MV CAPITAL MANAGEMENT

Weekly Market Flash

Could Inflation Be the Wild Card Spoiler?

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In these weekly commentaries we periodically float "wild card" theories about the global economy. These are not outcomes we expect to happen, but alternatives with in our view a better than zero, less than fifty percent (more or less) probability. We do this not for the sake of near-term predictions, which are always silly, but as a way to identify potential ways your portfolios could be at risk. Some time late last summer we ran one of these outlier theories up the flagpole: the risk of an unexpected bounce in inflation. Now, you could say that inflation was about the last thing on anyone's mind last fall when markets went into a funk over the prospects of lower or negative growth and observers worried about the Fed making a bad situation worse with higher interest rates. Since then, though, circumstances have changed. On the heels of a succession of outperforming economic data releases and the Fed's embrace of dovish monetary policy, it is worth taking another look at the inflation wild card.

Where There's Growth…

As recently as February, the economic consensus around Q1 real GDP growth was that it would barely scratch two percent, if it even managed to clock in above one percent. Today's release by the Bureau of Economic Analysis put paid to that idea: the economy grew at a rate of 3.2 percent in the first quarter (this figure will be subject to two subsequent revisions before going into the books). Yes, there are some one-off quirks to this performance: inventory build-up by the private sector, higher exports and sharply lower imports probably won't be sustainable trends. But personal consumption perked up nicely towards the end of the quarter and nonresidential business investment was also a positive contribution. On the heels of last month's rebound in payroll gains, along with strong retail sales and durable goods orders, the stage would seem to be set for a near-term growth spurt.

…There Should Be Pricing Pressure

We have already seen pricing pressure work its way into corporate income statements. Companies across many key industry sectors are reporting cost pressure in their supply chains, particularly raw materials and transport costs. Wage pressures are also prevalent, which should not be surprising given the historically long run of positive monthly job creation numbers. The main concern analysts have expressed regarding these cost pressures is the effect on profit margins. If companies can't pass on their cost increases to end customers, their own profits go down and so do their valuations.

But if consumer confidence, buoyed by rising wages and a still-tightening labor market, feeds into increased end-market demand, then companies have more leeway to pass their own intermediate goods inflation onto consumers. Voila – those consumer price indexes stuck forever just shy of two percent suddenly come to life. Again – we don't yet see evidence of this happening. But it is plausible.

The Spoiler Argument

And if it were to come to pass…so what? Here's the rub. Right now markets are priced for anything other than a renewed burst of inflation. The bond market has taken "Fed pivot" and run with it, now projecting a greater-than-not likelihood that the Fed will cut rates at least once before the end of the year. Well, guess what: if this vortex of higher than expected economic growth pushes up those consumer inflation numbers then we're not going to see a rate cut. More likely we would see a yield curve steepening, leading to a repositioning of equity valuations as analysts go back and plug higher discount rates into their free cash flow valuation models. In the long run the repositioning might be good for markets (if investors think the higher growth is sustainable). In the short run it would likely be disruptive.

To repeat: this is a wild card scenario – a joker in the deck, not a most-likely outcome. But it's worth keeping an eye on. It's also worth keeping an eye on the Q1 productivity number when that comes out next week. One way (the only way, really) to marry higher growth with low to moderate inflation is through higher productivity and lower unit wage costs. We haven't seen much of an uptick in productivity for many, many quarters. Now would be a good time for that to change.

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