Richard Bernstein Advisors

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Insights

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Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an investment manager focusing on longer-term investment strategies that combine top-down, macroeconomic analysis and quantitatively-driven portfolio construction. We strive to be the leading provider of innovative investment solutions for investors, and our competitive edge is our research-driven macro style of investing.

Our top-down macro approach differentiates our firm from the more common, traditional bottom-up approach of most asset managers. Our extensive array of macro indicators allows us to construct portfolios for clients that are innovative, risk-controlled, and focused on overall portfolio construction instead of individual stock selection.

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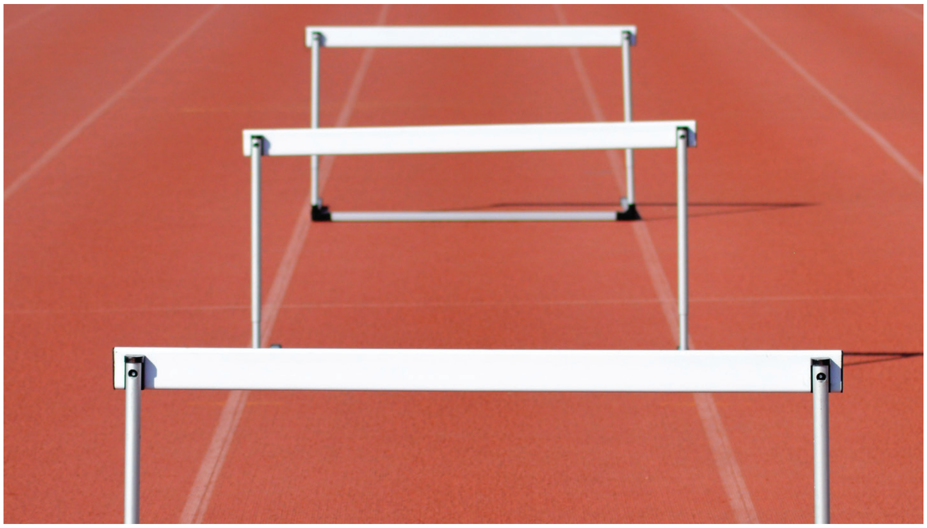
Inflation: the game has shifted from limbo to hurdles



For the past several decades, investors have generally been playing limbo with inflation. No matter how much they lowered their expectations, somehow inflation seemed to squeeze under the bar. The limbo dance could be over. Investors should now realize inflation expectations are set very low and inflation seems increasingly likely to hurdle that very low bar.

Whenever one hints at an increase in inflation, one is immediately asked how high inflation might go. However, that's the wrong question. Investors should ask "what's the probability inflation could be higher than expected?"

Consensus inflation expectations are roughly 2% (based on TIPS break even rates), so the pertinent question is what is the likelihood that inflation will be higher than roughly 2%. We think jumping that hurdle is currently much easier than investors believe.

The game has shifted from limbo to hurdles.

Breakevens on the rise

TIPS breakevens, or the implied inflation rate that equates TIPS[1] to nominal Treasuries, has been rapidly rising of late. Of course, some of the increase is simply attributable to the increase in economic

[1] TIPS: For descriptors, see "Index Descriptions" at end of document.

activity subsequent to the pandemic shutdown, but it is likely attributable to other factors as well.

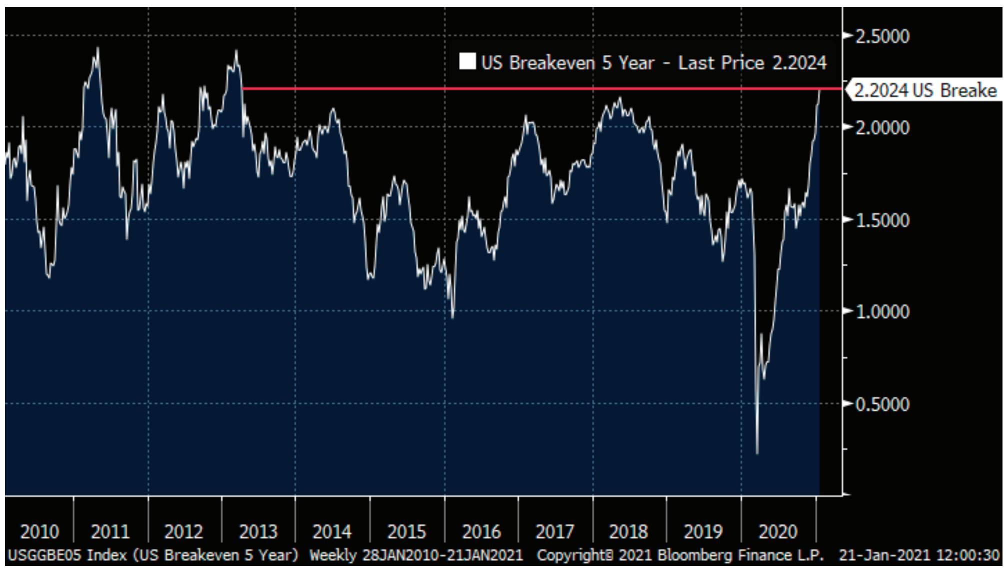
Production bottlenecks have appeared in the global economy, US wages are rising at a fast pace, unionization may be increasing, import prices are no longer fostering deflation, and record US money growth seem to suggest the upward trend in breakevens might not be quite as temporary as some believe.

