Zacks INVESTMENT MANAGEMENT

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY April 19, 2021

Inflation Worries May be Overstated

The just-passed $1.9 trillion stimulus plan—combined with the $3.3 trillion in government spending that came before it—have been key factors driving the inflation conversation.

Fears of rising inflation are not unwarranted. Much of the Covid-19 stimulus has been direct payments to American businesses and households, and M2 money supply is growing at a 25% year-over-year pace.[1] Commodity prices are on the move. Supply chain bottlenecks are putting pressure on factory input costs.

Inflation concerns are legitimate, but I think the widespread concern may be slightly overdone. For one, investors should be wary any time there is such clear market consensus about something like inflation. When we manage money, we lean on our own proprietary research to make decisions – not on what is being widely reported in financial media.

Second, I think some key, under-appreciated forces at work could neutralize inflation pressure in the years to come. I detail four of these forces in this piece:

1. **Demographics**

About 10,000 baby boomers turn 65 every day. This means a significant portion of the workforce is marching towards retirement. The pandemic has accelerated the trend – baby boomers have not returned to the workforce as the economy reopens at nearly the pace of younger workers.

On the other end of the spectrum, the Brookings Institution estimates there will be 300,000 fewer births in the US in 2021 than there would have been absent the pandemic and economic recession. Couple that data point with a 2016 landmark study published by the Federal Reserve, which found that sharp drops in fertility in the 1960s and 1970s were the biggest factor responsible for falling growth rates and interest rates after 1980.

At the end of the day, economic output (GDP growth) is driven by total workers in the economy multiplied by how productive each worker is. With demographic trends pointing to fewer total workers in coming years and

decades, I think there could be some secular deflationary forces at work.[2]

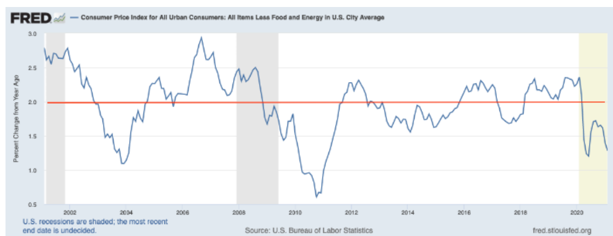
2. **Technological Investment and Worker Productivity**

Over the last year, companies across every sector of the economy invested in productivity-enhancing technology. Business investment in consumer equipment and software rose by 17% and 6% in Q4, respectively, even as GDP fell -2.4%. Companies also invested more in automation, videoconferencing software, and enterprise cloud services. In my view, this type of investment will continue scaling up in future years.

Investing in technology puts downward pressure on input prices and in many cases, increases productivity per worker – two deflationary forces.[3]

3. **Two Decades of Low Inflation**

The issue over the last 20+ years in the U.S. has been not enough inflation. In the chart below, the red line shows the target 2% rate of inflation, which readers can see has been met only about half the time.



Source: Federal Reserve Bank of St. Louis[4]

That's why I think seeing inflation run above-target for a few quarters could be a good outcome, and it should not necessarily sound alarm bells at first. Inflation can be pernicious if unchecked, but a healthy amount of inflation is also good for the economy.

4. **The Federal Reserve Has Tools to Fight Inflation**

If inflation becomes a concern down the road, the Federal Reserve has tools to push back. Among the primary tools available to the Fed, they could raise the interest rate paid to banks on excess reserves, reduce or end bond purchases, or raise the federal funds rate. One concern for many investors is that Fed action to tighten monetary policy and fight inflation automatically means selloffs and/or the end of the bull market. But bear markets usually start after the last Fed rate hike, not the first one.

Bottom Line for Investors

My point here is not to say that inflation will be unimportant or even modest in the quarters and years to come. But I do think the narratives currently surrounding inflation are painting it as an inevitable killer of economic growth and the bull market, which I think is overdone. There are economic forces at work that could neutralize inflation over time, and the Fed has tools to keep it in check.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Fred Economic Data. March 25, 2021. https://fred.stlouisfed.org/series/WM2NS

[2] Wall Street Journal. December 3, 2020. https://www.wsj.com/articles/covid-shrinks-the-labor-market-pushing-out-women-and-baby-boomers-11607022074

[3] Wall Street Journal. April 4, 2021. https://www.wsj.com/articles/u-s-s-long-drought-in-worker-productivity-could-be-ending-11617530401

[4] Fred Economic Data. April 13, 2021. https://fred.stlouisfed.org/series/CPILFESL#0

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- Magnets – an unlikely front in the economic battle against China
- Banks look to be in a strong position for 2021
- The realness of semiconductor shortage

