BRIDGES | TRUST®

MARKET COMMENTARY

July 7th, 2021

Starting On A Dime

Investors haven't had to pay much attention to inflation since the George W. Bush administration. For more than a decade, aspiring economists have had to be content studying its absence rather than its effects. If the 'Dismal Science' has anything like a universal theory, it's that inflation is triggered when an economy exceeds full employment or monetary supply expands faster than productive capacity. Yet despite unemployment hitting a 66-year low in 2020 and more rounds of Quantitative Easing than *Star Wars* sequels, inflation has fallen short of the Fed's 2% target pretty much since 2008. Until recently, inflation was beginning to seem like a quaint thing that happened in the 1970s (kind of like disco).

The suspected causes are many. Some of the more frequently mentioned are demographics (an older nation saves more than it consumes), the productivity benefits of technology and cheap imports (read China). But before we begin to opine on current events, it's worth noting that in recent years, deflation seemed like a far more pressing concern, especially when viewed through a global lens. Because recent US GDP growth has exceeded much of the developed world, foreign investors have gravitated towards US assets, driving up demand for dollars and increasing their value. A currency that appreciates is, you guessed it, deflationary.

The primary debate in the second quarter was whether this current spate of inflation is transitory or sustainable. Count us among the former. Here are a few reasons why.

Demand Was Unknowable

Just as economies aren't supposed to stop on a dime, they're not built to start on one either. Imagine you are a production manager. It's October 31st and you're trying to forecast demand for 2021. COVID cases are setting new highs (and won't peak for another 10 weeks). The past year has been one of the hardest of your career. In the spring, your sales had their steepest decline ever, so you intentionally destocked, attempting to align inventory with very uncertain demand. It seemed wise to slow new orders, allow lengthening lead times and consume safety stock lest the pandemic accelerate (which it did) leaving you with a warehouse of unsaleable goods.

Nine days later, Pfizer announces an effective vaccine followed by Moderna a week later. Within six months, 152 million Americans have received at least one dose and GDP is forecast to grow 9%. In hindsight, your inventory position is woefully inadequate, and consequently, you're left facing the mother of all supply crunches.

Now multiply that headache by every business in America. Because recent economic growth has been extremely range-bound, manufacturers leaned out their supply chains, relied heavily on just-in-time delivery and became a little complacent given extremely predictable demand. For ten years, it had been a goldilocks economy, 'neither too hot, nor too cold.'

The same is true on the labor front. In a little over a year starting February 2020, unemployment went from 5.7 million to 23.1 million back down to 9.3 million. The gig economy has trained us to open an app and expect workers to show up. As much as we'd like to 'turn it back on' there are frictional considerations to bringing 14 million people back into the workforce. Never mind the paperwork.

Spenders Gonna Spend

Savings usually go up in a recession, but this is the first time the US has made $807 billion of direct payments to consumers. The Personal Savings Rate peaked last year at 34% and has since fallen to 12.4% (5% is considered 'normal'). Thanks to government stimulus and a reopened economy, consumers spent 29% more in April 2021 than they did in April 2020. We view these rates as the definition of unsustainable. Every flavor of economic stimulus has its own half-life. Some are slow burn (like tax cuts, which can take years to take effect), while others are sugar rushes with extremely limited duration (like direct payments). Once it's spent, it's spent, and right now, it's being spent.

Capacity Is Ample

For inflation to persist, there must be a persistent mismatch between supply and demand. When it comes to commodities, it's hard to find many that are structurally under-supplied once demand 'normalizes.'

Take oil for example. Historically, it's been one of the best predictors of inflation as it's an input cost in many of the goods and services we consume. The cost of Crude oil is currently up 52% YTD. But how long will that last? The US is currently producing 12% less oil than it was at the beginning of 2020. Saudi Arabia cut oil production 53% in 2Q20 and is currently increasing it 28%. One of the most timeworn adages in commodity investing is 'high prices cure high prices.' The supply response is coming.

