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FIRST ANALYSIS

Institute Alert

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Gary Schlossberg
Global Strategist

Inflation then and now

Key takeaways

- Many investors have expressed concerns over a possible repeat of the great inflation and stagnant economic growth that hampered markets during the 1970s and early 1980s.
- We believe differences between conditions now and those over 40 years ago outweigh similarities and point toward a return to more moderate inflation if recent shocks subside as we expect, but to a rate above the historically-low average of the past decade.

What it may mean for investors

- Our view is that long-term inflation will moderate beyond its current spike, supporting long-term allocations to high-quality, liquid U.S. Large Cap Equities and to longer-dated U.S. investment-grade bonds and other yield-advantaged securities.

Price increases seem to have taken on a life of their own this year, turning decades of low and declining inflation into a distant memory. Wrenching adjustments during the pandemic have been compounded by supply-chain disruptions and soaring goods demand tied to it. Soaring commodity prices, wage increases, and added shortages created by the war in Ukraine have propelled inflation — already at a 40-year high — even higher.

Inflation inevitably is topic number one among investors aware of its role at the heart of asset performance. Inflation pressures directly influence bond prices through their effect on interest rates. Commodity prices have risen, propelled by the asset's role as a potential inflation hedge. And inflation can influence companies' selling prices, costs, and interest rates, which has an impact on revenues, margins, and ultimately the market valuations in investors' portfolios.

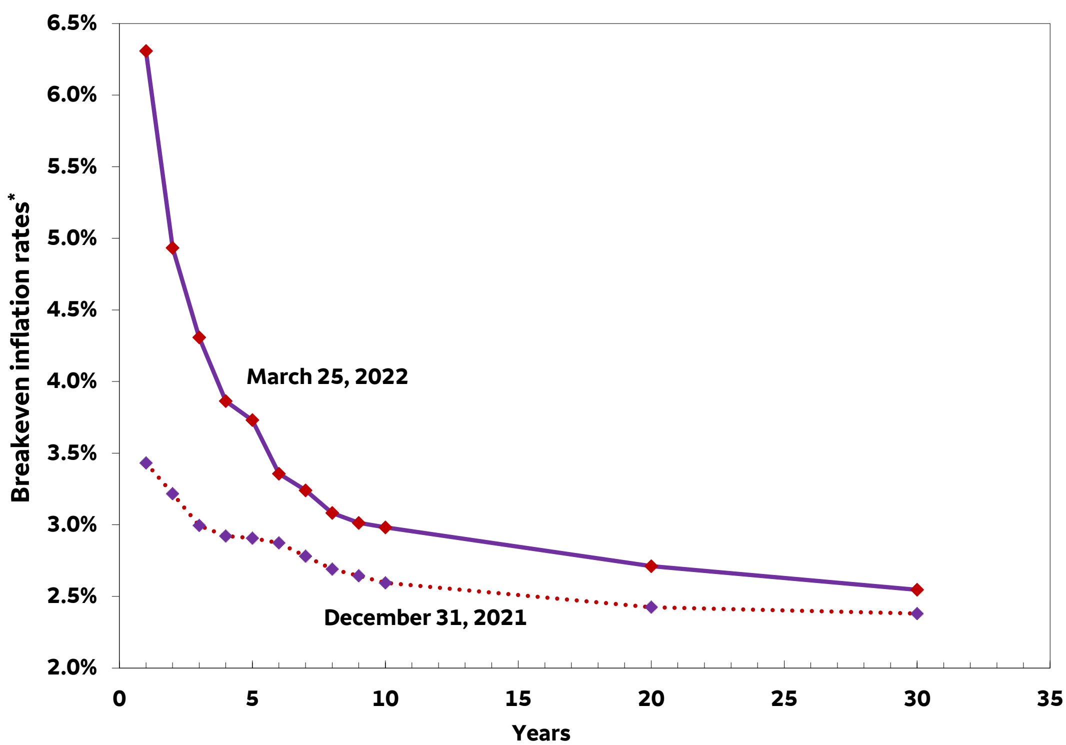
More than just inflation myopia?

