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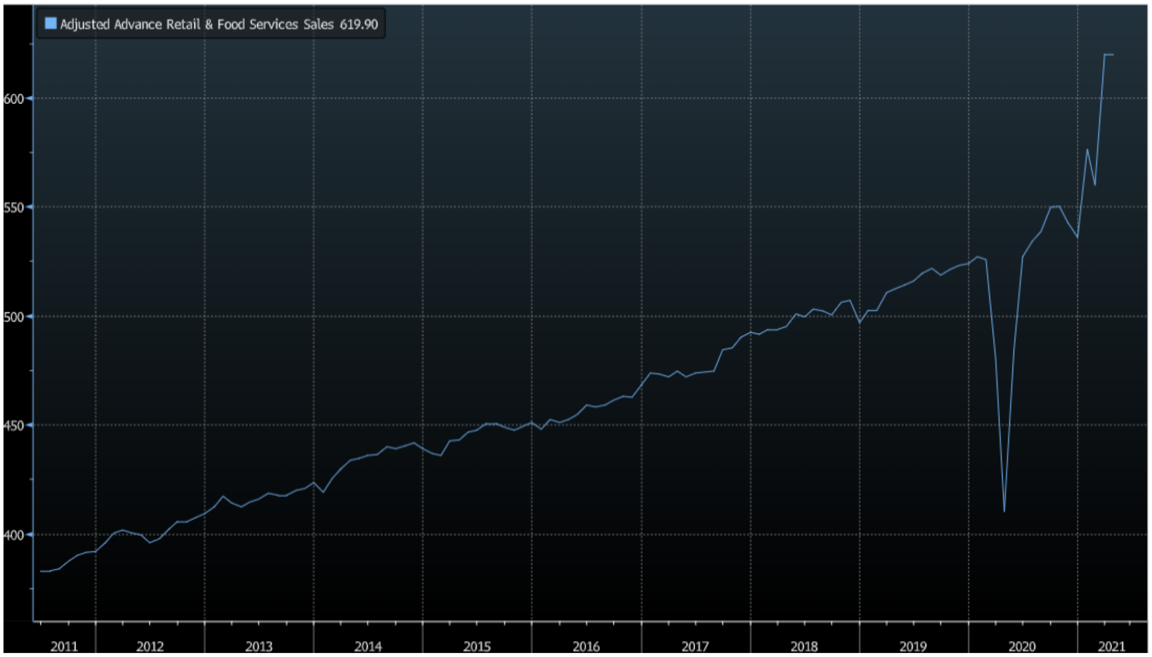
Economic Update: Inflation