What About Stocks?

Whether inflation is transitory or persistent very much matters for stock prices. Because inflation has been modest for quite some time, and we're currently experiencing the sharpest inflation since 1982, securities that are the most inflation-sensitive tend to be the best performers (think energy and banks). This strikes us as odd as oil prices and 10 year government interest rates (the two biggest determinants of those industries' profitability) aren't that much different than 2018-19 when most considered them blasé.

What does matter to us is inflation's impact on growth stocks. Because we've shown a preference for companies demonstrating exceptional growth in an unexceptional economy, many of our holdings have higher-than-market multiples. These stocks are sensitive to inflation because you're discounting earnings far into the future and inflation erodes purchasing power. Growth stocks may continue to underperform if inflation remains stubbornly high.

But it seems odd to us to jettison great businesses demonstrating exceptional earnings growth because inflation expectations go from 2% to 2.3%. It seems even stranger to want to replace them with businesses facing structural headwinds like banks (interest rate policy, leverage limits, FinTechs) and energy (excess supply, a strong dollar, carbon regulation). That’s not to say we don’t find attractive businesses in either of those sectors, but we don’t see the merit in chasing a ‘reflation trade’ should the inflation reset prove transitory in nature.

As usual, we thank you for your confidence and should you have any questions, please don't hesitate to reach out to your relationship manager.

Bridges Investment Management Investment Committee

BRIDGES | TRUST®

DISCLOSURES AND IMPORTANT INFORMATION

This communication is provided to clients of Bridges Trust Company (BTC), Bridges Trust Company of South Dakota (BTC-SD) and Bridges Investment Management, Inc. (BIM) for informational purposes only and is not a recommendation to purchase, hold, or sell any security. We believe the information presented is reliable, but we do not guarantee its accuracy. Each investor's situation is unique, so please work with your Investment Adviser or Trust Officer to develop an individualized investment plan before investing.

"Bridges Trust" and its logo reference independent services offered by BTC, BTC-SD, and BIM. Trust, custody and related services are provided by BTC, a trust company chartered through the Nebraska Department of Banking and Finance, and BTC-SD, a trust company chartered through the South Dakota Banking Commission. BTC and BTC-SD as well as certain individual clients directly utilize the investment management services provided by BIM, an SEC registered investment adviser, with further information available at www.adviserinfo.sec.gov/firm/108028 and www.bridgesinv.com. The registration of an investment adviser does not imply any level of skill or training.

Sources: Unemployment. Personal Saving, Inflation, and Consumer Spending rates courtesy of FRED®, Federal Reserve Bank of St. Louis, US Bureau of Economic Analysis; Crude oil prices and market data courtesy of FactSet Financial Data and Analytics; Oil production statistics courtesy of US Energy Information Administration. Data and analysis are the property of their respective owners, all rights reserved.

Investing involves risk and the possibility of loss.
Past performance is no guarantee of future results.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS: This communication contains forward-looking statements that involve substantial risks and uncertainties. We believe it is essential to communicate our expectations to our clients. However, there may be events in the future that we are not able to predict accurately or over which we have no control. Actual results or actual business or other conditions may differ materially from those contemplated by any forward-looking statements, and we are not under any duty to update the forward-looking statements contained herein. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward- looking statements.

CAUTIONARY STATEMENT REGARDING THIRD PARTY INFORMATION: This communication includes financial information, market data, and certain other statistical information and estimates based on reports and other materials prepared by other independent sources, as well as management's own good faith estimates and analyses. We believe this third-party information to be reputable but have not independently verified it. Information that is based on estimates, forecasts, projections, market research, or similar methodologies or assumptions is inherently subject to uncertainties, and actual events or circumstances may differ materially from events and circumstances reflected in this information.

Visit bridgestrust.com for more information on Bridges Trust's capabilities.
To read more commentary provided by Bridges Trust, please visit our INSIGHTS page.