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Demystifying the link between stimulus and inflation

Key takeaways

- Despite concerns from Wall Street to Main Street over the potential for an excessive rise in inflation, we believe that investors are likely to see a more moderate and benign recovery of inflation in 2021 and beyond.
- Structural changes in the U.S. have contributed to decades-long disinflation; as inflation picks up with the economic recovery, these structural forces are slowing the turn toward higher inflation.

What it may mean for investors

- We see 2021 as a year of reflation, with stronger earnings growth and improving credit quality supporting our favorable view of economically sensitive stocks and higher-quality corporate bonds.

Concerns about rising consumer prices (inflation) have been an inevitable by-product of the months-long rise in equity prices (reflation). Households' near and longer-term inflation expectations have climbed to a 6-year high of well over 2%, reinforced by much the same outlook among investors. Inflation worries have resurfaced on Main Street and Wall Street — even as actual inflation remained at less than 1.5% through January.

Why the disconnect between expectations and reality? Which is a better guide to what lies ahead? The answer will likely be critical to shaping interest rates and financial-asset values in the months and years ahead. We believe the best way to frame the outlook is through responses to investor questions about inflation, which follow.

1.) Why has inflation stayed so low for so long?

There's no "smoking-gun" explanation for inflation's decades-long decline. What is clear is that Federal Reserve (Fed) Chair Paul Volcker's aggressively high interest rates in the early 1980s were the catalyst for a break in double-digit inflation, coinciding with fundamental changes allowing disinflation to endure. The interplay of weakening labor unions, deregulation, and, ultimately, globalization of supply chains was instrumental in removing so-called "price rigidities" supporting high inflation in the late 1960s and early 1970s. With an aging population in the U.S., spending patterns also have become less inflationary. Online shopping and technology's contribution to price transparency more recently added to pricing restraint. Disinflation also has become self-perpetuating, as greater competition spurs business cost-cutting in response to reduced pricing power.

2.) Can inflation stay down?

We expect a steady increase in inflation in 2021 — our year-end target is 2.2%. This increase likely will be propelled by a lift in services activity from the economy's reopening, along with more supply-chain disruptions as economic growth accelerates. The make-or-break period for inflation, in our view, lies beyond this year's expected acceleration. The real test will be inflation's ability to build on those increases as the catch-up period for spending winds down. A potential upside risk comes from some erosion in the factors that suppressed inflation in the past decade. Labor's market power is set to improve under the new administration. Government antitrust involvement in technology and closer scrutiny of energy, financial services, and other industries is primed to tame competition. And globalization is becoming less a force for competition and price restraint as it is imbedded with a dose of nationalism and becomes more fragmented. However, evolutionary changes like these point toward a more gradual swing of the pendulum away from cost and price restraint.

3.) What are the surveys of households, experts, and market participants saying about inflation this year, and what are they not saying?

Surveys so far are consistent with our outlook for a moderate increase in still-subdued inflation. What really matters is whether expectations for inflation can remain stable beyond the economic recovery in 2021. In the 1960s and 1970s, people came to expect that future inflation would be higher. If our forecast proves correct, the Fed is unlikely to raise interest rates.

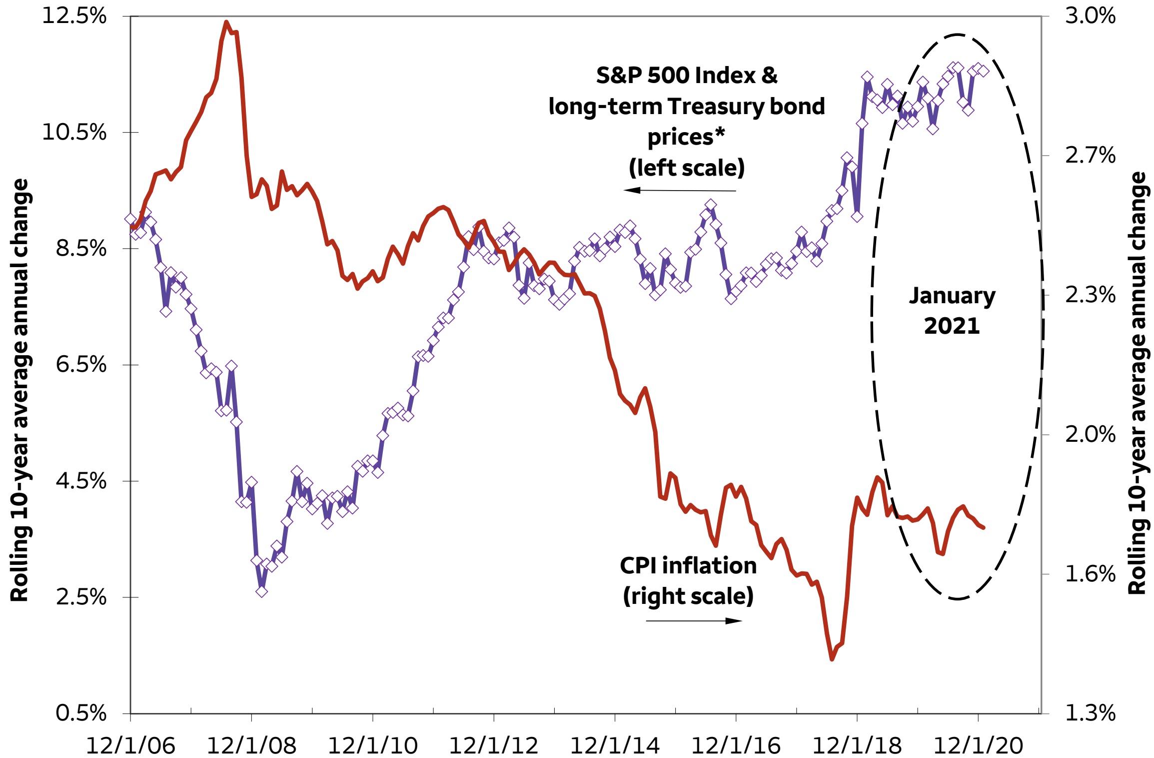
4.) Could another fiscal-stimulus package of more than $1 trillion drive inflation higher?