June 18, 2021

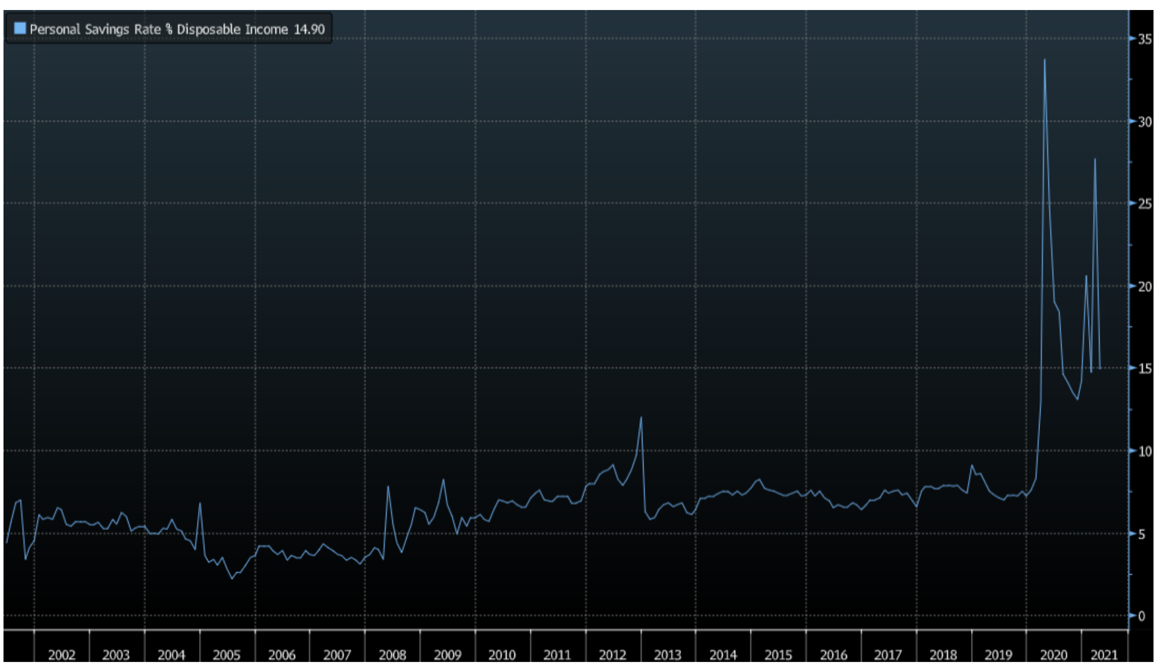
In recent economic commentary provided by the Federal Reserve in their bi-monthly Beige Book, districts across the country reported rising labor costs and input costs, signaling the potential for higher inflation in the near and intermediate term. Furthermore, the most recent reading of the Consumer Pricing Index (CPI), the most common measure of inflation, came in at 5.0% on a year over year basis in May, the highest reading since 2008, while Core CPI which excludes volatile items such as groceries and energy prices increased 3.8%, the highest reading since at least 1992. Rising prices may have a significant impact on the economy and financial markets in the coming months, and it is important investors prepare proactively for these future risks. Mersberger Financial Group has taken steps in both its fixed income and equity portfolios to attempt to hedge these risks and is continually monitoring economic and market conditions to assess the potential risks inflation may present to investor portfolios.

Recent inflation has been driven by a combination of supply chains continuing to see persistent disruption due to the COVID-19 Pandemic, a record consumer savings rate over the last twelve months as well as historic fiscal stimulus being implemented to ease the economic burden created by shelter in place orders and social distancing restrictions. Traditionally it takes several years for vaccines to be developed, approved, and distributed to the general population, which led many businesses to believe social distancing restrictions arising from COVID would continue to impact economic activity into 2022 and 2023. In response to these expectations, businesses told their suppliers their orders for the year would continue to be well below average, and as such many suppliers of raw materials and components used in productions reduced their inventory levels and output plans for the year. However, the COVID-19 vaccination was developed, approved and distributed in record time, meaning demand across the economy has surged back towards pre-pandemic levels much faster than anticipated, so many businesses have been caught understaffed with low inventories and unprepared suppliers, leading to shortages and price increases until production can catch-up with the current surge in demand. Further fueling demand was massive Fiscal Stimulus at levels unseen since the New Deal. In April and March of 2020, congress passed the $2.3 trillion CARES act providing relief to the economy which far exceeded the total $940 Billion of fiscal stimulus approved by congress in 2008 and 2009 to combat the financial crisis. In December of 2020 and March of 2021, congress passed two more stimulus bills, providing $900 billion in stimulus in December and $1.9 trillion in the form of the American Rescue Plan in March of 2021.



Adjusted Retail & Food Services Sales 2011-2021

The economic relief checks distributed to Americans has helped to keep Americans spending, and fueled record retail sales of $620 billion in April of 2021 well above the pre-pandemic April retail sales of 2019 level of $516 billion according to Fred Macro and shown in the chart above.

