Inflation Expectations Update

The strong pickup in economic activity projected for this year should generate a temporary boost to inflation; but whether this becomes embedded into inflation expectations and produces a more sustained increase in underlying inflation is an open question.

Going forward, the unwinding of strong demand in some sectors and a sharp recovery in others could lead to new capacity constraints and higher prices in select sectors of the economy. Some analysts have noted that we could see some higher top-line inflation numbers in the spring because of temporary capacity constraints.

The semiconductor industry has recently reported exactly this issue. During Qualcomm's (QCOM) Q4-20 earnings conference call (2/3/21) management noted that demand is significantly outstripping supply. In fact, CEO Steve Mollenkopf stated that Q4 results would have been stronger if it weren't for supply constraints. A convergence of trends that emerged from the pandemic and the subsequent recovery has created a stampede of chip orders across multiple industries, particularly the automotive sector. The main takeaway is that business is strong for QCOM, but the company's results didn't quite stack up to the lofty expectations that investors held. Compounding the issue is that supply constraints are preventing the company from fully meeting the robust demand. Situations like this could result in a temporary uptick in the inflation rate.

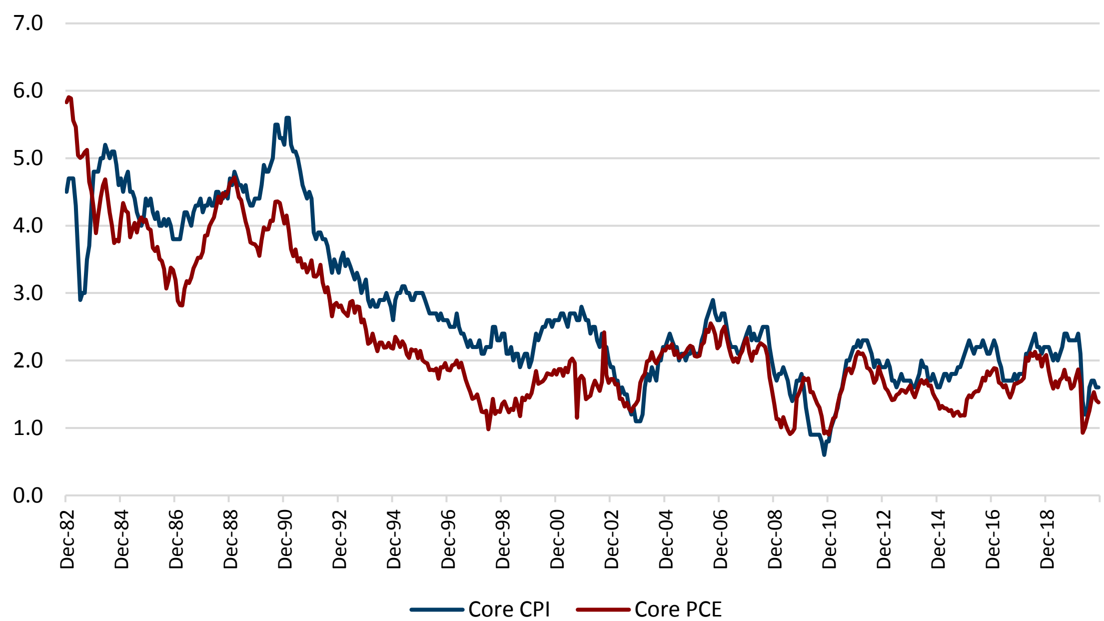
Moreover, analysts tend to look at average inflation over the past year, and there will likely be a visible increase in the average inflation rate as very low readings from last March and April roll off of the annual calculation. After these factors have run their course, expectations are for the inflation rate to normalize, ending the year in the range of 1.5% to 1.75%.

Additionally, Goldman Sachs has noted that the changing mix of policy support suggests an inflection point toward a more reflationary environment than seen since the financial crisis, which is likely to drive the bull market higher in coming months.

On Jan 13th, the Bureau of Labor Statistics released data for December 2020, showing that the total Consumer Price Index (CPI) increased 0.4% m/m (versus consensus 0.4%) while core CPI increased 0.1% m/m (versus consensus 0.1%). The uptick in total CPI was driven largely by an 8.4% increase in the gasoline index, which accounted for more than 60% of the overall increase. Total CPI increased 1.4% yr/yr, versus 1.2% in November, while core CPI held steady at 1.6% yr/yr for the third straight month.

Core CPI & Core PCE YoY % Chg - Long-term

Source: Bureau of Labor Statistics, Bureau of Economic Analysis



We believe that higher nominal growth expectations, steeper yield curves, higher commodity prices and higher operational leverage should support a renewed rotation of leadership relative to the previous cycle. This view supports our thesis of reducing our preference for growth securities in favor of value securities. For equities, best returns tend to be when inflation is below 1% but rising; conversely, equities don't typically perform well in periods of sharp, sudden changes in bond yields.

