US Core Inflation Higher for Longer? A Functional Framework Approach May Help to Clarify Risks.

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Persistent inflation can weigh on investment returns for a variety of reasons, but a diversified basket of inflation hedging assets and a functional approach to asset allocation could provide ballasts and clarity for investors when price of goods and interest rates are elevated.

US headline inflation peaked ten months ago and has steadily fallen since the Federal Reserve launched a historic rate hiking and quantitative tightening campaign. Inflation, rising since late 2020, was argued by the Federal Open Market Committee (FOMC) to be temporary; however, elevated inflation had proved to be stubborn. In early 2020, when the global lockdowns were new, April's annual headline inflation was just 0.3% but by 2021 inflation hit 4.3% and by 2022 was 8.3%.[1] In April 2023, headline inflation was 4.9%.[2] Supply chain bottlenecks and breakneck economic growth in 2021 and 2022 certainly wreaked havoc with typical inflation measures, but the welcome cooling of inflation is cause for relief and markets are pricing in interest rate cuts by the end of 2023.

[1] Source: Bureau of Labor Statistics as of May 2023 and FRED.

[2] Source: Ibid.

While the message from Chairperson Powell and the FOMC on May 3, 2023 was a bit more guarded, the Committee raised the target range for the fed funds rate to 5 and 5.25%.[3] The FOMC also indicated a willingness to take further action if needed. "In determining the extent to which additional policy firming may be appropriate to return inflation to 2% over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."[4]

[3] Source: Federal Reserve FOMC press release May 3, 2023.

[4] Source: Ibid.

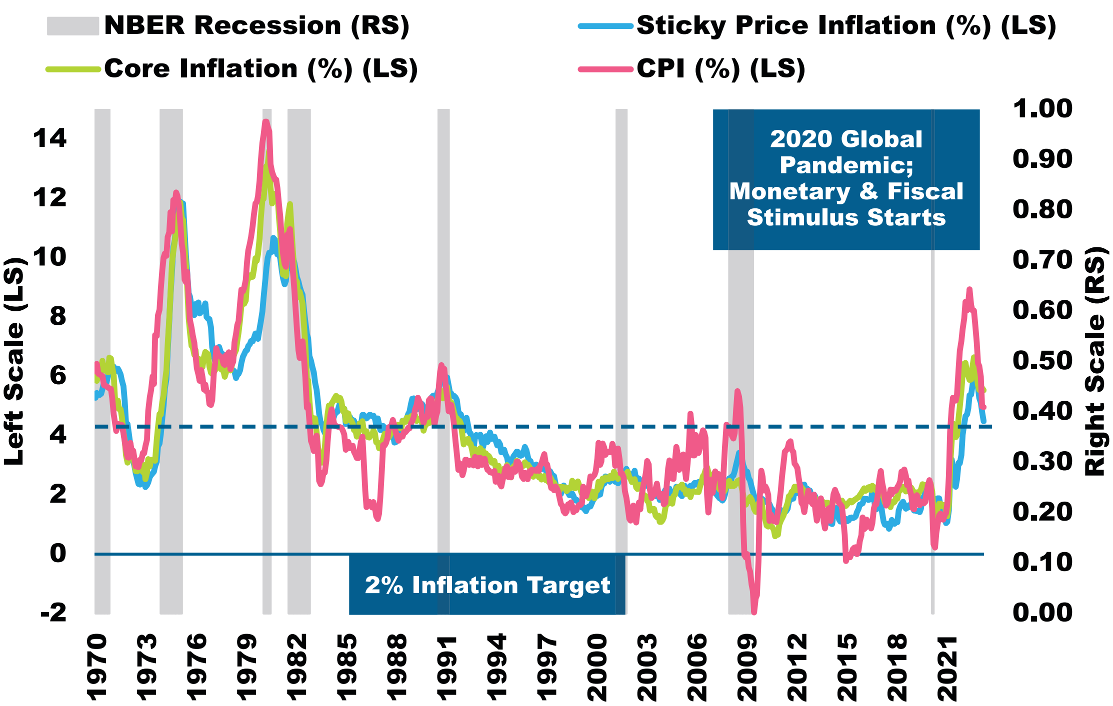

FIGURE 1

US Sticky Price, Core, and Headline Inflation (%yoy)

Source: FRED data as of May 11, 2023. BLS April inflation report published on May 10, 2023.