Our stark outlook on inflation through 2023 contrasts with a more sanguine longer-term view, which can be even more important to asset performance. "Transitory" now may be a dirty word at the Federal Reserve, but households' longer-term inflation expectations have been edging higher far less rapidly than their short-term (12-month) expectations. In fact, the gap between the two is greater now than at any time since at least 1990, according to a University of Michigan survey for late March.

Much the same message is coming from investors through so-called breakeven rates in the market for Treasury Inflation-Protected Securities (TIPS). The breakeven rate is the yield on a conventional security less the all-in yield on an inflation-protected security of comparable maturity and is widely viewed by market analysts as a gauge of investors' inflation expectations. Long-term inflation expectations measured this way are close to the current 3% rate reported in the University of Michigan's late-March survey.

Note in Chart 1 the steepening breakeven curve as of March 25 (purple line) compared to the curve at the end of last year (red dotted line). This chart shows inflation expectations keyed to specific Treasury debt maturities. The widening gap between short and long-term inflation expectations signals a view that inflation's latest run up largely is the result of shocks from the pandemic and the war in Ukraine.

Chart 1. Breakeven rates in the TIPS market show rising short-term inflation expectations



Sources: Bloomberg Financial News, Inc. and Wells Fargo Investment Institute estimates. Data as of March 25, 2022. *Equating nominal, or observed, Treasury interest rates with their inflation-protected counterparts. **Past performance is no guarantee of future results.**

Lower long-term inflation expectations in the U.S. Treasury market have not prevented an ongoing debate over the ultimate impact of these short-term shocks on long-term inflation. On many investors' minds is whether we can expect a repeat of the great inflation during the 1970s through the early 1980s —double-digit interest rates, a struggling housing market, and pressure on household budgets. Much of the period also was marked by poor stock and bond performance and by a deep recession.

Not the 1970s stagflation

Stagflation — a combination of rising inflation and slowing economic growth — has resurfaced for the first time in over 40 years. However, the term has a different meaning now than when it first was coined during the great inflation of the 1970s and early 1980s. Worries over a period of rising inflation and weakening economic growth raise legitimate concerns over the outlook, and we believe they can complicate the Federal Reserve's efforts to achieve an economic soft landing while cooling inflation.

Fifty years ago, the term stagflation described more of a chronic condition, in which high inflation showed little response to extended periods of modest or even stagnant growth. Whether or not economic growth and inflation morph into the kind of stubborn stagflation seen in the 1970s will depend on the extent to which structural changes prevent inflation from responding to weakening growth. We believe the influence of market forces ultimately will be strong enough to pull inflation lower if economic growth cools.

So, do we think history is about to repeat itself? The latest inflation cycle checks off some of the boxes explaining uncomfortably high inflation 40 to 50 years ago:

1. **Policy errors:** Guns-and-butter fiscal policy in the late 1960s was similar in this cycle by aggressive fiscal stimulus supercharging an already powerful economic recovery from the worst of the pandemic. The Federal Reserve's slow response to inflation's rise in the past year has been similar to its late start to inflation control in the 1970s.
2. **Another shock to fuel costs:** The latest jump in oil prices has been similar those during the first two energy crises in the mid and late-1970s. Fossil fuels still have a pervasive effect on costs throughout the economy, despite a more muted economic impact in recent decades from increased energy efficiency and the shift toward less energy-intensive services spending.
3. **Soaring commodity prices:** Now, as in the 1970s, soaring fuel costs have been accompanied by double digit increases in industrial metals and agricultural prices, adding to the cost of food and manufactured-goods inputs.
4. **Slowing capacity growth:** Our research shows that an aging workforce is likely to slow economic growth potential in the decade ahead. Slower productivity growth had much the same effect after the first oil shock in 1973-74, leaving inflation exposed to periods of strong economic demand.

That was then, this is now

So why not throw in the towel and state that higher inflation is here to stay? Our view is that there are compelling reasons for households and investors to expect subdued longer-term inflation.

