Chart of the Month

May 2021

The U.S. Bureau of Labor Statistics reported yesterday that the Consumer Price Index (CPI) increased 0.8 percent in April on a seasonally adjusted basis. Over the past year, the "headline" index climbed 4.2 percent, the largest 12-month hike since September 2008. Core CPI (which excludes food and energy) rose 0.9 percent, the sharpest monthly increase since April 1982. The core rate is up 3.0 percent over the past 12 months, the highest year-over-year advance since January 1996.

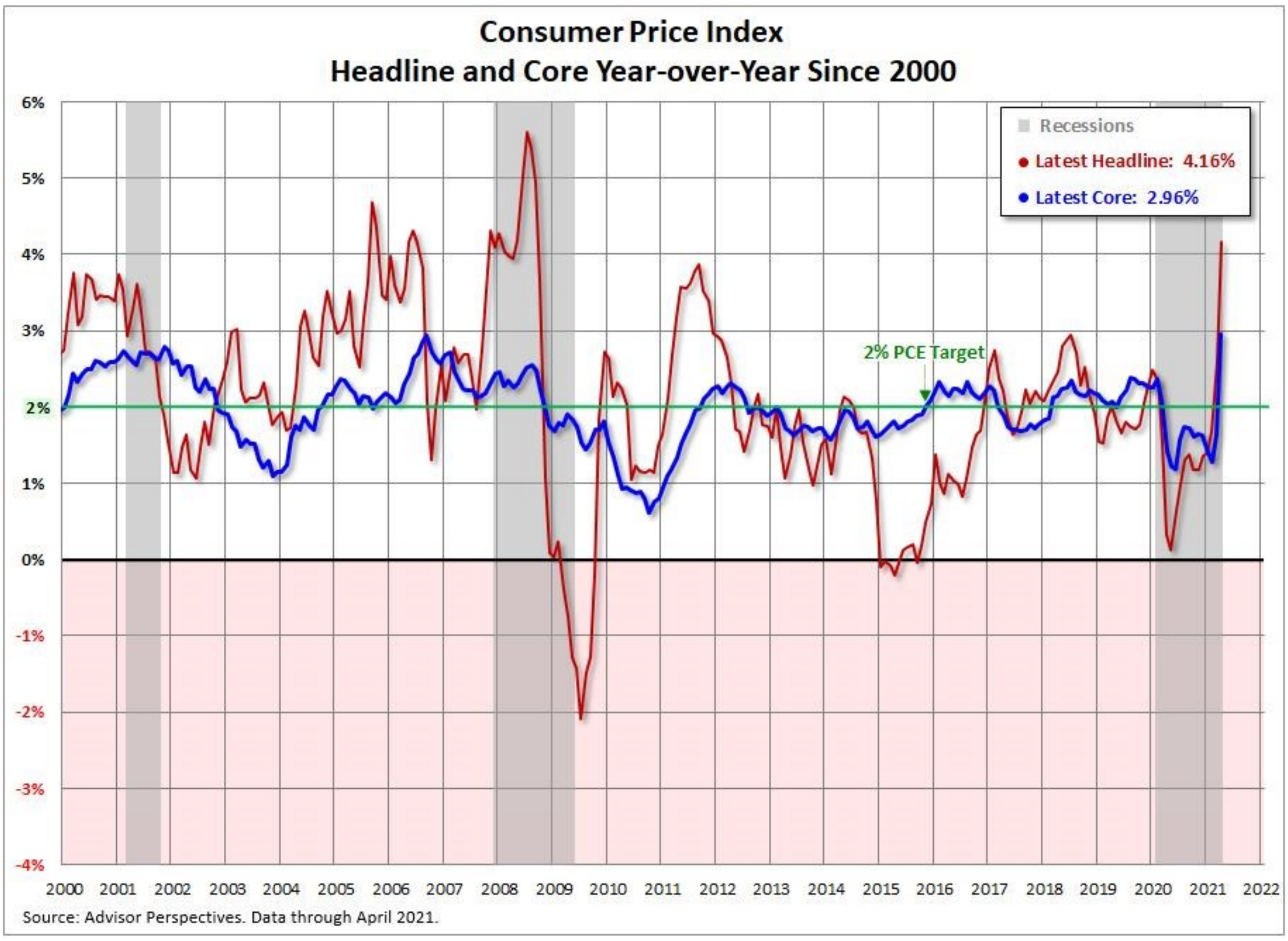
The inflation rate has now accelerated for six straight months, an unprecedented streak going back to World War II. If the headline CPI rises by the same rate in May as it did in April, the annual level will escalate to 5.1 percent.

As shown in the chart below, the headline and core CPI have fluctuated above and below the Fed's target of 2 percent almost equally since 2000. The Fed prematurely raised rates when the headline inflation spiked to nearly 3 percent in the summer of 2018, causing a nearly 20 percent decline in the stock averages during the fourth quarter. The Fed doesn't want to make the same mistake again but appears to be still fighting last year's war. Chairman Jerome Powell did a masterful job in 2020 during the downturn but the economy is emerging from the recession and producing GDP readings not seen in decades. As such, it is no longer in need of "life support" in our opinion.

Nevertheless, the policymakers believe the higher inflation rates are due to the depressed levels from the pandemic-induced lockdowns and are, therefore, "transitory." While time will tell whether they are right, we are concerned that the central bank may be "behind the curve" in terms of normalizing monetary policy. If so, the Fed might be forced to slam on the brakes to curb inflation if the latter gets out of control.

Of note, the stock and bond markets reacted negatively on Wednesday to the hotter-than-expected numbers. The inflation jitters sent the Dow Jones Industrial Average to its worst one-day drop since February. The S&P 500, Nasdaq, and Russell 2000 all fell more than 2 percent on the day. The yield on the 10-year Treasury note responded by jumping seven basis points to 1.69%.

What's an investor to do in such an environment? We believe a balanced approach among stocks, shorter-duration bonds (and perhaps Treasury Inflation-Protected Securities or TIPS), and real estate investment trusts (REITs) still makes the most sense. However, one must be tolerant of daily, weekly, and monthly fluctuations while tempering expectations for capital appreciation as valuations potentially suffer from the combination of rising inflation and interest rates in the future.



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