percent difference in real GDP four years after each crisis (the current forecast for 2024 in the case of Covid-19) relative to the anticipated real GDP for the same period prior to the crisis.
Source: International Monetary Fund staff estimates; data as of April 5, 2021.

Near-Term Inflation Expected to Move Higher

While an environment of resurgent demand and still-lagging supply would seem ripe for an inflationary impulse, realized inflation metrics remain underwhelming. Consumer prices have rebounded from their mid-2020 lows, but core personal consumption expenditures (PCE) growth in the US, as shown in Exhibit 4, stood at only 1.8% in its March print and other inflation metrics demonstrate a similarly muted pattern. That is not to say that consumers haven't felt a pinch in certain staples. For example, food prices rose 3.4% in 2020, well above the 20-year average of 2.4%, while gas prices at the pump on April 26, 2021, were up more than 56% from a year prior, reflecting base effects from exceptionally low 2020 prices.[2]

The rebound in demand seems poised to widen as the economy continues to reopen. US consumers more than doubled their savings rate in 2020 compared to 2019, socking away an extra $1.6 trillion thanks to a combination of stimulus payments, the accessibility of remote work for high-income professionals and limited outlets for discretionary spending.[3] It's likely many Americans, when able, will be eager to spend some portion of this pile, especially on the services—travel, dining and entertainment, and other out-of-home experiences—that have been unavailable to them for so long. In contrast, the demand for goods has remained elevated since the initial Covid shock, and it is unlikely to further benefit from economic reopening and may actually decline.

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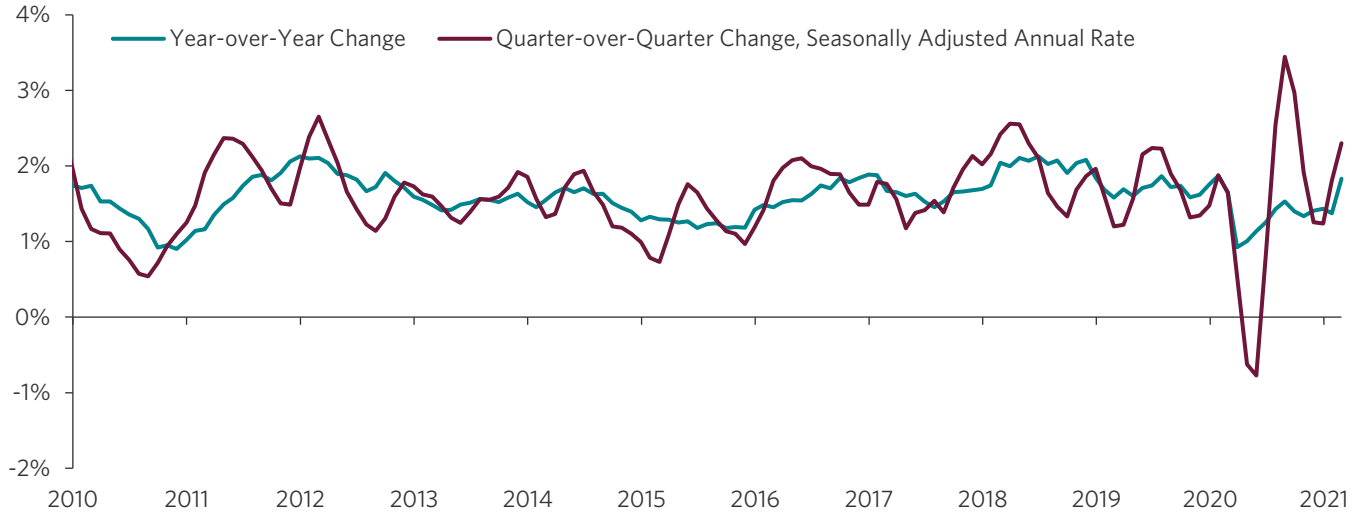
Producer prices have spiked over the past year, as manufacturers have been forced to deal with pandemic-related disruptions as well as a rash of more recent issues like shortages in petrochemicals and semiconductors, a week-long blockage of traffic through the Suez Canal, and a backup in cargo ships off the coast of southern California. The March ISM index of prices paid for raw materials by manufacturers remained near highs not seen since July 2008, with all 18 industries included in the survey seeing higher input costs; as depicted in Exhibit 5, higher producer prices historically have trickled down to consumers with a lag, though some could be absorbed through tighter margins. The services sector, where activity is expanding but at a slower rate than in manufacturing, also has seen costs push to multiyear highs.[4]

Exhibit 4. Though Measures of Inflation Remain Subdued...