1. **Globalization's transformation:** Globalization, at the heart of disinflation since the 1980s, has come under a cloud created by trade tensions with China, rising costs in China, and pressure on other countries to reshore to more costly home markets. Supply-chain disruptions, aggravated by the war in Ukraine, have sharpened a debate over just-in-time versus less efficient, just-in-case inventory management. We believe that pressure on companies to simplify, shorten, and create supply chain backup systems will take time to develop. To this point, after four years of U.S.-China trade tension, we have not seen a broad reshoring of

production to the U.S. Until technology and other cost-saving decisions incentivize reshoring, it will not make sense to move production from overseas factories and limit inflation in consumer goods.[1]

2. Online shopping and other technological advances. Prices have been contained and, in some cases, lowered by efficiencies and greater price transparency created by the internet and other advances in telecommunications and logistics. Sheltering at home during the pandemic lifted the growth of tech-based business and lowered costs through increased efficiencies tied to economies of scale.

3. Fewer institutional rigidities: Today's economy is considerably less encumbered by industry regulation, despite signs of a shift toward greater government control. Antitrust is focusing more on competition than on a broader concept of consumer welfare, often accommodating increased industry concentration and pricing power.

4. Lower barriers to entry: A more services-oriented, less capital-intensive economy now than it was over 40 years ago has boosted competition by lowering capital costs. Other innovations, such as cloud computing, have further eased entry of new firms by lowering software, equipment, and data processing costs. Increased focus on de-concentration and competition in antitrust policy has increased the scope for business cost containment.

5. Market-driven wages: Institutional flexibility has extended to the labor market, where union representation fell to 11.6% last year — from 12.1% in 2020 and over 23% in 1983 despite recent Biden administration efforts to boost labor's bargaining power. This drop has reduced the likelihood of the kind of cost-of-living-adjustments and other contractual obligations that reinforced a wage-price spiral during the great inflation. Labor's increased bargaining power during the pandemic has been due to a market imbalance between supply and demand. We believe this can correct through economic policy restraint and improved immigration policies or through management innovations and increased investment to boost productivity.

6. Demographics and the savings glut: Some observers have used Japan's sluggish growth and low inflation as a counter-argument to refute any link between an aging population and higher inflation. In an aging society, slower population growth can dampen demand, and more savings may be conserved. This can offset price pressure from reduced labor supply and from the drawdown in savings accumulated during an individual's working years.

7. A demographic offset to the housing shortage: Changing migration patterns and cyclical changes in demand (measured by household formations) can temper the impact of a persistent shortage of housing supply on rents and other shelter costs. Evidence of that comes from subdued, pre-pandemic increases in housing costs, despite increases in the housing stock falling short of underlying demand.

