Inflation: Keeping It Real

While the Delta variant of Covid-19 is a new cause for concern, the mostly reopened US economy has enabled large swaths of the country to enjoy more normal seasonal activities this summer—and caused inflation metrics to spike to levels not seen in decades.

Current inflation numbers likely come as little surprise given the heady cocktail of pent-up consumer demand, ongoing fiscal support and large base effects from 2020's depressed price levels. If transitory, as the Federal Reserve insists it will be, this episodic burst of post-Covid inflation would represent little more than a bit of noise amid 40 years of moderation. Of greater concern, if lesser probability, is that such a surge—amid a backdrop of massive public and private indebtedness, significant and ongoing fiscal stimulus, and a Fed determined to drive inflation higher—may awaken long-dormant structural impulses and lead to a durable shift higher in the pricing environment.

While inflationary conditions are not necessarily a death knell for stocks, changing dynamics may complicate the decision-making process for investors that seek to mitigate the ravages of rising prices over time by focusing on generating attractive real rates of return. With this in mind, First Eagle's Global Value team focuses on constructing all-weather portfolios that can perform in multiple environments, rather than relying on tactical shifts in response to inherently unpredictable metrics like inflation.

Key Takeaways

- Multiyear highs in a number of US inflation metrics as the economy reopens has some observers fretting over the possibility of a more durable shift higher in prices and what that may mean for equity portfolios.
- Though price levels in the US were quite volatile for much of the 20th century, inflation has remained subdued since the mid-1980s thanks in part to the Fed's success in keeping expectations anchored.
- Looking forward, we believe the Fed will be marginally successful in generating inflation consistently at or slightly above its 2% target, in keeping with its recently adopted average inflation-targeting policy framework. A structural shift to meaningfully higher prices is less likely, but not inconceivable if the Fed-financed stimulus tap remains open indefinitely.
- Rather than trying to discern among the range of inflation scenarios possible in the years ahead, First Eagle's Global Value team focuses on building all-weather portfolios composed of businesses we expect to be resilient across economic regimes.

A Strong Fed Anchor Has Kept Inflation Low for Decades

As shown in Exhibit 1, price levels in the US were quite volatile through much of the 20th century. This volatility came to a head in the 1970s and early 1980s as a confluence of factors—rising social spending commitments, oil and food price shocks and the collapse of the Bretton Woods system among them—left policymakers unable to contain the inflationary pressures they had unleashed. The decade-plus Great Inflation period featured not only rising price levels but also high unemployment, sluggish economic growth and deteriorating productivity (aka, stagflation), before an extreme tightening of the money supply ultimately brought inflation to heel by the mid-1980s. Pricing pressures have remained subdued in the Great Moderation that followed despite challenges ranging from the dot-com bubble to 9/11 to the global financial crisis.

Exhibit 1. Inflation Has Been Absent in Recent Decades

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.

It's reasonable to think 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 attributes much of the price stability evident in recent decades to its anchoring of longer-term inflation expectations through better inflation targeting and management of private-sector expectations. However, the Fed's anchoring success also has made it difficult to drive inflation higher when necessary, which was among the reasons cited for its August 2020 shift to an average inflation-targeting framework, a significant change in Fed orthodoxy.[1] 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-target levels that have prevailed since the global financial crisis. It's reasonable to think that a period of above-target inflation may reset expectations at moderately higher levels—or, in a worst-case scenario, potentially unmoor them.

1. 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).

Aggressive Policy Countermeasures Buoyed Markets and Economy, at Significant Cost

The Fed's response to the dislocations of Covid-19 was rapid and forceful. With policy rates already near their effective lower bound when the pandemic hit, the Fed rolled out all the facilities it implemented to fight the global financial crisis—including very large-scale asset purchases—as well as new, more-targeted programs. These initiatives appeared to soothe jittery investors and to enable risk assets to mount an astonishing comeback from their initial selloff in February and March 2020. The swift development and so-far successful rollout of vaccines combined with multiple fiscal spending packages have brightened the US economic outlook for 2021 after 2020's 3.5% GDP contraction. The June edition of the Fed's full-year 2021 GDP forecast called for growth of 7.0%, up from a 4.2% forecast six months prior; the economy grew at a 6.4% pace in first quarter 2021.[2]