Core PCE Price Index, January 2010 through March 2021

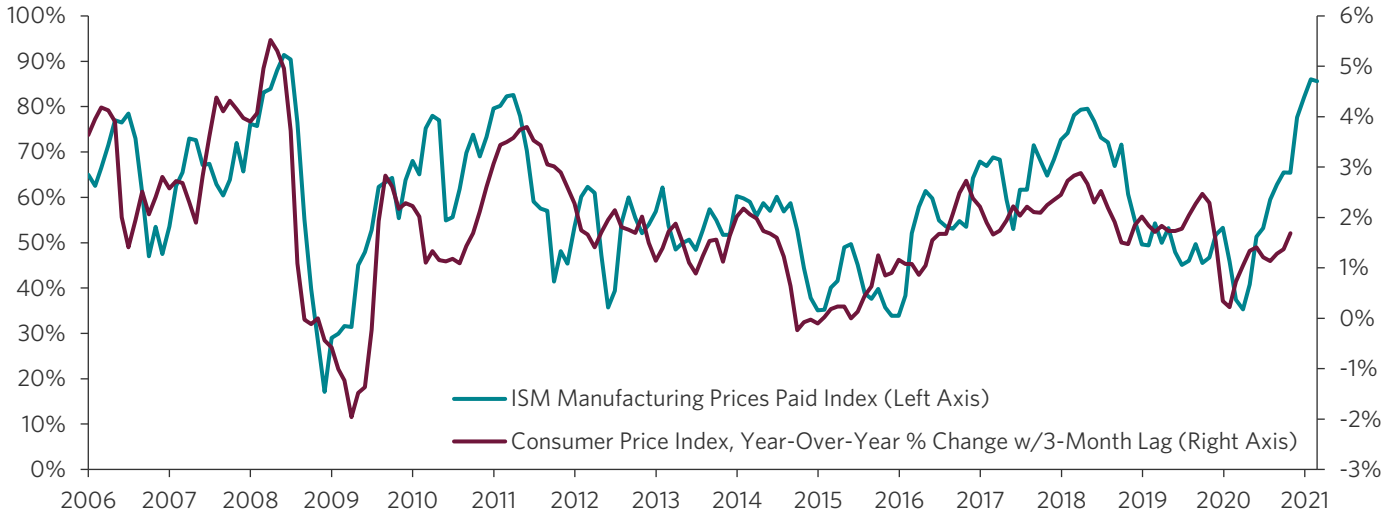


Source: Bureau of Labor Statistics, Haver Analytics, First Eagle Investment Management; data as of April 12, 2021.

2. Source: US Department of Agriculture, Energy Information Agency; data as of March 19, 2021.
3. Source: Bureau of Economic Analysis; data as of March 19, 2021.
4. Source: Institute for Supply Management; data as of April 2, 2021.

Exhibit 5. ...Higher Producer Prices May Soon Translate into Higher Consumer Prices

January 2005 through March 2021



Source: Institute for Supply Management, Bureau of Labor Statistics, First Eagle Investment Management; data as of April 12, 2021.

Acknowledging these emerging supply/demand imbalances, the Fed increased its 2021 year-over-year PCE inflation growth forecast to 2.4%, compared to its previous estimate of 1.8%. However, inflation forecasts of 2.0% for 2022 and 2.1% for 2023, respectively, suggest the central bank expects this year's inflationary pressures to be transitory and mild. The dot-plot of Fed officials' policy rate expectations point to a near-zero fed funds rate through at least the end of 2023, reflecting the central bank's shift to a flexible average-inflation targeting policy framework, which we discuss in more detail later.

A Very Abridged History of US Inflation and Monetary Policy Since the Early 1900s

The Fed's sanguine view on inflation shouldn't come as a total surprise. We haven't had meaningful levels of inflation in nearly 40 years, and developed market central banks worldwide have struggled to produce even target-level price increases since the global financial crisis despite massive stimulus programs and mounting debt piles. That said, inflation dynamics in the US have evolved over time, reflecting myriad changes in the drivers of the economy and in the execution of monetary and fiscal policy.

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For the first half of the 20th century, meaningful inflation in the US was mostly a wartime phenomenon, as shown in Exhibit 6. World Wars I and II, in particular, were economic boons for the US. The American entry into these wars marked a formal shift to a wartime economy and unleashed massive waves of federal spending. Once the wars were over, pent-up consumer demand met a world in which supply remained constrained, ushering in periods of significant growth in the US economy and price levels.[5] The Fed—established through the Federal Reserve Act of 1913—was challenged in its ability to respond to these inflationary pressures before they got out of hand. Philosophical tensions among the individual regional reserve banks and an ineffective decision-making structure left the central bank ill-equipped to react effectively in times of crisis, a shortcoming that played to tragic affect in the Great Depression.[6] Further, though nominally independent, the central bank had yet to achieve true autonomy from the executive and legislative branches of the government, which at times meant that monetary policy was driven primarily by fiscal goals.

5. Hugh Rockoff, "Until It's Over, Over There: The US Economy in World War I," NBER Working Paper Series (2004).
6. Stephen Slivinski, "The Evolution of Fed Independence," *Region Focus*, Federal Reserve Bank of Richmond (Fall 2009).

Exhibit 6. US Price Levels Were Volatile Through Much of the 20th Century

Average Annual Percent Change in Consumer Price Index, 1914 through 2020; Index, 1982-84 = 100

Source: Bureau of Labor Statistics; data as of March 30, 2021.

During World War I, for example, the Fed loaned money to its member banks at a discounted rate to encourage their purchase of "Liberty Loan" bonds issued by the Treasury. During World War II, the Fed formally committed to maintaining a low interest rate peg on longer-term Treasury bonds through open-market purchases as necessary to suppress yields, effectively ceding control of its balance sheet and the country's monetary base in the process. Its reluctance to maintain this peg in the face of mounting post-WWII/pre-Korean War inflation pressures ultimately resulted in the Treasury-Federal Reserve Accord of February 1951 in which the two bodies agreed to work toward the common purpose of financing the government's spending needs while seeking "at the same time, to minimize monetization of the public debt." Thus, was the concept of a truly independent central bank born.[7]

Having fallen behind the curve in the mid-1960s, policymakers proved unable to contain the inflationary pressures they had unleashed, resulting in a structural shift higher in inflation that persisted through the early 1980s.

The monetary policy that followed in the 1950s and early 1960s embraced a countercyclical approach that prioritized economic stability and predictable Fed behavior in an effort to establish the central bank's credibility and anchor inflation expectations in the market. However, a new economic policy paradigm emerged under the Kennedy and Johnson administrations in the 1960s predicated on the belief that careful management of aggregate demand through proactive fiscal and monetary policy adjustments could minimize unemployment and generate strong economic growth in exchange for a manageable level of inflation. While this approach saw success for a time, the assumptions upon which the model was built were challenged by a variety of emerging factors, including rising federal spending commitments (to finance Johnson's Great Society programs and a costly war in Vietnam), oil and food price shocks, artificial inflation suppression through price controls, and the collapse of the Bretton Woods system of exchange rates.