An Unlikely Front in the Economic Battle Against China

Many economic battles are being waged between the West and China, as the world's second largest economy (China) angles to become the most important on the world stage. One of the unlikely fronts in the economic battle: magnets. Magnets have far more critical uses than many might expect. They are key components in electric vehicles, wind turbines, and a slew of other next generation technology. In other words, demand for magnets is likely to press higher from here. The problem in the marketplace currently is that China mines over 70% of the world's rare earths and is responsible for 90% of the process of turning them into magnets. What's more, China can both mine and convert rare earths at a much lower cost than other developed countries, given state subsidies, lower labor costs, and a decades-long head start on the technology needed to process the rare earths. The West is not necessarily sitting idly by – businesses are posturing for government support to ramp up supply chains for producing magnets at a lower cost, but maybe years or even decades away from contributing a steady supply. President Biden signed an executive order in February directing a review of supply chains for critical materials, in an effort to take steps to diversify away from China.[1]

Banks Look to Be in a Strong Position for 2021

In the years following the 2008 Global Financial Crisis, banks engaged in a years-long effort to recapitalize and boost their tier 1 capital ratios. The banks acted out of necessity – new laws required them to hold a certain amount of cash on hand relative to debt and other liabilities. It follows that going into the Covid-19 pandemic, banks were well-capitalized and ready to weather a fairly severe economic storm. Banks set aside billions in reserves to brace for a wave of loan losses, and they booked the reserves against profit for the first half of last year. Turns out, for banks, that storm did not turn out to be as bad as many anticipated. One year later, and banks are ready to release some of the 'rainy-day money' they set aside in the wake of the pandemic, which should provide a stiff tailwind to Q1 2021 earnings and also perhaps feed into lending in the new year. Another economic indicator supporting the case for banks to do well in 2021: the yield curve. An upward sloping yield curve generally favors bank earnings, since banks can borrow money on the short-end of the curve and lend it out at long-term rates. The spread is known as a bank's net interest margins, and the steeper the yield curve, the higher the profit. When the line below is rising, the yield curve is steepening. Which you can see has been the case of late.[2]

Source: Federal Reserve Bank of St. Louis[3]

The Semiconductor Shortage is Real

Global supply chain disruptions have created bottlenecks for many key inputs, but none perhaps as acute and critical as semiconductors. The issues are prevalent on two fronts: supply and demand. On the demand side, the global movement to set up home offices and buy new computers and other electronics led to a sharp increase in the need for semiconductors. On the supply side, semiconductor manufacturers did not expect demand so sustain or even go up during the pandemic, and were caught flat-footed when it did. Semiconductors are most often associated with computers and electronics, but they are also critical components of automobiles. Automakers across the spectrum, including Ford, Toyota, Honda, and General Motors have gone as far as to halt or reduce production due to lack of essential components. One fear among economists is that the semiconductor shortage will eventually find its way down into consumer prices, and we are starting to see early evidence of that – in March, the average used vehicle cost 13% more than a year earlier.[4]

ZACKS INVESTMENT MANAGEMENT, INC.

[1] Wall Street Journal. April 11, 2021. https://www.wsj.com/articles/u-s-faces-uphill-climb-to-rival-chinas-rare-earth-magnet-industry-11618133603

[2] Wall Street Journal. July 14, 2020. https://www.wsj.com/articles/this-is-not-a-normal-recession-banks-ready-for-wave-of-coronavirus-defaults-11594746008?mod=djemMoneyBeat_us

[3] Fred Economic Data. April 14, 2021. https://fred.stlouisfed.org/series/T10Y2Y#0

[4] Wall Street Journal. April 12, 2021. https://www.wsj.com/articles/chip-shortage-is-bad-for-gm-but-worse-for-car-buyers-11618234080

DISCLOSURE

Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

Inherent in any investment is the potential for loss. Zacks Investment Management, Inc. is a wholly-owned subsidiary of Zacks Investment Research. Zacks Investment Management is an independent Registered Investment Advisory firm and acts as an investment manager for individuals and institutions. Zacks Investment Research is a provider of earnings data and other financial data to institutions and to individuals.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting, or tax advice, or a recommendation to buy, sell or hold a security. Do not act or rely upon the information and opinions given in this document without seeking the services of competent and professional investment, legal, tax, or accounting counsel. Publication and distribution of this document is not intended to create, and the information and opinions contained herein does not constitute, an attorney-client relationship. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors, or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.

Any projections, targets, or estimates in this document are forward looking statements and are based on the firm's research, analysis, and assumptions. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications. All expressions of opinions are subject to change without notice. Recipients should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed in this document.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties. Zacks Investment Management does not assume any responsibility for the accuracy or completeness of such information. Further, no third party has assumed responsibility for independently verifying the information contained herein and accordingly no such persons make any representations with respect to the accuracy, completeness or reasonableness of the information provided herein. Unless otherwise indicated, market analysis and conclusions are based upon opinions or assumptions that Zacks Investment Management considers to be reasonable.

Any investment inherently involves a high degree of risk, beyond any specific risks discussed herein.

It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns, which will be reduced by fees and expenses.