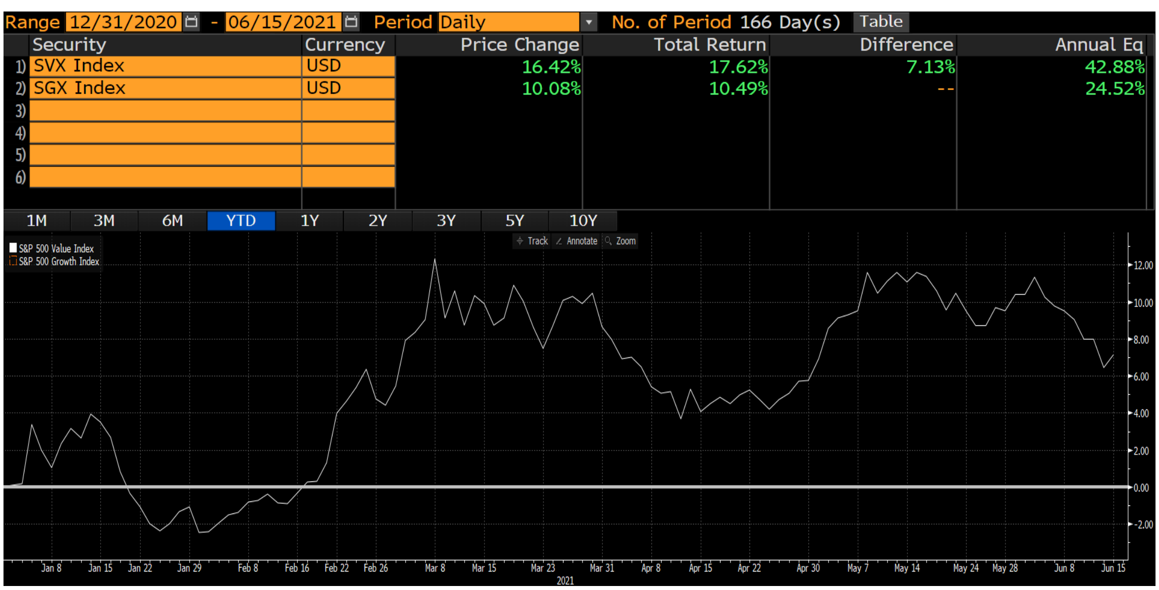


Personal Savings as % of Disposable Income: 2001-2021

This surge in retail sales and consumer spending has been the other piece of the current inflationary environment, with the economy not only reopening, but reopening even stronger than it had been prior to the pandemic. Retail sales were driven by the highest personal savings rate since at least 2002, with the personal savings rate surging to 33% in March of 2020, far exceeding the previous peak of 12% realized in November of 2012. These savings were a result of materially lower discretionary spending on travel, entertainment, and food during the shelter in place orders in 2020 and were further bolstered by government relief checks.

In aggregate, the rapid recovery in consumer and business spending combined with undersupplied and still recovering supply chains has led to the surge in input prices the economy has seen recently, and the 5.0% increase in prices the economy saw last month. The Federal Reserve believes current inflation data is transitory in nature, and as supply chains return to normal and the impacts of fiscal stimulus begin to wear off, then shortages and price pressures will begin to ease as well.

Mersberger Financial Group has taken steps inside its portfolios to hedge the risks created by an inflationary environment. First, inflation tends to make bonds with fixed coupon payments appear less attractive, which has historically resulted in market interest rates rising and bond prices falling. To hedge against interest rate risk, the firm introduced a short-term bond fund to its Terrapin Fixed Income Portfolio to reduce the duration of the model and its sensitivity to changes in interest rates. MFG also increased its allocation to short-term Treasury Inflation Protected Securities (TIPS) in the portfolio to potentially benefit from rising inflation rates, as well as to further decrease the interest rate sensitivity of the portfolio. In the Discovery Stock Portfolio, MFG recently introduced a homebuilder which may be positioned to pass through rising input costs to its customers as well as to capitalize on surging demand for homes resulting from the higher savings rate Americans achieved in 2020. In the firm's Foundational Equity model, it trimmed its exposure to highly valued growth stocks at the start of the year due to their high valuations making them sensitive to increases in interest rates and increased its exposure to more cyclical value stocks which are positioned to capitalize on rising consumer demand and a pickup in business activity. To start the year, buying and holding the S&P 500 Value Index would have generated a total return of 17.62% according to Bloomberg, outperforming the S&P 500 Growth index by 7.13%, as outlined in the graph below.



S&P 500 Value Index V S&P 500 Growth Index YTD