Having fallen behind the curve, policymakers proved unable to contain the inflationary pressures they had unleashed, which resulted in a structural shift higher in inflation that persisted across five US presidents and four Fed chairs before being brought to heel in the early 1980s. Inflation hit three unique peaks during the Great Inflation—in 1971, 1975 and 1981—a period that featured not only high inflation but also high unemployment, sluggish economic growth and deteriorating productivity (aka, stagflation).[8] An extreme tightening of the monetary supply under Fed chair Paul Volcker, who raised the federal funds rate to as high as 20%, ultimately broke the back of inflation; inflation peaked

7. Stephen Slivinski, "The Evolution of Fed Independence," *Region Focus*, Federal Reserve Bank of Richmond (Fall 2009).
8. Source: Federal Reserve Bank of St. Louis; data as of April 30, 2021.

near 15% in early 1980 before falling below 3% by 1983.[9] While Volcker's disinflationary policy resulted in a double-dip recession in the early 1980s, the large and protracted output loss that some economists had feared was avoided.

The Great Inflation gave way to the Great Moderation, a period of relatively consistent output and inflation levels that persisted until the global financial crisis in 2008–09. Though not without its difficulties—including Black Monday, the dot-com bubble, 9/11, various external debt and financial crises—the Great Moderation delivered what at the time was the country's longest economic expansion alongside mild inflation.

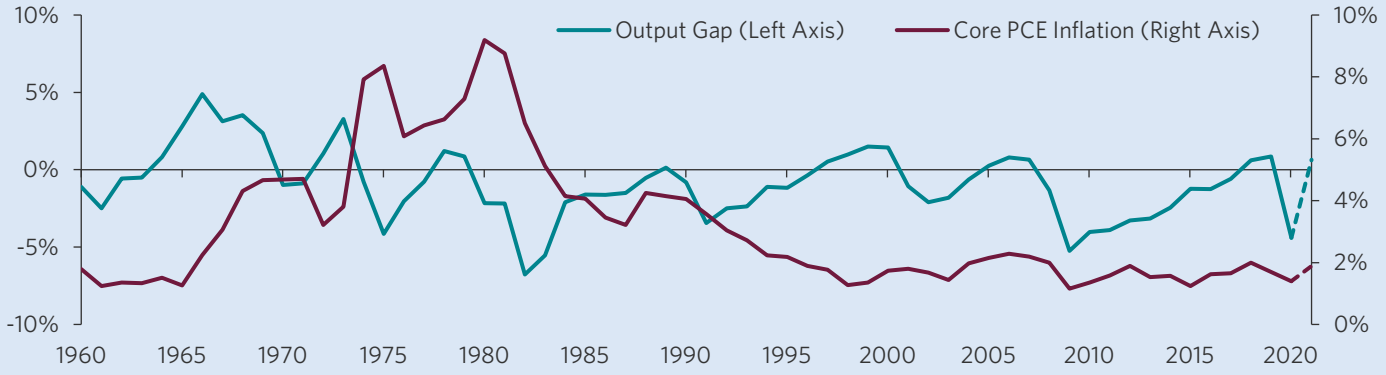
The Output Gap and the Phillips Curve

Many economists, including those at the Fed, view output gap estimates as useful tools when considering the potential for future inflationary pressures. The output gap reflects the difference between an economy's real GDP and what it is capable of sustainably producing when operating at full capacity given its current factors of production (the quantity and quality of capital, technology and worker knowledge). That is to say, it is the difference between an economy's actual output and its potential output. From a theoretical perspective, potential output reflects a neutral, efficient economic state in which supply and demand are in balance and thus there is no pressure on prices to rise or to fall.

Actual and potential economic output rarely align perfectly, however, and the resulting output gaps tend to oscillate over time in relation to the business cycle. A positive output gap occurs when the economy is strong and demand is high, as production exceeds its sustainable capacity in order to meet it; in contrast, a negative output gap occurs when the economy is weak and low demand leaves capacity idled. Basic economic theory dictates that a positive output gap—an environment in which demand exceeds supply—would bias prices higher, as it did throughout the 20th century (see Exhibit 7).

Exhibit 7. Large Output Gaps in the 1960s and 1970s Led to Spikes in Inflation

1960 through 2021



Note: Dashed lines reflect forecasts.
Source: Congressional Budget Office, Bureau of Economic Analysis, Haver Analytics, First Eagle Investment Management; data as of April 1, 2021.

While positive output gaps have emerged toward the end of the last three business cycles—at the peak of the dot-com bubble in the late 1990s, as the excesses that spawned the global financial crisis accumulated in the mid-2000s, and right before the outbreak of Covid-19 dealt a massive blow to demand in 2020—these were quite small compared to those observed in the past. At the same time, the Phillips curve, which describes the inverse relationship between employment and inflation, appears to have "flattened" according to both academic research and empirical observation, implying that inflation now is less sensitive to resource slack.

9. Source: Federal Reserve Bank of St. Louis; data as of April 30, 2021.

A flatter Phillips curve may be seen as a positive development in certain environments, as it lowers the perceived inflationary risk associated with a positive output gap. However, a flat curve also denies policymakers real-time market feedback, exacerbating the potential for price instability and increasing the likelihood of undesirable outcomes. Further, it's unclear whether the weakened relationship between inflation and unemployment reflects an enduring shift in the dynamic of these two variables or is simply an indication that the Phillips curve is nonlinear in the current environment. That is to say, instead of depicting a symmetrical, gradual tradeoff between inflation and unemployment suggested by a regression line, the curve currently may more closely resemble a hockey stick in which heretofore unresponsive inflation suddenly becomes extremely responsive once unemployment tightens to a certain level. Regardless, we only need to look back to the 1970s to see what can happen when the inflationary impact of stimulative policy is underestimated.