Federal Reserve Targets

Following are the median economic projections from the Federal Reserve governors and reserve bank presidents:

	2020	2021	2022	2023	Longer Run
Real GDP:					
Dec. 16, 2020	-2.40%	4.20%	3.20%	2.40%	1.80%
Sept. 16, 2020	-3.70%	4.00%	3.00%	2.50%	1.90%
BP Change	1.3	0.2	0.2	-0.1	-0.1
Unemployment Rate:					
Dec. 16, 2020	6.70%	5.00%	4.20%	3.70%	4.10%
Sept. 16, 2020	7.60%	5.50%	4.60%	4.00%	4.10%
BP Change	-0.9	-0.5	-0.4	-0.3	0
PCE Price Index:					
Dec. 16, 2020	1.20%	1.80%	1.90%	2.00%	2.00%
Sept. 16, 2020	1.20%	1.70%	1.80%	2.00%	2.00%
BP Change	0	0.1	0.1	0	0
Core PCE Central:					
Dec. 16, 2020	1.40%	1.80%	1.90%	2.00%	n/a
Sept. 16, 2020	1.50%	1.70%	1.80%	2.00%	n/a
BP Change	-0.1	0.1	0.1	0	n/a

Source: Bloomberg

Economist Expectations

The following table shows results of a Bloomberg survey of 40 economists conducted Jan. 15-20 ahead of the Jan. 26-27 Federal Reserve meeting.

1. When the FOMC next alters the pace of its asset purchases, it is most likely to:

Response Count: 40	No. Responses	Percentage
Increase the pace of monthly purchases	5	13%
Decrease the pace of monthly purchases	35	88%

2. In their Dec. 16 statement, the FOMC pledged to continue purchasing at least $120 billion a month in Treasuries and MBS "until substantial further progress has been made toward the committee's maximum employment and price stability goals." **When do you anticipate the FOMC will acknowledge substantial further progress and announce a tapering of asset purchases?**

Response Count: 40	No. Responses	Percentage
Q1 2021	0	0.00%
Q2 2021	1	2.50%
Q3 2021	3	7.50%
Q4 2021	11	27.50%
Q1 2022	14	35.00%
Q2 2022 or later	11	27.50%

3. Once the tapering of asset purchases begins, how long will that phase last?

Response Count: 40	No. Responses	Percentage
Up to 6 months	2	5%
7-12 months	19	48%
13-18 months	8	20%
19-24 months	7	18%
Longer than 2 years	4	10%

4. The Fed statement says: "asset purchases help foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses." **Has the Fed adequately described how asset purchases help it obtain its full employment and inflation goal?**

Response Count: 40	No. Responses	Percentage
Yes	28	70%
No	12	30%

5. When do you expect the FOMC to lift the target range for the federal funds rate off zero?

Response Count: 40	No. Responses	Percentage
2021	3	8%
2022	3	8%
2023	18	45%
2024 or later	16	40%

6. **How credible is it that the Fed will achieve its 2% inflation goal by the end of 2023**? Please rank with 10 being most credible and 1 being least credible

Response Count: 39
Median: 7
Mode: 8

	No. of responses	Percentage
1 - Least credible	**1**	**3%**
2	**0**	**0%**
3	**2**	**5%**
4	**3**	**8%**
5	**6**	**15%**
6	**2**	**5%**
7	**7**	**18%**
8	**10**	**26%**
9	**6**	**15%**
10 - Most credible	**2**	**5%**

7. Combining the December fiscal package and your expectations for additional stimulus, will that materially change (or has it already changed) your 2021 year-end forecasts? Please select all those affected:

Response Count: 36	No. Responses	Percentage
Inflation	18	50%
Unemployment	26	72%
GDP growth	35	97%
Fed funds rate	5	14%
Level of Fed asset purchases	8	22%

8. Can the Fed obtain its employment and inflation goals over the next three years, as it forecasts, without additional fiscal stimulus?

Response Count: 40	**No. Responses**	**Percentage**
Yes	17	43%
No	23	58%

9. The Covid relief package passed in December includes a provision that prohibits the Fed from launching an emergency credit facility that is "the same as" the Primary Corporate Credit Facility, the Secondary Corporate Credit Facility, the Municipal Liquidity Facility or the Main Street Lending Program without congressional approval. Does this represent a significant erosion of the Fed's emergency lending powers?

Response Count: 39	**No. responses**	**Percentage**
Yes	14	36%
No	25	64%

10. Do you believe President-elect Joe Biden is likely to offer Jerome Powell a second term as Fed chair beginning in 2022?

Response Count: 40	**No. responses**	**Percentage**
Yes	29	73%
No	11	28%

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