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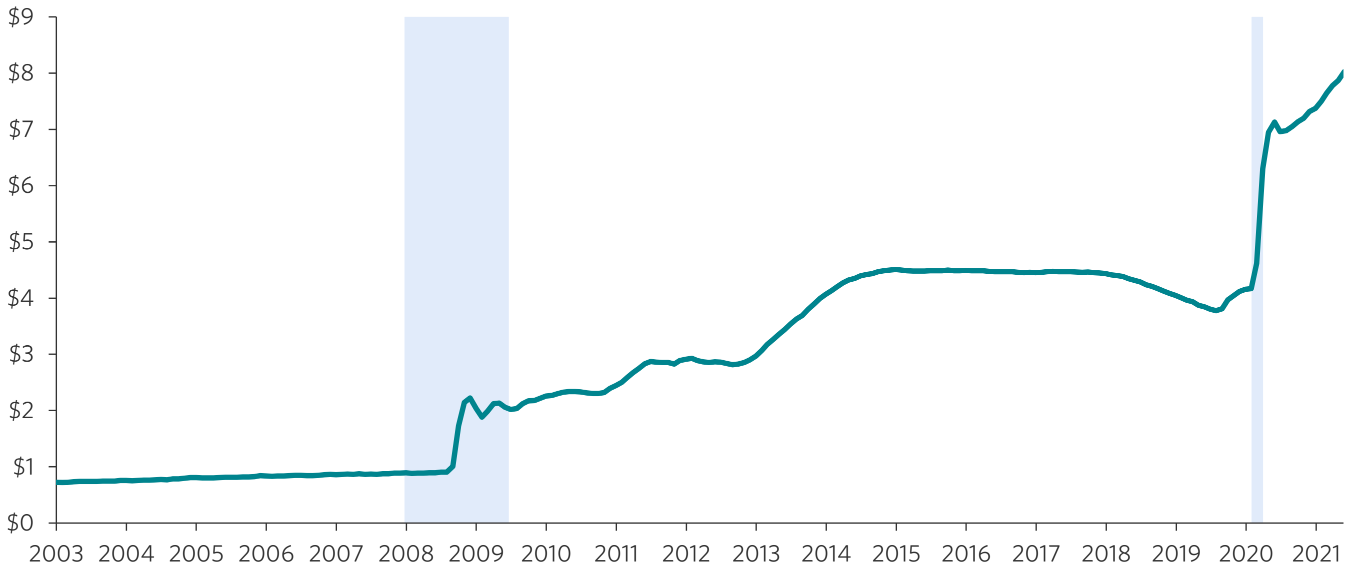
The cost of this recovery, however, was staggering. As shown in Exhibit 2, the Fed grew its balance sheet by about $3 trillion from March to May 2020 to reach $7.2 trillion; by the end of June 2021 it had eclipsed $8 trillion in size. The balance sheets of other major central banks depict a similar pattern.

Exhibit 2. Strong Response to Covid-19 Has Further Bloated the Fed's Balance Sheet

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



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

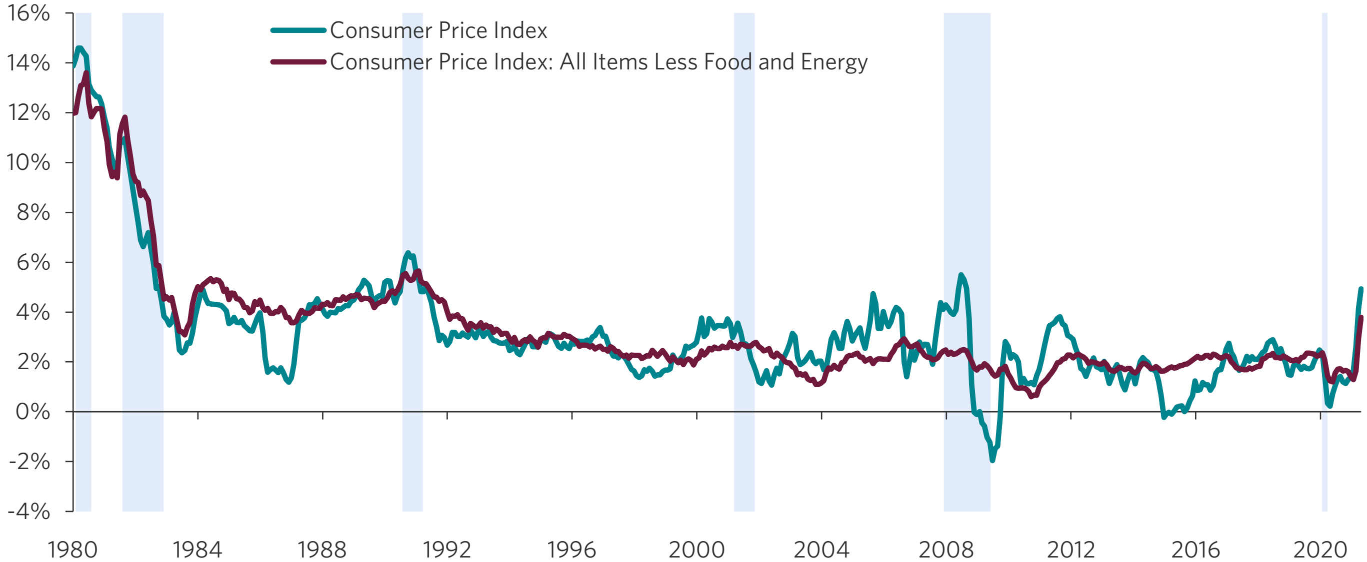
Will this rapid pace of money supply growth worldwide—which remains ongoing—have inflationary consequences, especially as economies reopen and pent-up consumer demand is unleashed? While it's highly likely that inflation will be elevated in the near term, the long-term trend is less certain.