In Search of a Structural Inflationary Impulse

With that historical background, it may be useful to consider circumstances that could potentially nudge inflation from its current low orbit and foment persistently higher price conditions.

Monetary Regime Change

Inflation expectations historically have been self-fulfilling, as private sector actors embed these expectations into their behaviors. Indeed, the Fed attributes much of the price stability evident since the mid-'80s to the anchoring of longer-term inflation expectations it achieved through better inflation targeting and expectation management, as illustrated in Exhibit 8. The central bank appeared to have emerged from the misstep-plagued Great Inflation period with a renewed commitment to its role as "the chaperone who has ordered the punch bowl removed just when the party was really warming up,"[10] acting decisively in response to signs of inflationary pressure over the years and reestablishing its credibility in the process. In addition, the Fed has become considerably more transparent in the conduct of its business. It began formally announcing its policy decisions in 1994, for example, and in 2000 started to issue carefully worded forward guidance, initially on risks to its economic outlook but eventually expanded to include policy inclinations. In 2012, a formal inflation target of 2% was adopted.[11]

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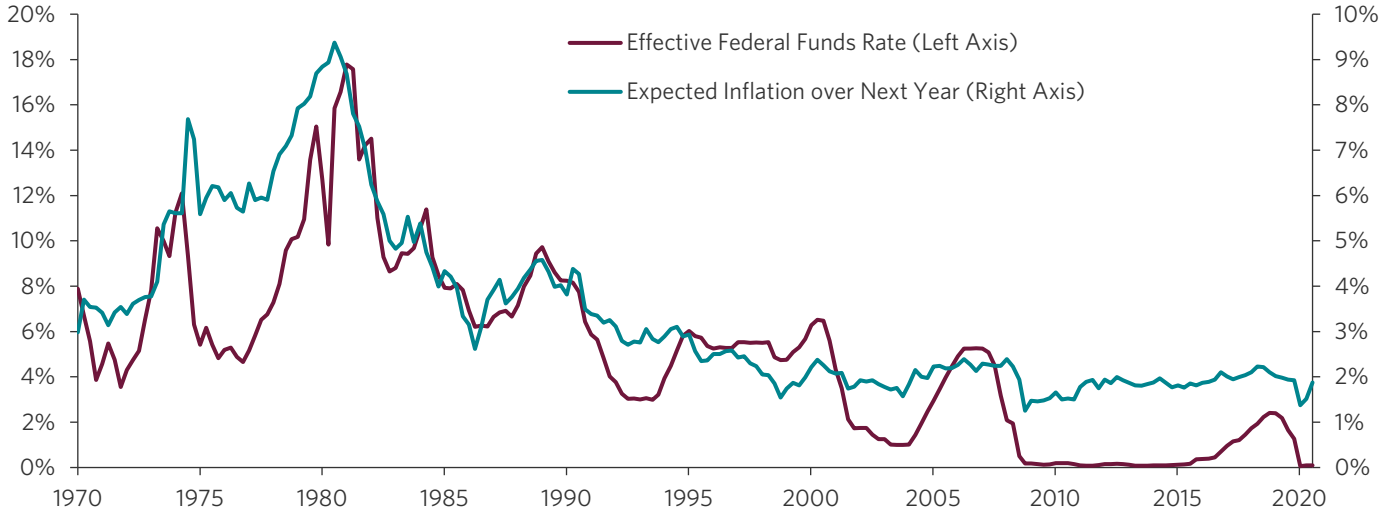
Exhibit 8. A Responsive Fed Has Helped Anchor Inflation Expectations

1970 through 2020



Source: Federal Reserve Bank of St. Louis, Federal Reserve Bank of Philadelphia; data as of March 24, 2021.

10. William McChesney Martin, Jr., "Address before the New York Group of Investment Bankers Association of America," Federal Reserve (October 1955).
11. Source: Federal Reserve; as of January 2012.

While anchoring inflation expectations at a low level has played a significant role in curbing inflation since the early 1980s, it also has made it difficult for the Fed to drive inflation higher in the years following the global financial crisis despite an extended period of monetary stimulus. Persistently low realized inflation was among the reasons the Fed cited for its August 2020 shift to an average inflation-targeting framework, alongside a decline in the estimated natural rate of unemployment (or, more generally, the degree of resource slack), a decline in the natural interest rate and the resulting limited "policy cushion," and the complications of a flatter Phillips curve.[12]

The Fed's shift to an average inflation-targeting framework represents a substantial change in central bank orthodoxy and introduces a new element of uncertainty to forecasting.

Its intention to target an inflation rate that averages 2% over time represents a substantial change in Fed orthodoxy; to maintain the credibility of its expectations anchor, the Fed since the 1980s has rarely tolerated inflation above its 2% target and has acted to cool the economy if rates even approached that level. Now, however, it will actively seek to generate inflation somewhat above 2% to offset the sub-2% levels that have prevailed since the global financial crisis. While the Fed, to preserve its flexibility, has not specified the timeframe it would allow the economy to run hot, the fact that core PCE has averaged 1.6% since 2010 suggests there may exist meaningful room.[13] It's reasonable that a period of above-target inflation may reset expectations at moderately higher levels—or, in a worst-case scenario, potentially unmoor them.

The Fed's new framework also introduces a new element of uncertainty to forecasting. The Covid-19 recession has been unique in that its trajectory was fairly visible. Though the duration was uncertain at the time, the shuttering of the economy in 2020 would obviously serve as a massive shock to demand and result in a significant negative output gap. Ample fiscal stimulus combined with mass re-openings as the vaccine rollout continues should drive a very sharp rebound in demand, erasing the output gap in 2021 and turning it very positive in 2022. Base effects point to inflation levels moving sharply higher in the near term as a result. However, because of the limited signal provided by the flat Phillips curve and the uncertainty around the degree of Fed tolerance for above-target inflation, the longer-term outlook is cloudy. That said, both policymakers and markets appear unconcerned that inflation will spike.