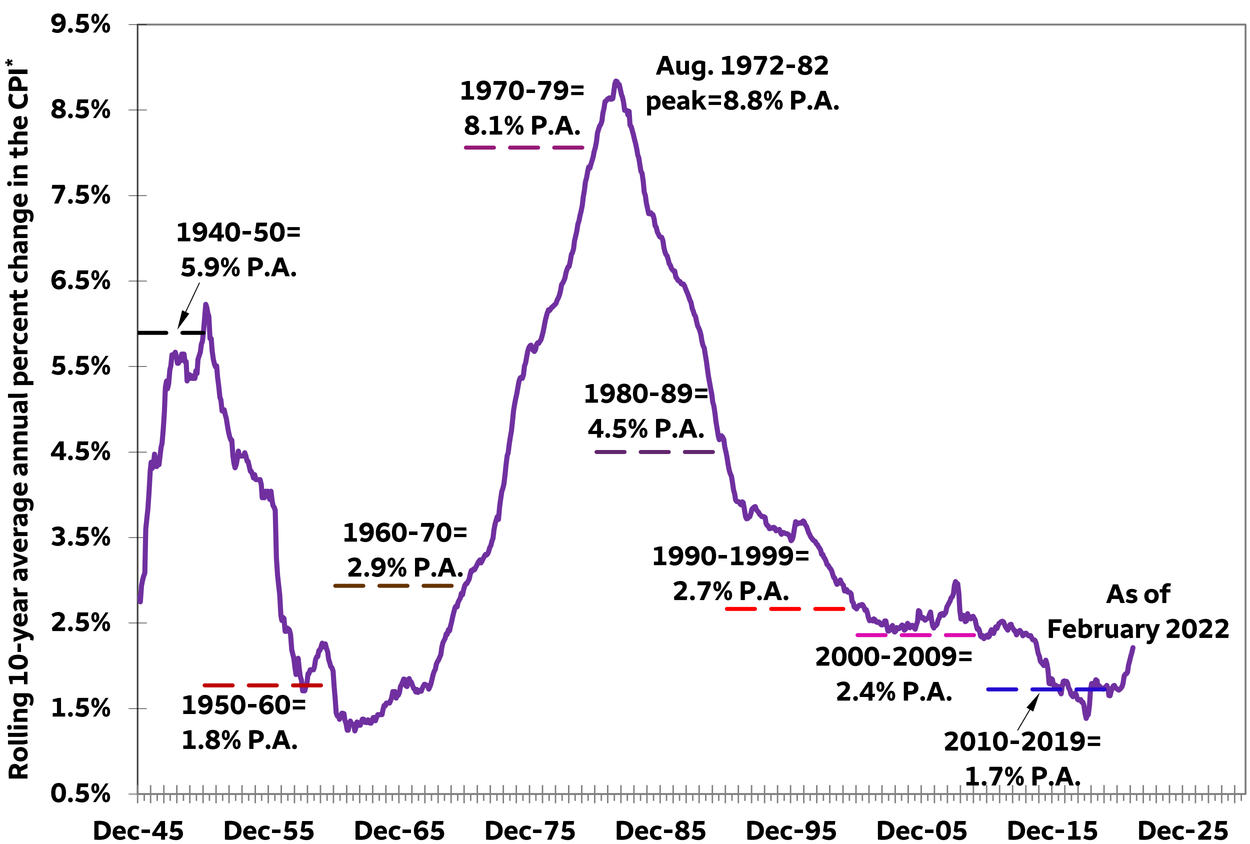
1. For more on how globalization is not ending but changing, please see our report, "The Future of Globalization: Investing in an Interconnected World", September 2021.

The outlook for financial assets

The debate over inflation's longer-term outlook hinges essentially on structural changes shaping the economy's performance in the decade ahead. Our view is that similarities to the 1970s are not as strong as current secular trends. As outside shocks subside, we believe inflation will return to what we view as historically moderate levels.

The great inflation of the 1970s and early 1980s, peaking at 8.8% in the 10 years to August 1982, was a 20th-century anomaly, as Chart 2 illustrates. The rate soared higher and for longer than at any time since at least the early 1920s, approached only when the U.S. lifted price controls after World War II. Even a more moderate, but elevated average rate exceeding 4% a year is an exception to the rule, occurring little more than one-third of the time since the beginning of 1946.

Chart 2. Putting the great inflation in perspective



Sources: U.S. Department Of Labor and Wells Fargo Investment Institute estimates. *Based on monthly data. P.A.= "per annum," or annual rate. CPI = Consumer Price Index.

A return to more moderate inflation is critical to a positive long-term outlook for stocks and other financial assets. Viewed strategically (10 to 15 years), we believe long-term interest-rate restraint should ease pressure on equity valuations and dividend-oriented stocks. Moderately higher, longer-term inflation also fits well with our constructive long-term outlook for higher-quality, more liquid U.S. Large Cap Equities, best positioned to deal with incremental improvement in pricing power and moderately higher interest rates.

Finally, we anticipate higher but still moderate interest rates also should support bonds after years of low yields. More specifically, our expectation for bond market's longer-term stability ultimately can support a return to favorable ratings on longer-term U.S. Treasury issues, preferred and tax-exempt securities, and other higher-quality, yield-advantaged sectors of the market.

Risk Considerations

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. **Dividends** are not guaranteed and are subject to change or elimination. **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. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. **Treasury Inflation-Protected Securities (TIPS)** are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until maturity. **Preferred securities** have special risks associated with investing. Preferred securities are subject to interest rate and credit risks. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

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