Five-year breakevens have rebounded sharply and are now the highest in eight years.

CHART 1:

TIPS 5-Year Breakeven

(Jan 28, 2010 – Jan 21, 2021)



Source: Bloomberg Finance L.P.

In 1981, Reagan disbanded PATCO. Today, Google unionizes.

August 5, 1981 was a seminal date in the fight against inflation. On that day, President Reagan disbanded the Professional Air Traffic Controllers Organization (PATCO), and union power began a multi-decade ebbing. The link between union membership and wages has been a hot political issue ever since, but it is relatively clear the decline in US union membership has been a major disinflationary force.

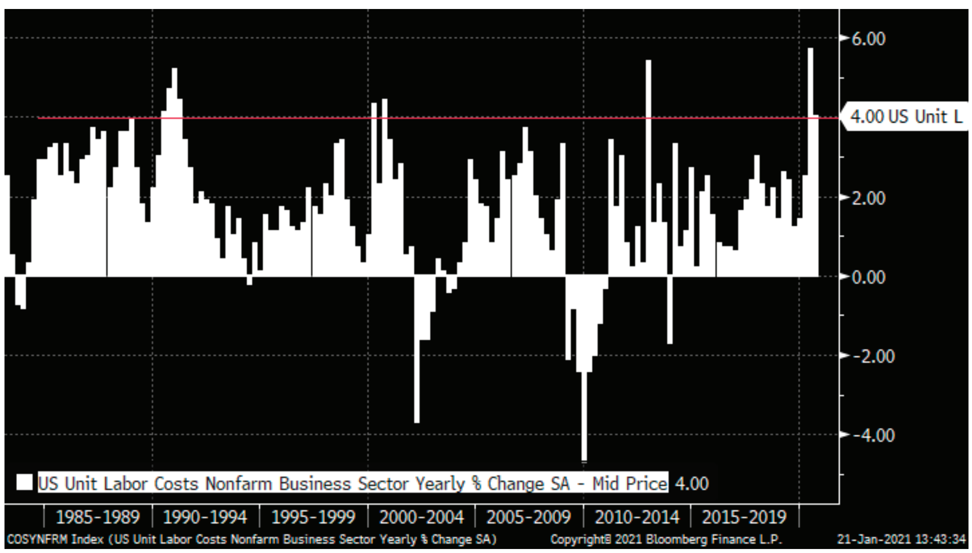
Recently, there was an event that seems equally as important, but in the opposite direction. Few observers have commented on the inflation implication of the recent unionization of Google. It will be interesting to see if the declining trend in union membership that began in 1981 starts to reverse, labor costs increase, and 2% inflation becomes more easily achievable.

Unit Labor Costs rising at an unusual rate

Unit Labor Costs (ULCs), which measure the cost of labor per unit produced, are one of the basic building blocks of inflation. Higher ULCs imply lower productivity and lower profit margins, and companies have historically often reacted to margin pressure by attempting to increase prices.

From 1983-2019 there were only 7 quarters during which ULCs rose 4% or more and only 1 quarter since 2000. However, ULCs during the past two quarters have risen faster than 4%. There have not been two consecutive quarters during which ULCs rose more than 4% since the early 1990s. Yet, forecasters remain sanguine about inflation despite that the past two quarters' increase in ULCs is so rare.

CHART 2:
Unit Labor Costs
(Mar 31, 1983 - Sep 30, 2020)



Source: Bloomberg Finance L.P.

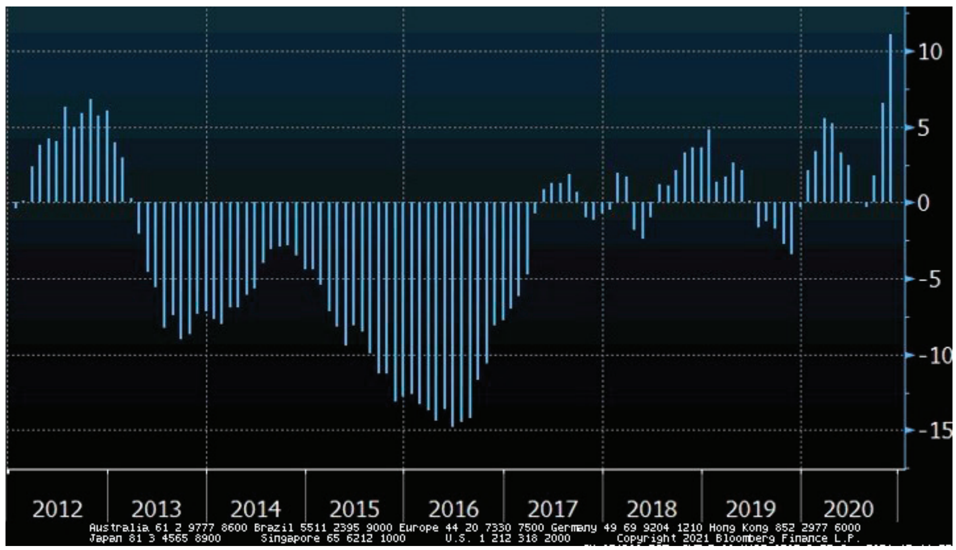
Trade costs rising

Despite political rhetoric, the US trade deficit has again ballooned, and is back to the worst levels of 2008/9. A trade deficit is not necessarily bad if the dollar is strong and the US imports deflation.