Rising Federal Debt and the Risk of Eroding Central Bank Independence

High and rising debt levels—particularly to fund noninvestment spending—are less than ideal for an economy. High debt typically leads to higher borrowing and debt-servicing costs, weighing on productivity and economic output and potentially undermining sovereign creditworthiness. The exact opposite has been the case since the global financial crisis, however, as low interest rates have tempered debt-service costs even as the amount owed continued to accumulate. In response to the pandemic, the US federal government enacted large fiscal support packages; 2020 saw the federal deficit reach 15% of GDP and government debt held by the public hit 100% of GDP, the highest level since World War II.[14]

Independence is essential to a central bank's claim on credibility.

An independent central bank is the cornerstone of modern economies, and independence is essential to a central bank's claim on credibility. As noted earlier, the Fed's independence from the executive branch of the government did not come easy; it wasn't until the Treasury-Fed Accord of 1951 that the central bank was able to draw a sharp line between its monetary policy decisions and the fiscal policy determined by Congress. Unlike politicians, whose subjectivity to election cycles tends to encourage short-termism, the Fed is structured specifically to promote a focus on long-term macroeconomic stability and a certain amount of philosophical continuity among its members. This intentionality is evident in both the composition and term structure of the Federal Open Market Committee (FOMC) as well as how the central bank funds its operations. Unlike other government agencies, the Fed does not rely on appropriations from Congress and is thus

12. David Altig, Jeff Fuhrer, Marc P. Giannoni and Thomas Laubach, "The Federal Reserve's Review of Its Monetary Policy Framework: A Roadmap," FEDS Notes (August 2020).
13. Source: Federal Reserve Board of St. Louis; data as of April 3, 2021.
14. "The Budget and Economic Outlook: 2021 to 2031," Congressional Budget Office (February 2021).

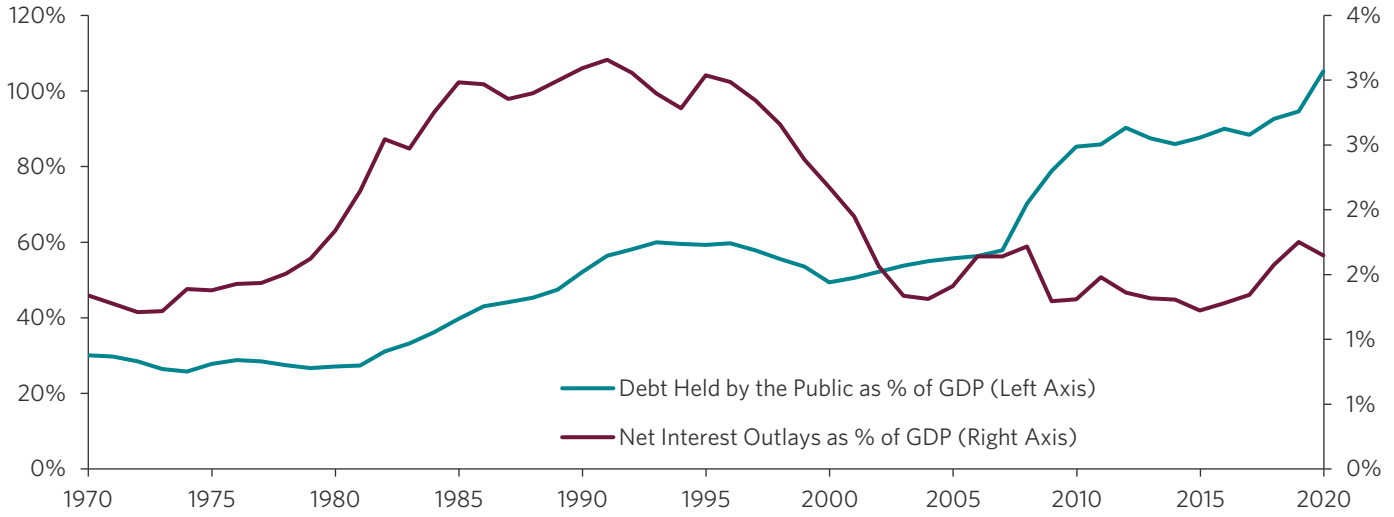
free from the influences that can sometime accompany such funding decisions. Instead, the Fed self-funds primarily through the interest on securities acquired via its open-market operations. This income typically far exceeds its expenses, and the remaining balance is relinquished to the Treasury, which uses it to reduce the federal debt.

These remittances are not insignificant. The Fed sent the Treasury an average of $75 billion annually from 2010 to 2017, up from $35 billion in 2007, as a result of the interest earned off its expanded securities portfolio.[15] This figure hit $82 billion in 2020 and is forecast to creep upward over the next several years as the central bank balance sheet grows and interest rates remain low; the Congressional Budget Office (CBO) expects remittances to peak at $134 billion in 2024 before steadily decreasing for the balance of the decade as higher interest rates cut into central bank profits.[16]

In addition to promoting higher income streams to the Treasury, very low interest rates have kept net interest outlays of the federal government manageable even as the debt ballooned. Despite the five-fold increase in government debt since 2000, historically low rates have pushed net interest expenses down to 1.6% of GDP, as shown in Exhibit 9. The CBO estimates that an annual 0.1% increase in the interest rates for newly issued Treasuries would push the Treasury's interest expenses higher by 25%—or $972 billion—between now and fiscal 2030.[17]

Exhibit 9. Very Low Interest Rates Have Kept Interest Outlays Manageable even as Debt Ballooned

1962 through 2020



Source: Congressional Budget Office; data as of March 2021.