2. Source: Federal Reserve; data as of June 16, 2021.

As expected, we've already seen a number of inflation metrics hit their highest levels in more than a decade. The headline consumer price index (CPI) increased 4.9% for the 12 months ended May, the largest increase since 2008; core CPI, which strips out food and energy prices, posted a jump of 3.8%, its biggest since 1992.[3] The personal consumption expenditures (PCE) price index—the Fed's preferred inflation metric—was directionally similar, if lesser in magnitude (see text box on page 5 for more information on inflation rates). Inflationary pressures seem likely to continue as the economic reopening stokes a rebound in US consumer demand and producers globally face rising input costs.

Exhibit 3. Is Inflation Breaking Out?

Percent Change from a Year Ago, January 1980 through May 2021



Source: Bureau of Labor Statistics, Federal Reserve Board of St. Louis; data as of July 1, 2021.

Though the introduction of two potential Fed rate hikes for 2023 struck some as a surprisingly hawkish pivot, we expect the central bank's decision-making to remain data-driven.

Acknowledging these emerging supply/demand distortions, the Fed's 2021 year-over-year PCE inflation growth forecast now stands at 3.4%, up from 2.4% earlier in the year and 2020's 1.2% print. However, forecasts of 2.1% for 2022 and 2.2% for 2023 suggest the central bank expects this year's inflationary pressures to be transitory and mild. The dot-plot of officials' expectations released after the June Federal Open Market Committee meeting points to a near-zero fed funds rate through at least the end of 2022. Though the introduction of two potential rate hikes in 2023 struck some as a surprisingly hawkish pivot, we expect the central bank's decision-making to remain data-driven, especially in light of the flexibility its average-inflation targeting policy provides.[4]

3. Source: Bloomberg; data as of July 1, 2021.
4. Source: Federal Reserve; data as of June 16, 2021.

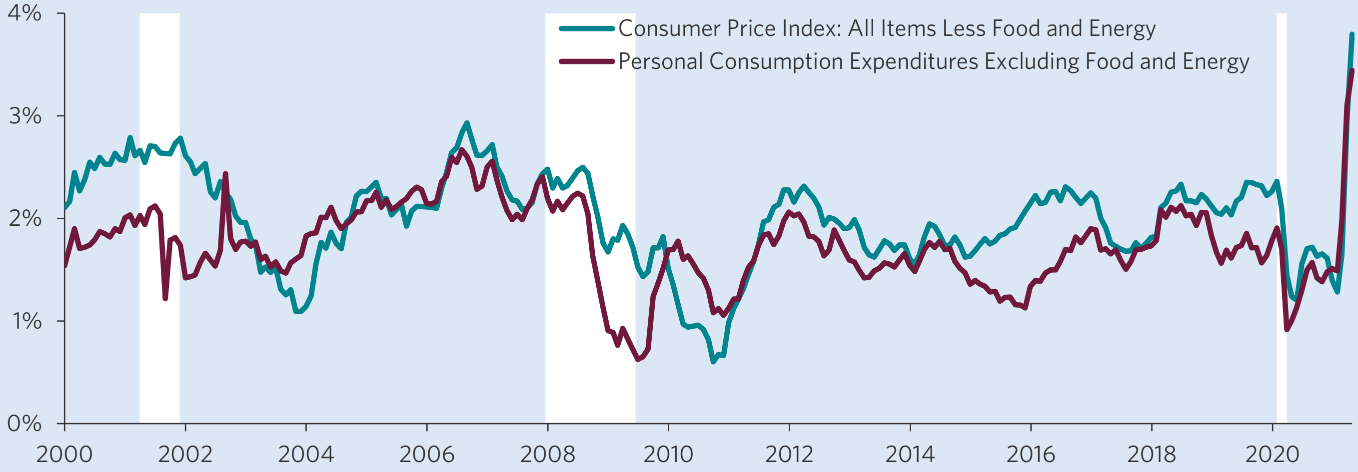
What We Talk About When We Talk About Inflation