However, as many a developing world economist can attest, a trade deficit's negatives can be compounded by a weak currency and importing inflation.

While one has to be careful making hyperbolic comparisons of the US economy to developing world economies, the combination of ballooning trade deficit and global trade bottlenecks suggest the consensus forecast of 2% inflation could be too low. For example, global container prices are now rising more than 10% and anecdotal evidence shows shipping bottlenecks appear to be increasing both in number and magnitude.

CHART 3:
Global Container Prices Y/Y Percent Change
(Jan 31, 2012 - Nov 30, 2020)



Source: Bloomberg Finance L.P.

Money growth off the charts

US money growth is literally off the charts. M2[2] growth is now 27%, by far the fastest growth in the nearly 40 years of data. To further put this in perspective, this is the first time US money growth is faster than China's money growth. It won't take much for 27% money growth to translate to an inflation rate greater than 2%.

Some have said very low velocity of money[3] prevents inflation from occurring. The velocity of money has indeed been decreasing, but "prevents" may be too optimistic when money growth is so strong. The current velocity of money is about 1.1. Using 25% M2 growth and current money supply and nominal GDP, nominal GDP would still grow more than 6% even if the economy could not absorb the extra money and velocity plunged to 0.95.

[2] M2: For descriptors, see "Index Descriptions" at end of document.

[3] Velocity of Money: For descriptors, see "Index Descriptions" at end of document.

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CHART 4:
US Money Supply Growth: M2 Y/Y Percent Change
(Weekly, Jan 10, 1981 - Jan 11, 2020)

Source: Bloomberg Finance L.P.

Take the "over"

For many years, investors repeatedly won by taking the "under" on inflation regardless of how low inflation expectations were. However, the global and US economies may be changing in such a way it might prove beneficial to start taking the "over" on inflation. Such a shift would drive a wholesale reshuffling of leadership as investors reposition within markets. Long-duration growth tech stocks would not look as attractive in a period of sustained higher inflation. Cyclical companies levered to nominal growth may come back in vogue. The long duration bet within fixed income that worked so well for the last several decades may be jettisoned in favor of shorter duration bonds. Indeed, inflation seems to hold the key to a sea change in nearly every asset class.

Get ready for inflation to shift from limbo to hurdles.

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To learn more about RBA's disciplined approach to macro investing, [please contact your local RBA representative.]()

INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

TIPS: US Treasury Inflation-Protected Securities, or TIPS, provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, it pays out the adjusted principal or original principal, whichever is greater. TIPS pay interest twice a year, at a fixed rate. The rate is applied to the adjusted principal; so, like the principal, interest payments rise with inflation and fall with deflation.

M2: M2 Money Supply consists of M1 plus (1) savings deposits (including money market deposit accounts); (2) small-denomination time deposits (time deposits in amounts of less than $100,000) less individual retirement account (IRA) and Keogh balances at depository institutions; and (3) balances in retail money market mutual funds less IRA and Keogh balances at money market mutual funds. Seasonally adjusted M2 is constructed by summing savings deposits, small-denomination time deposits, and retail money funds, each seasonally adjusted separately, and adding this result to seasonally adjusted M1. M1 consists of (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; and (3) other checkable deposits (OCDs), consisting of negotiable order of withdrawal, or NOW, and automatic transfer service, or ATS, accounts at depository institutions, credit union share draft accounts, and demand deposits at thrift institutions. Seasonally adjusted M1 is constructed by summing currency, demand deposits, and OCDs, each seasonally adjusted separately.

Velocity of Money: Velocity of money is the average number of times a unit of money (as measured, for instance, by a monetary aggregate, in this case M2) turns over during a specified period of time.

About Richard Bernstein Advisors

Richard Bernstein Advisors LLC is an investment manager focusing on long-only, global equity and asset allocation investment strategies. RBA runs ETF asset allocation SMA portfolios at leading wirehouses, independent broker/dealers, TAMPS and on select RIA platforms. Additionally, RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has $11.9 billion collectively under management and advisement as of December 30th, 2020. RBA acts as sub-advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund, the Eaton Vance Richard Bernstein All-Asset Strategy Fund and also offers income and unique theme-oriented unit trusts through First Trust. RBA is also the index provider for the First Trust RBA American Industrial Renaissance® ETF. RBA's investment insights as well as further information about the firm and products can be found at **www.RBAdvisors.com**.

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