This investor concern centers on the risk of increased government spending supercharging a post-pandemic recovery that quickly bumps up against the economy's capacity to produce needed goods and services. However, the economy's capacity to produce likely is greater than that estimated by the Congressional Budget Office and other official scorekeepers. One indication: the economy was operating above estimated capacity in the late 1990s and in 2018-2019 without a material rise of inflation. Ample sidelined labor and productivity enhancements developed during the pandemic add to the cushion against inflation in this economic cycle.

5.) Why do we believe large-scale Fed purchasing of securities isn't inflationary, and why don't we believe it will be in the future?

Investors worry that the Fed's willingness to buy government debt — pumping fresh funds into the economy — increases the risk that too much money will be chasing too few goods. A loosened link in the past decade between money growth and the economy has meant that the Fed has been more successful in boosting asset values and in preventing credit crunches than in raising economic growth. An indication of that loosened link is a banking system flush with cash as a result of the Fed's securities purchases, opting to deposit the funds with the Fed because of insufficient lending opportunities. There's little indication that monetary policy will re-couple fully with the economy anytime soon. If it does, inflation's structural headwinds, mentioned earlier, will act as a counterweight to price pressures emerging from stronger growth. For now, persistently subdued prices have prompted the Fed to redefine its inflation target as an average of 2% over time, giving it added leeway to leave interest rates unchanged even if price pressures build.

"Easy" monetary policy has lifted asset prices, not goods and services inflation



Sources: Standard & Poor's, Inc.; ICE BAML, Wells Fargo Investment Institute, February 16, 2021. *Based on an average price index of the S&P 500 and long-term Treasury bonds (as represented by the BofA ML U.S. Treasury Bill Index — average maturity of over 15 years). CPI = Consumer Price Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Investment implications

Inflation is likely to rebound with the economy, but we think it is unlikely that households, businesses, and investors will come to expect open-ended acceleration serious enough to change spending, saving and investment behavior. The departure from the rapid money growth of the 1960s and 1970s has less to do with changes to economic theory than with structural adjustment at home and abroad disrupting the link between low interest rates and higher inflation. Spending growth has not followed money growth higher, keeping demand low for the extra cash that banks hold.

Moreover, long-term factors still promote falling production costs and prices. Despite some erosion, the forces holding down money demand are likely to remain in place in 2021 and in the years ahead. We interpret our expectation of 2.2% inflation in 2021 as consistent with the rest of the recovery in the economy.

Our outlook remains for a strong recovery in economic growth, with low interest rates and moderate increases in inflation. We continue to favor high-quality corporate fixed income in this low-yield environment, but we continue to emphasize that selectivity and careful credit research are important. This backdrop also should favor most equity markets globally, and especially those markets and sectors most closely correlated with economic growth. Equity markets do not typically rise in a straight line indefinitely, and some consolidation in prices may occur –

possibly once measured inflation makes a more concerted move towards 2%. Inflation may even overshoot 2% on a trailing 12-month basis as part of this rebound in the coming months.

We continue to see pullbacks or consolidations as an opportunity to add cash into equities, especially in U.S. Large Caps and U.S. Small Caps, and Emerging Market Equities. We are favorable on sectors that have the potential to benefit from stronger economic growth — we recently moved to favorable on Financials and Industrials, and we remain favorable on Communication Services, Consumer Discretionary, Health Care, Information Technology, and Materials.

Risk Considerations

Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **Sector investing** can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

Definitions

BofA Merrill Lynch U.S. Treasury Bill Index that tracks the performance of U.S. dollar-denominated U.S. Treasury bills publicly issued in the U.S. domestic market.

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

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