MAY 21, 2021

Zevin Asset Management
INVESTMENT UPDATE

Inflation, Powdered Milk & Toothpaste

PHILIP HERGEL, SENIOR QUANTITATIVE ANALYST

As an undergraduate student I recall my macroeconomics professor describing inflation as toothpaste, "Once it's out of the tube, it's extremely difficult to get back in". Every time I brush my teeth these days I think of Professor Sims and the point he made; should inflation get out of control it becomes very difficult to rein in. Inflation in raw materials can create more inflation as higher input prices force higher output prices, which in turn leads to wage increases as workers demand higher pay so they can afford higher goods prices. Manufacturers then further increase prices to protect their profits and make up for higher labor costs. And so on.

Inflation has become a major talking point in the press, in the investment industry and even around dinner tables this year. The big debate is whether the recent increases we've experienced in raw material prices, wages, and select goods and services prices will continue and intensify, or whether they are only temporary.

A little over a year ago global central banks and governments unleashed huge amounts of stimulus in response to the onset of the COVID-19 pandemic and ensuing economic collapse. If the 1930s was the Great Depression, 2008/2009 the Great Recession, then 2020 was the Great Cessation. Economic activity stopped on a dime in March 2020. To prop up economies, central banks slashed interest rates and embarked on quantitative easing, where they themselves became massive purchasers of fixed-income securities in efforts to artificially tamp down interest rates and stimulate economic activity. Meanwhile central governments embarked on massive fiscal spending programs to protect businesses and their citizens. While these measures were undeniably necessary to support very sick economies around the world, they also ran the risk of creating inflation down the road. We are now down that road.

I HATE POWDERED MILK

Born in the 1960s, I am old enough to remember the horrible effects of runaway inflation in the 1970s as it destroyed my family's purchasing power. I recall heating oil becoming too expensive to sufficiently heat our cold Montreal home in the winter, so my mother set the thermostat to 5°C (40°F) and we resorted to a single kerosene heater in our kitchen where we all gathered to stay warm, do our homework, and socialize. I also recall the price of milk spiraling upwards, so the luxury of a milkman was abandoned for trips to the grocery store to buy our milk. As milk prices continued upwards, we resorted to watering down our milk and eventually replaced it with powdered milk. I hope I never drink powdered milk again! Inflation like we had in the 1970s is painful and demoralizing when one's ability to provide necessities becomes ever more difficult, or even impossible.

For people on fixed incomes, 1970s-style inflation would mean losing the ability to consume and live as they did previously. Bit-by-bit and day-by-day, sacrifices must be made to strategize and prioritize consumption. For people looking to buy a home or car it means these goals are ever more difficult or even completely out of reach as borrowing costs rise along with inflation, not to mention the price of the home or car also inflating.

So back to the important question: is the current inflationary period transitory or the new normal? While all of us at Zevin Asset Management are very aware of the possibility for inflation to continue and intensify, we tend to side with the Federal Reserve, European Central Bank, and the International Monetary Fund; we believe it's too soon to declare this inflationary episode as anything more than temporary. We will diligently assess changing conditions that prove otherwise, but here is what we see now:

- Most economies around the world are operating far below potential with unemployment still well above pre-pandemic rates and GDP well below potential.
- Raw material prices are soaring, but this reflects a short-term mismatch. Supply-chain delays, due in part to the pandemic, can't satisfy resurgent demand. This should work itself out in time as supply catches up to demand and a new equilibrium is established.

- The majority of the increasing consumer prices are concentrated in so-called "re-opening" goods and services. Once economies are fully reopened, we expect the rush of demand for these goods and services will subside and supply will be able to satisfy demand once again.
- Financial markets are signaling transitory inflation based on various measures of inflation derived from government bond markets.
- The "base-year effect" is distorting current measures of inflation, as current price levels are compared to artificially low levels from one year ago when global economic activity ceased. With time, the year-over-year price comparisons will no longer consider the temporary and abrupt collapse in prices which existed in early 2020.
- There are several secular trends which have contributed to the recent disinflationary trend and should continue to do so. Globalization remains intact allowing consumers to buy a good cheaper from across the world rather than across the street. Likewise, advancements in technology have also created a long-term disinflationary environment. Finally, declining global birth rates and aging populations continue to act as secular deflationary dampers on global economic activity.

Bottom Line: As vaccine roll outs continue around the world in the coming months and life returns to normal, global economies will begin to reopen for business. Consumers will return to restaurants and go on vacation and shop in-person again. Pent-up demand will be strong for goods and services, especially those off limits during the lockdown, but this initial burst of demand will subside with time. Meanwhile, supply-chain disruptions are likely to continue in the early stages of reopening, but here too, we expect solutions to resume the flow of goods and services to eventually meet demand. We expect current inflationary conditions to persist in the coming months but beyond that timeframe demand and supply should converge and inflation will normalize. We here at Zevin Asset Management are confident that resorting to drinking powdered milk will be avoided.

Zevin Asset Management

Certified B Corporation

2 Oliver Street, Suite 806, Boston, MA 02109 • www.zevin.com • invest@zevin.com • 617.742.6666