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Investment Strategy Insights

July 19th, 2021

Earnings, Infrastructure & Used Cars

- Inflation Fixation
  - Diversified portfolios of stocks, bonds and real estate should fare well amid what appears so far to be transitory inflation pressures
- Beyond Peak (Earnings) Growth
  - Earnings growth will inevitably decline from its peak at 70%, but should remain strong enough to satisfy investors
- Mapping Out an Infrastructure Timeline
  - Infrastructure negotiations are worth monitoring, but investors should not bank on fiscal policy as an ever-present tailwind

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Inflation Fixation

- **June Inflation Update.** Last week brought another round of inflation data in the U.S. for June. The Consumer Price Index (CPI) jumped to 5.4% year-over-year in a report that was highlighted by 45% annual growth in prices for used cars and trucks. Additionally, the Producer Price Index (PPI) report ticked up to a 7.3% annual price gain for June as well, highlighting that there are still some economic dislocations working themselves out in the post-pandemic economy.

- **From One Transitory Factor to the Next.** Skyrocketing prices for lumber were cited as a factor for accelerating inflation a few months ago. After more than quadrupling since the beginning of 2020, lumber prices have begun to normalize, declining from an early May high of $1,670 per board foot, back down to around $575 today. However, as one anomaly wanes, another appears to be taking its place, as prices for used cars/trucks have hit a 45% annual growth rate. As the economy continues to shake the rust off amid ongoing reopening, the effect of supply constraints on inflation should begin to fade.

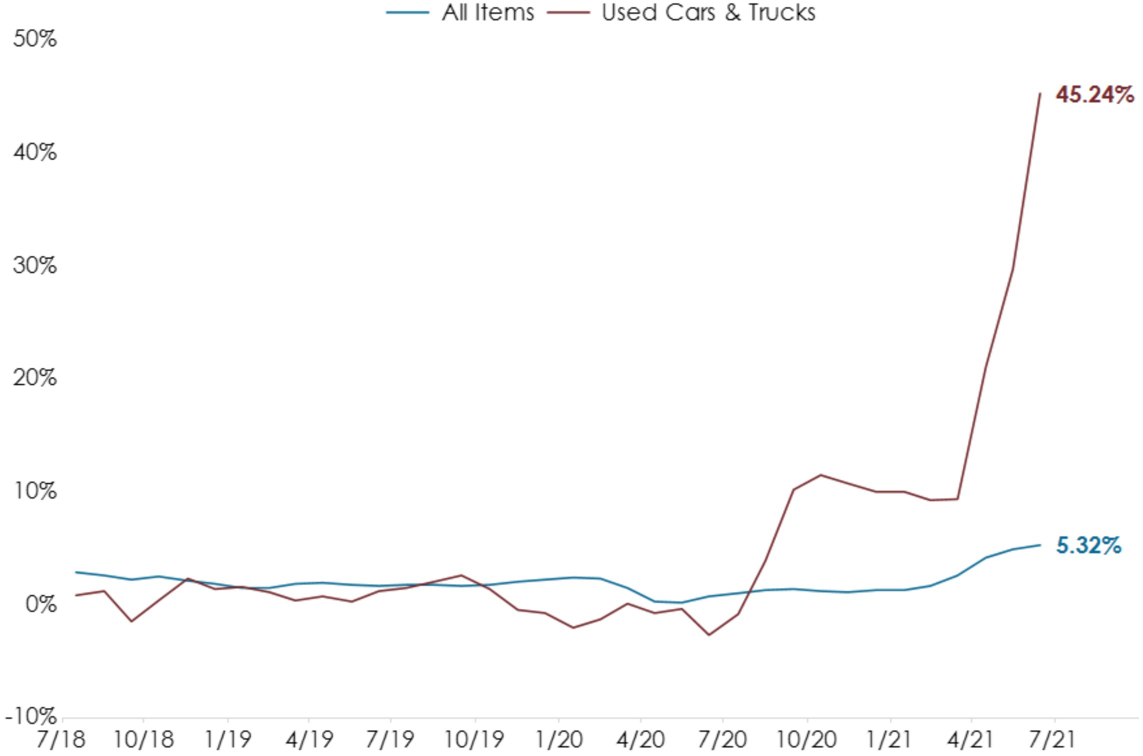
- **What to Watch.** Inflation has become problematic in the past when both the sticky and flexible components of inflation (via the Federal Reserve Bank of Atlanta) move higher in tandem, as they did in the 1970s. While Flexible CPI has hit multi-decade highs, Sticky CPI has barely managed to recover to pre-pandemic levels, suggesting that this recent pickup in inflation should prove transitory. This is good news for investors, as diversified portfolios of stocks, bonds and real estate have historically performed well in periods of 3% - 5% inflation.