It's not hard to see how the Treasury's ongoing need for low interest rates to support debt spending may inspire a potential challenge to the Fed's independence, as it has a number of times in the past.

In a political climate disinclined toward fiscal restraint, it's not hard to see how the Treasury's ongoing need for low interest rates may inspire a potential challenge to Fed independence, as it has a number of times in the past. Though independent from the other branches of government, the Fed remains accountable to Congress and by extension to the American electorate, and the resulting tension between long-term prudence and near-term outcomes has represented an ongoing complication for the Fed. Paul Volcker's hard stance against inflation during his time as Fed chair paid obvious dividends for the country over the long run, for example, but this achievement likely was small consolation to the citizens who bore the near-term economic costs of these policies and to the elected officials who lost their jobs as a result.

15. Marc Labonte, "The Federal Reserve's Response to COVID-19: Policy Issues," Congressional Research Service (February 2021).
16. "Additional Information About the Budget Outlook: 2021 to 2031," Congressional Budget Office (March 2021).
17. "The Budget and Economic Outlook: 2021 to 2031," Congressional Budget Office (February 2021).

While there are few who would argue that extraordinary Fed intervention was not needed to stem the economic impacts of the Covid-19 outbreak, the extension of these programs longer than necessary likely would provoke more nuanced debate. The issue of Fed support becomes even more thorny in the context of trends in income inequality that—while decades in the making—have been exacerbated by the uneven impacts of the Covid-dislocations and economic recovery. Lower-wage workers, often concentrated in the service sectors of the economy, suffered the greatest job losses during the early shutdowns of the pandemic and have been slower to recover; while employment among high-wage workers is above pre-pandemic levels, 14% of low-wage workers' jobs remain lost, [18] exemplifying the K-shaped nature of the economic recovery and, some would argue, of the US economy itself.[19]

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Will policymakers have the stomach to pull away the proverbial punchbowl when the time comes? Or will a regime shift toward permanently expansionary policies demand tight coordination between monetary and fiscal policy? While we think the Fed will remain true to its dual mandates above all else, history suggests the risk of competing influences should not be overlooked.

Potentially Abating Deflationary Forces

While the Fed's ability to win back the confidence of markets and economic participants has certainly played a large role in suppressing the wild swings in inflation and output characteristic of previous eras, the central bank has gotten an assist from a number of structural changes in the economy that appear to have had a significant deflationary impact—the rise of globalization and the evolution of technology chief among them. While there are signs that multinational organizations may be reconsidering their globalization strategies in a world in which its benefits have become less obvious, re-engineering these complex webs of interdependencies likely will take some time. Technology's impact, meanwhile, seems only to be gaining strength.

Globalization. The development of intricate global supply chains over the past several decades, fueled by the fall of the Soviet Union and the emergence of China, has been a boon both for manufacturers seeking production efficiencies and for consumers in search of low-cost goods. While the Covid-19 pandemic highlighted the vulnerability of these supply chains, many manufacturers—having grown sensitive to rising global trade tensions and other sources of potential disruption, from natural disasters to malicious actors—already had been reassessing the just-in-time nature of their operations.

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Covid-19 may have represented a once-in-a-century dislocation to global economic activity, but shocks that impact production have increased in frequency and severity. A recent study by McKinsey Global Institute found that a company can expect to lose the equivalent of 42% of a year's profits, on average, over the course of a decade due to garden-variety supply chain disruptions. The desire for more resilient value chains suggests 16–26% of global trade (worth $2.9–4.6 trillion) could change domiciles over the next five years through some combination of onshoring, nearshoring or relocating offshore sites.[20] Notably, the wage arbitrage that was once the primary driver of location decisions—particularly in labor-intensive goods and services—has both narrowed and given way to other concerns, like the high-quality human and physical capital readily accessible in certain markets, proximity to consumers and robust legal infrastructures that respect intellectual property, as well as opportunities for technological substitution. Countries able to deliver these features may find their borders stickier for existing multinationals and more attractive for those looking to relocate, independent of rising labor costs.

18. Jaison R. Abel and Richard Deitz, "Some Workers Have Been Hit Much Harder than Others by the Pandemic," *Liberty Street Economics*, Federal Reserve Bank of New York (February 9, 2021).
19. Janet Yellen, "Day One Message to Staff from Secretary of the United States Department of the Treasury Janet L. Yellen," U.S. Department of the Treasury (January 26, 2021).
20. "Risk, Resilience and Rebalancing in Global Value Chains," McKinsey Global Institute (August 2020).

As the geopolitical stage has grown increasingly fractured in recent years, national security interests also are factoring into supply chain decisions made in the private sector. We've seen this in pharmaceuticals, where the shortage of medicines and other healthcare supplies in the immediate outbreak of Covid brought to light the country's reliance on foreign suppliers for these critical items. We've also seen it in a variety of emerging technologies—ranging from 5G telecommunications and semiconductors to artificial intelligence and quantum computing—that have both civilian and military applications. China, for its part, has made no secret of its desire to unseat the US as the world's premier tech superpower and whatever line that may have existed between its public and private sectors has been blurred in pursuit of this goal. These sensitivities have inspired a general distrust along with pointed countermeasures.