CPI and PCE are the two most commonly used inflation gauges in the US. The former is likely more familiar to the average American, as it is often cited by the media when referencing inflation and underlies adjustments to social security payments and the pricing of financial contracts like Treasury inflation-protected securities (TIPS). PCE, however, has been the Fed's preferred metric of inflation since 2000, as the central bank believes it to be the more flexible and comprehensive measurement. Both indexes can be quoted in their "headline" or "core" forms; while the former includes all inputs, the latter strips out volatile food and energy costs. The Fed's 2% inflation target over time refers to core PCE.

Though these metrics tend to track one another directionally, their readings typically are not identical. As shown below, CPI generally tends to come in somewhat higher than PCE; the Fed's target PCE growth of 2.0% is roughly equivalent to 2.3% in CPI terms, due primarily to differences in methodology.

CPI Readings Tend to Be Higher than PCE

Percent Change from a Year Ago, January 2000 through May 2021



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Bank of St. Louis; data as of July 5, 2021.

Of course, an individual consumer's experience of price changes may diverge substantially from both indexes, and this anecdotal inflation perhaps has a larger influence on consumer behavior. For example, frequent drivers are probably not happy about paying 56% more for gas in May 2021 compared to a year ago, especially if they just paid 30% more for a used car or truck. While home cooks likely are relieved to see the increase in food-at-home prices ease after surging during the supply disruptions of mid-2020, restaurant diners may consider sharing a desert their next time out, as food-away-from-home prices climbed at their highest rate since 2009. Americans who delayed non-emergency medical care during the 2020 lockdowns would have seen their costs increase by only 0.9% over the past 12 months; however, given that medical-care prices have increased at an average annual rate of more than 5% since 1980, the highest among categories in the CPI basket, it may be wise to consume necessary health care sooner rather than later.

Source: Federal Reserve Bank of St. Louis, Federal Reserve Bank of Cleveland, Bureau of Labor Statistics; as of July 5, 2021.

A Focus on Resilient Companies with Scarce, Durable Assets

While inflation seems very likely to reach multiyear highs in 2021 due to base effects and a variety of one-off considerations, a number of scenarios appear possible beyond this year.

We think the Fed likely will be 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. For inflation to shift materially higher, we likely would need to see some sort of new fiscal regime in which the stimulus is the

Not all companies held in First Eagle Global Value team strategies will meet all the criteria discussed.

default policy stance and the central bank cedes its independence in order to finance it. We don't believe the risks of this are high currently, but they are not zero either.

Estimating the potential behavior of an asset across various inflation scenarios requires not only bottom-up judgment, but also the temperament to accept that neither the worst-case nor best-case may come to pass.

Given the range of potential outcomes, where can investors turn? Estimating the potential behavior of an asset across various inflation scenarios requires not only bottom-up judgment, but also the temperament to accept that neither the worst-case nor best-case may come to pass. This is why First Eagle's Global Value team seeks to build all-weather portfolios that we believe have the potential to deliver attractive real returns across a variety of economic regimes. We do this in part by selectively targeting companies we believe have the potential for persistent earnings by virtue of possessing a scarce, durable asset—a tangible or intangible factor that in our view provides it with a long-term operational advantage and is highly difficult for other businesses to replicate.

For tangible assets, we seek companies with physical resources that are well located relative to their competition—as manifest in the ability either to have consistently generated strong revenues or kept costs low—and that have a long natural duration. That is to say, assets we expect to earn a spread relative to the average asset in the same industry.

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Real estate values, for example, might rise alongside other prices in an inflationary environment, but high-grade properties in prime areas are likely to appreciate at a faster pace than average while also commanding higher rents. **Equity Residential**, as an example, controls nearly 80,000 apartment units in urban and suburban markets of key US gateway cities, providing the company with above-average rental incomes and higher free cash conversion.[5] And given the relatively short duration of residential rental leases—compared to leases on office space or industrial properties—companies like Equity Residential can quickly adjust their pricing in an inflationary environment.