Diversified portfolios of stocks, bonds and real estate should fare well amid what appears so far to be transitory inflation pressures

Chart of the Week:

Idiosyncratic Supply Constraints Continue to Play an Inflationary Role

U.S. Consumer Price Index (CPI, Y/Y Percent Change)



Source: Glenmede, FactSet, U.S. Bureau of Labor Statistics *Data through 06/30/2021*

Consumer Price Index (CPI) measures the percent change in the price of a basket of goods and services consumed by households in the U.S. "All Items" shows the year-over-year growth in U.S. headline CPI on a seasonally adjusted basis. "Used Cars & Trucks" is a subset of U.S. CPI, also on a seasonally adjusted basis.

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Beyond Peak (Earnings) Growth

- **Monitoring Results.** Last week kicked off Q2 earnings season, with many expecting signs that the rebound in corporate profitability carried additional momentum into Q2. With 8.5% of companies reporting so far, the blended year-over-year earnings estimate for the S&P 500, which combines actual results with consensus estimates for firms that have yet to report, currently sits at 69.8%. If earnings reports continue to unfold as expected, this would mark the largest year-over-year growth in S&P 500 earnings since Q4 of 2009.
- **Peak Growth?** Due to what was, in many respects, an extraordinary year in 2020, some economic and fundamental data reports compared to a year ago are posting some eye-popping growth (i.e., base effects), and earnings are no exception. While the S&P 500 may hit near-term peak earnings growth within the next quarter or two, corporate profits should be on a path to settle in at a lower, but more sustainable, growth trajectory as the next economic cycle unfolds.
- **Looking Beyond Base Effects.** Current earnings growth expectations are not entirely due to base effects. If the assumption is that the economy is entering a more normal environment, a comparison to the last normal environment (2019) is perhaps a more appropriate benchmark for reference. As such, the S&P 500 is on track for 10% earnings growth in Q2, if compared to Q2 of 2019. This suggests that underneath all the COVID-19-related noise, the earnings power of U.S. large-cap companies continues to make steady progress.

Though it will be difficult for earnings to sustain 70%+ growth, earnings are showing signs of strong underlying momentum

Mapping Out an Infrastructure Timeline

- **Infrastructure Deal Taking Form.** Congress is continuing its negotiations over a bipartisan infrastructure deal that would account for $1.2 trillion in spending over 8 years, with no broad-based tax hikes. The dearth of tax offsets is leading Democrats to push for a supplemental reconciliation bill, including ~$2 trillion in new spending, as well as tax hikes focused on corporate and personal rates. The implementation of these plans is far from inevitable, as there are still multiple steps in the process ahead.
- **The Road Ahead.** Currently, the most likely scenario appears to be one where a bipartisan infrastructure bill focused on spending initiatives with broad support passes first, perhaps as soon as late-August. After that, it's expected that Democratic senators will use the budget reconciliation process to implement other priorities not included in the bipartisan bill. This involves passing a budget to authorize higher spending levels, then pursuing separate legislation on the composition of that spending and any other changes to the tax code (corporate & personal), which may begin around October.
- **Fiscal Stimulus: Foot Coming Off the Gas.** While the infrastructure deal(s) appear to be taking form and working their way through Congress, there is still some uncertainty over the exact form the new spending and taxes will take. That said, this latest round of fiscal stimulus is almost certainly to be of lower scale than the prior COVID-19 relief packages. This suggests that heading into 2022, fiscal stimulus will be less of a tailwind than it has been over the past year.

Infrastructure negotiations are worth monitoring, but investors should not bank on fiscal policy as an ever-present tailwind

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