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Investment Strategy Insights

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The Fed & Its Dual Mandate

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Inflation Gestation

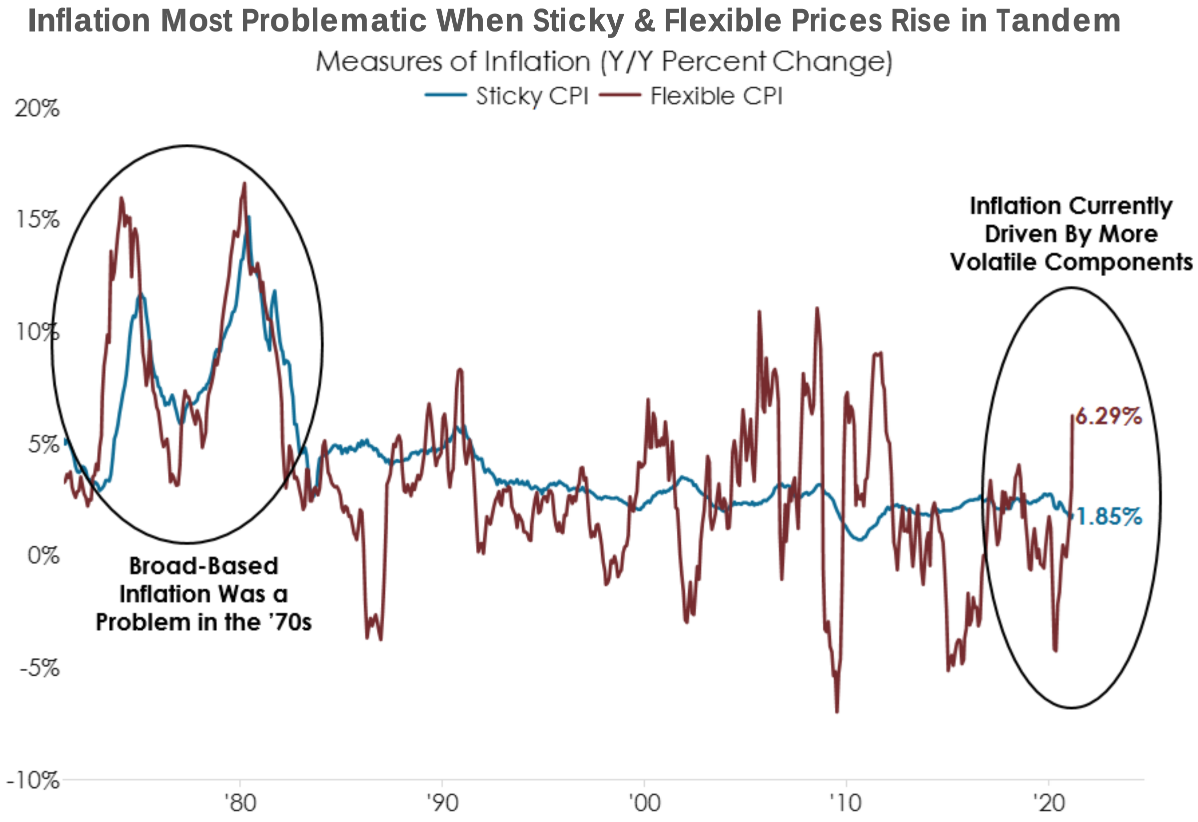
- **The Math on Inflation.** Inflation appears to be increasing, due in part to higher input prices and supply shortages. Both the U.S. Consumer Price Index (CPI) and Producer Price Index (PPI) have been trending higher over the last few months, at a pace where 3%+ inflation appears not too far on the horizon. However, investors should not be surprised by such levels of price increase when reported on a year-over-year basis, due to the base effects from deflation last spring.

- **Down in the Details.** The Atlanta Fed has developed two versions of CPI with very different characteristics. Sticky CPI represents inflation for items that tend to change price relatively slowly, like rent. In contrast, Flexible CPI includes prices that are typically a little more noisy, such as energy and food products. Inflation has historically become a problem when sticky and flexible prices move materially higher in tandem, which does not appear to be the case at this time. While the flexible piece has been volatile during the pandemic, the sticky portion still remains near multi-year lows.