Far from the population centers targeted by Equity Residential you'll find the potash mines of Saskatoon, Canada-based **Nutrien**. The world's largest producer of this key fertilizer and also a major player in nitrogen and phosphate, Nutrien maintains a network of high-quality, low-cost mines that allow for flexible growth optionality. It is also the world's largest agricultural retailer, with more than 2,000 stores and a robust online presence. Nutrien's integrated business model enables the company to leverage demand for fertilizer across the agricultural value chain.[6]

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Key to intangible assets is an advantaged market position, which often is related to a company's relative size in its industry. Dominant players in their space can be difficult to unseat, resulting in long duration in the form of customer loyalty, strong pricing power and steady cash flow.

Take **LVMH Group**, whose initialized name only hints at the breadth of its 75 luxury "houses" across fashion, liquor, jewelry and other sectors—including some of the world's most desired brands for which, in the eyes of its target audience, there is no substitute. The size and capital strength of LVMH enabled it to persevere through the challenges of Covid while also tackling the complexities and costs of building out a true omni-channel luxury retail platform, which we believe positions its well for the future.

While enterprise software may lack the cachet of LVMH's lineup of *maisons*, **Oracle's** scale and expertise has enabled it to maintain enviable customer renewal rates in excess of 90% and an annuity-like stream of recurring cash flows based on long-duration service contracts with its customer base of multinational blue chips.[7] This combined with its well-managed balance sheet has allowed Oracle to migrate its 40 years of database expertise to the cloud in keeping with shifting client needs.

We'd also note the potential opportunities that can be uncovered along the value chain between businesses and their end consumers; these include a variety of "middlemen"

5,6,7. Source: Company reports; data as of June 30, 2021.

that earn commissions or fees for providing services ranging from logistics to packaging to distribution. Inflationary environments may offer these intermediaries opportunities to capture a portion of rising transaction values in the industries they service without major increases to their own input and asset-carrying costs.

North America's largest freight broker, **C.H. Robinson** generally benefits when consumer demand for hard goods increases and drives the demand for vehicles to transport such goods from producers to retail outlets or end consumers. By linking businesses across industries to transportation providers—but not owning the trucks, train cars or airplanes that do the hauling—C.H. Robinson maintains an asset-light business model that can adapt quickly to changes in the pricing environment. In contrast, Germany's **Brenntag**—the global leader in the highly specialized function of chemicals distribution—maintains a more asset-intensive business model. With its broad footprint (670 locations in 78 countries) and diverse customer base (automotive, cosmetics, pharmaceutical and many others), however, we believe Brenntag is positioned to benefit from rising prices in a variety of industries and regions.[8]

Real Assets in Pursuit of Real Returns

Historically, investors often have turned to real assets in search of real returns during periods of higher inflation. This has included both physical assets as well as the stocks of businesses involved with their ownership or production, which can be found in such industries as base materials, chemicals, energy, infrastructure, real estate and utilities. Here, too, selectivity is essential.

For example, while energy was a good hedge in the 1970s given the massive disruptions to supply, its high beta to business activity could be a headwind in environments marked by declining business activity, particularly for operators with high costs per barrel. Timberland, another commodity play, also has served as an effective inflation hedge in the past and may now come with an additional source of demand as the market for carbon offsets develops. Real estate values may rise in alongside other prices in the economy; given the long-term nature of commercial leases, however, well-located residential real estate may be better positioned to benefit from a move higher in prices than office space.

First Eagle has a long history of digging through the real asset space for opportunities that meet our investment criteria. Perhaps most notably, many of our portfolios at First Eagle have a strategic allocation to gold—through bullion, miners and streaming/royalty companies—as a long-duration potential hedge that we believe can provide portfolios with a source of resilience in a wide variety of adverse circumstances while also supporting real purchasing power across market cycles.

Conclusion

Whether or not serious inflation is on the way, we believe selectivity will remain essential for investment success over the long term. First Eagle's Global Value team will continue to pursue all-weather portfolios, built from the ground up, that seek to deliver real returns for our clients over time by demonstrating resilience during challenging periods. We do this by selectively targeting companies that we believe possess a scarce, durable asset, either tangible or intangible. While these companies are not immune to the impact of inflationary pressures, their persistent free cash flow generation may provide a cushion in challenging environments while also creating opportunities to potentially enhance their competitive position against less-resilient rivals.

8. Source: Company reports; data as of June 30, 2021.

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