Technology. While globalization's impact on inflation appears to have waned somewhat in recent years, technology's has likely accelerated. The plummeting cost of ever-more-powerful technology has impacted consumer prices both directly and indirectly. Digital devices, for example, have become increasingly affordable, in some cases crowding out demand for duplicative products that were de rigueur in the past; the functionality of a camera, watch and even a wallet can be—and increasingly are—replaced by universally carried smartphones. Meanwhile, the growth of and ease of access to ecommerce has improved price transparency and comparability, providing consumers greater optionality and challenging the pricing power of traditional retailers. This trend accelerated during Covid-19, as the necessity of online transactions in 2020 prompted a 30% spike in US ecommerce retail sales relative to 2019.[21]

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On the business side, technology has increased workforce productivity through automation in a range of applications, from industrial robots on the factory floor to self-serve checkouts at the grocery store to the radio-frequency ID tags that help with supply chain management. Technology can serve as both a complement to and substitute for human labor; both promote improved productivity and thus lower production costs, but the latter may also worsen income inequality.[22] While this would weigh on aggregate demand among the labor class, mass automation as a substitute for human effort may increase the drumbeats for some form of guaranteed income, a fiscal policy that would present another challenge to the Fed's independence discussed earlier.

With or Without Inflation, Investment Selectivity Remains Essential

So, what is the path forward? Inflation seems very likely to accelerate as 2021 goes on, potentially topping 3% due to base effects and a variety of one-off considerations. Looking farther ahead, a range of scenarios appear possible. In our view, the most likely is that the Fed is marginally successful in generating inflation consistently at or slightly above its 2% target; a level not insidious by any means but higher than what we have grown accustomed to in the post-financial crisis period. For materially higher levels of inflation to occur, we would need to see some sort of fiscal regime shift in which stimulus becomes omnipresent and disconnected from the demands of the business cycle, combined with signs the central bank is prepared to cede its independence in order to finance it. We don't believe the risks of this are high at this point, but they are not zero either, and the growing debt burden only increases the possibility that monetary policy may stray ever closer to fiscal engagement.

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Higher realized inflation, greater inflation volatility and tail risks around a fiscal regime shift suggest investors should demand more inflation compensation. Market dynamics, however, show this is not the case. As depicted in Exhibit 10, expected inflation over the next five years is slightly higher than that for the five years that follow, implying the market isn't currently pricing in a sustained period of meaningfully higher inflation.

21. Source: US Department of Commerce; data as of February 19, 2021.
22. "Digitalization and Inflation: A Review of the Literature," Bank of Canada Staff Analytical Note (2017).

Exhibit 10. Markets Do Not Expect High Inflation to Persist

January 2005 through March 2021

Source: Haver Analytics, Federal Reserve; data as of April 12, 2021.

As fundamental, bottom-up investors focused on client outcomes over the long term, our portfolio construction decisions aren't predicated on pinpoint macroeconomic forecasts. Rather, we seek to build all-weather portfolios that deliver real returns for our clients over time by demonstrating resilience during challenging periods.

While we accept the future as uncertain, we are comfortable stating that the low interest rates that have prevailed since the global financial crisis have had a significant influence on the relative performance of financial assets, most starkly as markets began to recover from the initial Covid selloff in early 2020. With discount rates very low, investors were comfortable paying increasingly high multiples for tech-related mega-cap names whose financials had been boosted by the Covid-driven migration online. The limited opportunity cost represented by low rates also encouraged investors to roll the dice on concept stocks, initial public offerings and special-purpose acquisition companies (SPACs) with little to no current earnings but business models that give the impression of high residual values in the future. In contrast, there was less interest in the more mature, physical components of the economy—such as commodities, manufacturing and real estate—that had been particularly challenged by Covid-related lockdowns.

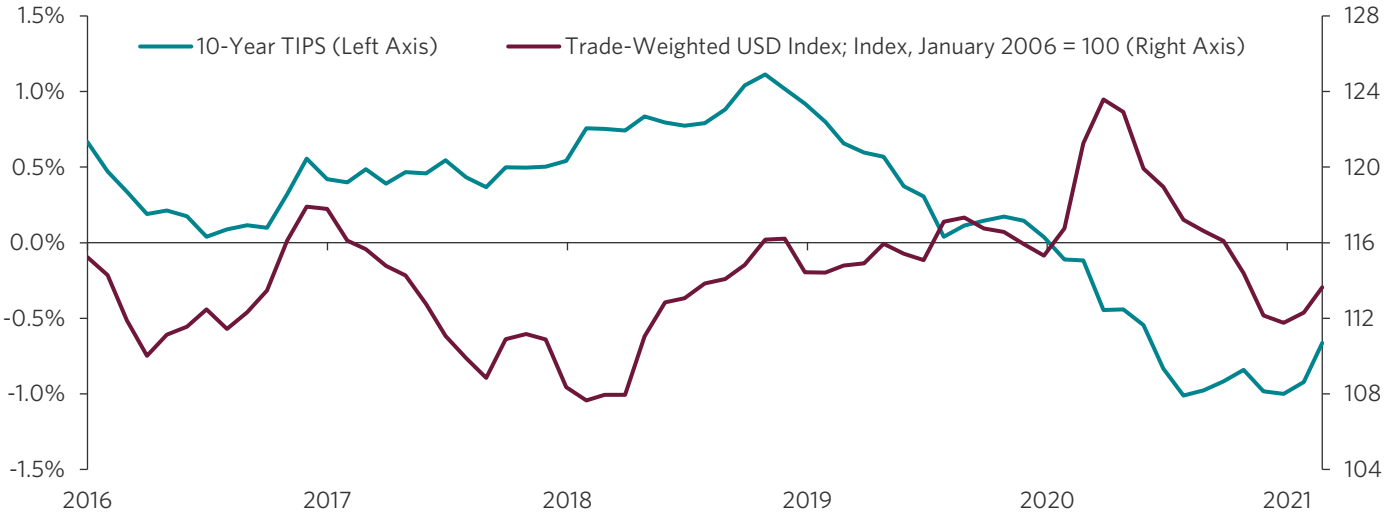
Optimism about an economic rebound grew as 2020 wore on, and global equities began to rotate into more cyclically sensitive areas of the market while fixed income investors priced in expectations of above-target inflation.