- **Inflation's Uphill Battle.** There are a few secular deflationary trends that have kept a lid on prices for quite some time, including technological innovation, globalization and an aging population in the U.S. As a result, inflation faces an uphill battle to break out persistently higher than 2.5% – 3.0%. This is perhaps why 10-year market-implied inflation expectations via TIPS and swaps markets have remained relatively anchored near the 2% mark, consistent within the range the Fed has stated comfort.

Inflation is rising, though unlikely to persist at such high levels that would cause concern for investors

Chart of the Week:



Source: Glenmede, FactSet *Data through 3/31/2021*
Sticky CPI refers to a weighted basket of items within the broader U.S. Consumer Price Index (CPI) that change price relatively slowly. Flexible CPI refers to a weighted basket of items within the broader U.S. Consumer Price Index that change price relatively frequently. Past performance may not be indicative of future results.

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Fed Under the Microscope

- **FOMC on Hold.** The Federal Open Market Committee (FOMC) will meet this week, with little expectation for any important changes to the stance of monetary policy in the U.S. While it may appear uneventful on the surface, market participants will be poring over the language of Wednesday's statement and Chair Powell's press conference for traces of any change in tone regarding the unfolding economic recovery. Of particular focus will likely be the Fed's assessment of labor market conditions and inflation.

- **Inflation & the Fed.** The Fed's dual mandate is to seek price sustainability and maximum employment for the U.S. economy. Chair Powell has indicated a willingness to tolerate inflation above 2% for some period of time and see through any short-term volatility in price levels. It is unlikely the Federal Open Market Committee will deviate from that posture at its meeting this week, so more of the same means investors can expect a continuation of accommodative monetary policy in the short-run.

- **A 3-Phased Roadmap for Monetary Policy.** If the U.S. economic recovery continues as expected, the Federal Reserve will likely follow a roadmap that begins with emphasizing forward guidance on monetary policy at some point later this year. The next step may be a gradual tapering of its bond purchases sometime in 2022 when the dust is (hopefully) settled on the pandemic. This trajectory likely sets the Fed up to begin raising rates again in 2023 to normalize monetary policy. Investors should watch trends in employment and inflation for signs the Fed may need to take a detour from this path.

[Expect the Fed to follow a 3-phased plan of forward guidance, gradually tapering bond purchases and rate hikes

Labor Market Rorschach Test

- **Hard Data → Labor Slack.** A review of the hard data suggests that there remains significant slack in the U.S. labor market. The unemployment rate sits at 6.0%, notably higher than its pre-pandemic level of 3.5%. In addition, the labor force participation rate for the working age population sits 2% below its early-2020 highs. These measures suggest that the American job market is not yet fully recovered from the adverse effects of the pandemic.

- **Survey Data → Labor Squeeze.** Survey data such as the NFIB* Small Business Optimism Index paint a bit of a different picture of labor dynamics than the hard data does. NFIB's Chief Economist Dunkelberg noted that "small business owners are competing with the pandemic and increased unemployment benefits that are keeping some workers out of the labor force." This is a phenomenon that has popped up in other business surveys as well, with firms hinting at some difficulty in finding qualified labor.

- **Reading the Inkblot.** The contradictory assessments on the state of the labor market are likely a product of the unique environment the pandemic has created. A recent study conducted by the U.S. Census Bureau found that 4.2 million Americans are not working because they are "concerned about getting or spreading the coronavirus." In addition, some parents have had to devote time to caring for children not in school, making it difficult to actively seek employment. This implies that reaching the herd immunity threshold may be the key to more normal labor force participation.

[As the pandemic is wrestled under control, this should instill confidence in Americans to re-enter the labor force

National Federation of Independent Business

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JASON D. PRIDE, CFA
Chief Investment Officer - Private Wealth

Responsible for formulating investment policy and strategy

Serves as a leading member of the Investment Policy Committee

B.S. from Massachusetts Institute of Technology

MICHAEL T. REYNOLDS, CFA
Investment Strategy Officer

Responsible for supporting the development of investment strategies, policy and portfolio construction methodologies

Is an active member of the CFA® Society of Philadelphia

B.S. from the Wharton School of the University of Pennsylvania

ILONA V. VOVK, CFP®
Investment Strategy Officer

Responsible for supporting the development of investment strategies, policies and portfolio construction methodologies applied to Private Wealth client portfolios

B.A. and B.S. from Drexel University

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