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Taming the Inflation Monster

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Everyone's talking about inflation, and while we think it is now occurring in a more systemic way, the fear is likely greater than the reality.

We, like many others, have spoken a great deal about inflation during the past year or two. Certainly, there have been some significant scares. Housing prices have risen across the board, driven by rising lumber and steel prices, and natural gas prices have skyrocketed in both the United States and Europe.

But the influence of rising prices impacts a broader segment of the market than just commodities. Food is affected, for example, and transportation. A significant increase in shipping containers is causing higher prices and delays for all products shipped via that method.

Still, we haven't bought into this fear, because we sensed it was greater than the reality, and it was already priced into the markets to some degree.

We didn't see much inflation in bond yields, for example. That's unusual. When inflation expectations rise, we expect bonds yields to rise as well, but with the exception of a relatively brief period earlier this year, that's not happening. The Federal Reserve (Fed) is managing rates.

When central banks say they're going to maintain interest rates at a certain level, we generally see their influence on the short end of the curve. But increasingly, we're seeing it on the long end. The most extreme example is Japan, which has locked the 10-year bond at a 0% yield. In the United States, less of that is being explicitly done, but it's hard to say it's not being done at all when the largest buyer of securities is the Fed.

So, inflation is rising but yields are not (because they're being managed). When that happens, the purported real rate—the real risk-free rate—goes further negative. That's the reason we haven't sold bonds in any material way (and in which we currently have a relatively small position, in aggregate).

Several years ago, we had a large aggregate short position in bonds, but that soon changed when we realized that our interpretation of central bank activity had to change, and that our fixed income valuation models weren't sufficiently calibrated to accommodate what we saw happening with central bank behavior and the real risk-free rate.

Today, however, the situation is beginning to evolve in a way that's more concerning to us. In particular, we observe on a personal level that prices are rising in many areas of the economy, from housing to food.

In almost every individual area, it's a common observation that inflation is idiosyncratic. Rising lumber prices are unique because labor to chop down trees is scarce or trucks and containers can't be located and secured in order to get the lumber where it needs to be. Rising semiconductor prices are unique because of a tremendous backlog of orders.

But as you go through the list, at some point you have to think: If every good and service has an idiosyncratic reason for its price rising, maybe something more systemic is actually occurring. And that's how we find our thinking beginning to evolve today. Rising prices are broad enough to weaken the case-by-case idiosyncratic rationalizations, making us think we have an emerging inflation problem.

We still believe inflation will be transitory. But what does transitory mean? Does it mean prices will begin abating next month? Does it mean we'll see inflation through the end of the year? Through the end of 2022? Many, even most, are saying inflation is transitory, but no one's being precise about what that means.

That's not a criticism. We, too, are struggling with exactly how we want to quantify "transitory." Right now, we believe transitory inflation will carry into the first half of 2022, but we discuss it often, and remain open to the possibility that it might be a bit shorter or a bit longer.

About one thing we are certain, however: Inflation will not decline to the very low levels to which we have become accustomed over the course of the last decade, in our opinion.

However, we are also not wildly fearful of hyperinflation (or any level of inflation that is uncomfortably high). But what is "uncomfortably high"? For people my age, who can recall inflation in the low teens, 3% is not uncomfortably high. Others may disagree.

The takeaways: We are concerned about inflation, which is bad for countries and citizens (at least those who save versus those who borrow), but good for governments (which can inflate their debt away). But we think it's transitory. That said, we don't believe it will revert to the low levels of the recent past and hyperinflation is most certainly not something to fear.

Brian Singer, CFA, partner, is a portfolio manager on and head of William Blair's Dynamic Allocation Strategies team.

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