Optimism about an economic rebound grew as 2020 wore on, however, and global equities began to rotate into more cyclically sensitive areas. The bond market saw inflation expectations—as reflected by five- and 10-year breakeven inflation rates—approach and ultimately push past the Fed's target[23] while the Treasury curve steepened to its highest level since 2015. Dollar strength waned following its initial "flight to safety" rally in the spring, as shown in Exhibit 11, weighed down by low real interest rates in the US relative to other developed markets; the greenback has regained some strength year-to-date 2021, however, as real rates have climbed.

23. Breakeven inflation rates reflect the yield spread between nominal US Treasuries and same-maturity Treasury inflation-protected securities (TIPS), whose principal is tied to the consumer price index (CPI). Core PCE growth of 2.0%, the Fed's expressed inflation target over time, is equivalent to approximately 2.3% in CPI terms.

Exhibit 11. Low Real Interest Rates Have Weighed on the Dollar

January 2016 through March 2021



Source: Federal Reserve Bank of St. Louis; data as of March 30, 2021.

It's a common misconception that equity markets in general do well during periods of elevated inflation; performance in inflationary environments is more nuanced than often thought.

It's a common misconception that stocks in general do well during periods of elevated inflation. Stocks historically have reacted most positively to low, stable inflation. While certain companies may be able to bolster their cash flows in inflationary environments by passing along higher input prices to consumers, the benefit of these higher cash flows may be more than offset by the increased discount rates used in stock valuations—particularly for long-duration growth stocks. Further, the desire for real, inflation-adjusted returns further erodes investor performance when inflation is high.

This is not to say that equity holdings cannot do well in inflationary environments, but performance is more nuanced. For example, moderate rates of inflation—say, of 3–5%—have tended to favor cyclically sensitive sectors like materials, energy and industrials. Moderate inflation like this may reflect an expanding economy where supply is lagging burgeoning demand; such "demand-pull" inflation is a possibility later this year or into the next as the economy continues to normalize.

Inflation above 5% or so is where monetary debasement really starts to kick in. In such scenarios, we believe we are best served by owning consumer-linked businesses that have the ability to reprice their products on a regular basis: grocery stores, consumer goods and other retailers with quick inventory turnover. Certain types of real estate can be attractive in this environment, too, for a similar reason. Residential buildings are able to reset rents every year or two, while hotels can do so nightly; in contrast, commercial lease terms can run 10 years or more depending on the city. All else being equal, hotels and residential properties should, in our view, generally hold up better than office real estate in a high-inflation environment. Other types of businesses, like food service or infrastructure projects, may have explicit inflation escalators built into contracts with clients, which can help mitigate the impact of high inflation. Infrastructure can be tricky given government involvement in these projects, though.

Nominal bonds typically struggle in inflationary times. While buy-and-hold investors may continue to clip coupons and collect the bond's principal at maturity, the real return on these cash flows are worth less in the future given the erosion of purchasing power due to inflation; at current low interest rates, it wouldn't take much inflation to guarantee that a bond holding is a real-money loser. Meanwhile, the higher interest rates that tend to accompany inflation weigh on the prices of outstanding bond issues and compromise total returns. In contrast, inflation-linked government bonds offer investors some shelter from unexpected inflation via variable coupon payments, along

with a degree of deflation mitigation given that they are designed to pay no less than par value at maturity. These bonds are issued at lower interest rates than comparable nominal bonds, however.

Real assets are often looked to for support as prices rise, but their utility as a potential hedge is likely to vary by the magnitude of inflation and by specific type of commodity. Energy was a good hedge in the 1970s given the disruptions to its supply, for example, but its high beta to business activity can be a headwind should the uncertainty around inflation levels cause a decline in business investment. Many of our portfolios at First Eagle have a strategic allocation to gold as a long-duration potential hedge that we believe can provide portfolios with a source of resilience in a wide variety of adverse circumstances—including both inflationary and deflationary environments as well as equity bear markets—while also supporting real purchasing power across market cycles. Gold's reputation as a "safe haven" during challenging times has been driven in part by the relative stability of its supply, which has tended to grow at levels well below that of fiat currency and thus the nominal demand for gold. Gold mine production from 1900 to 2020 has compounded at a rate of less than 2% per year and was down 4% in 2020 from the year prior. M2 money supply, in contrast, expanded by about 24% in 2020.[24]

Whether or not inflation emerges, we believe selectivity will remain essential to investment success.

Whether or not inflation emerges, we believe selectivity will remain essential to investment success. Ultralow policy rates have distorted the cost of capital, allowing new entrants into established industries and enabling "zombie" companies to persist beyond their useful life. All the while, the pool of corporate profits contracted by nearly 6% in 2020.[25] We seek exposure to the companies—across industries and geographies—most likely to claim their share of these profits based on a track record of resilient cash flow generation, strong market positions and clear sightlines into their forward prospects.

Conclusion

The Fed's highly accommodative monetary policy in response to Covid-19 has buoyed financial markets, supported the economic recovery and enabled the Treasury to fund massive fiscal stimulus programs at very low interest rates—with little sign of ill effect thus far. As they say: "If it ain't broke, don't fix it." As we've seen throughout history, however, macroeconomic models work until they don't, and the cracks in the framework can result from a range of issues, from endogenous shocks and armed conflicts to poor decisions and evolutions in economic thought.

At First Eagle, we're fond of admitting that we don't have a crystal ball. We can't say for sure what the future will hold for inflation, but we can make informed investment decisions based on extensive fundamental research as we seek to build portfolios that deliver our clients acceptable outcomes across a variety of macroeconomic and market backdrops.

24. Source: World Gold Council, Federal Reserve; data as of April 15, 2021.
25. Source: Bureau of Economic Analysis; data as of March 29, 2021.

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Investment in gold and gold-related investments present certain risks, and returns on gold-related investments have traditionally been more volatile than investments in broader equity or debt markets.

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