With a fed funds rate of 5.13% and headline inflation at 4.9%, it's important to note core inflation remains unyielding.[5] In April 2023, core inflation excluding food and energy was 5.5%.[6] (Figure 1) Prices for shelter, gasoline, and used cars and trucks rose in April, offsetting falling prices in other goods and services.[6] Not all prices of goods are as sensitive to higher interest rates. For example, shelter was the biggest contributor to the core CPI reading rising 8.1% as the costs of rents and leases rose dramatically over the past year.[7]

Since June 2022, inflation has fallen for the last ten months as has economic growth. The first quarter GDP for the US was somewhat better than expected at 1.1% but below the FOMC's long-run potential projections of 2.5%.[8] The FOMC's summary of economic projection estimates that annual growth for 2023 could range between -0.2% and 1.3%. The combination of weak economic growth and elevated inflation may prove transitory, but if core inflation (CPI less food & energy) or the sticky-price inflation (CPI less food, energy & shelter)[9] (Figure 1) remain elevated through the end of the year – concerns about stagflation could resurface again. So far labor markets have proven resilient with jobless claims rising in April but unemployment is still at historic lows.[10]

Today the markets appear to be pricing interest rate cuts by the end of the year, but comments from FOMC members appear to take a different view. What if the Fed is correct and inflation may be higher for longer? And what could institutional investors do to offset the impact of inflation on investment returns and possibly the declining purchasing power of the US dollar?

Inflation has a variety of impacts on investment performance, and moreover, the effects of inflation can vary with the level and duration of inflation. One of the ways institutional investors may prepare for the assortment of scenarios and investment

[5] Source: FRED data as of May 11, 2023. BLS April inflation report published on May 10, 2023.

[6] Source: Ibid.

[7] Source: Bureau of Labor Statistics as of May 2023 and FRED.

[8] Source: FOMC Summary of Economic Projections as of March 22, 2023. Bureau of Economic Analysis Real Gross Domestic Product (advanced estimate) as of April 27, 2023.

[9] Source: Atlanta Federal Reserve and FRED. As of April 2023, sticky price inflation rose 4.7% y-o-y and its 12-month change in April was 6.3%. Sticky price inflation rose 5.4% on a three-month annualized basis in April 2023. Sticky price inflation is a basket of goods and services which may be less responsive to interest rates. Rent in sticky price inflation is defined as rent of primary residence.

[10] Source: Department of Labor as of May 11, 2023. Continuing jobless claims rose to 264,000 in April 2023. The highest level of claims since October 30, 2021. Real hourly wages rose -0.5% yoy in April.

outcomes is to have a clear view on how inflation may impact a portfolio. By using category labels that reflect an investment strategy's role within the portfolio, it can help demystify the risk management process and highlight the function of an investment. As an example, having a clear label of "Inflation Hedging Assets" provides transparency for decision makers (e.g. trustees, investment committee members, and C-suite) to help them perform their duties of being watchful stewards of their institution's assets and reduces the opaque nature of portfolio management.

The current investment environment, a potential combination of low growth and elevated inflation, can be especially challenging for traditional assets. Diversification with assets that tend to better protect in an inflationary landscape such as Treasury inflation protected securities (TIPS) and commodities are more likely to perform well when inflation is persistent and elevated and when growth is scarce. No single real asset can be a silver bullet, but a diversified basket of inflation hedging assets could help offset dynamic inflation related risks.

To learn more about a functional asset allocation framework, five labor metrics we are watching, or inflation hedging assets such as tips, natural resources, and real estate, please visit the **Thought Leadership** section of our **website** or click the links here to learn more.

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