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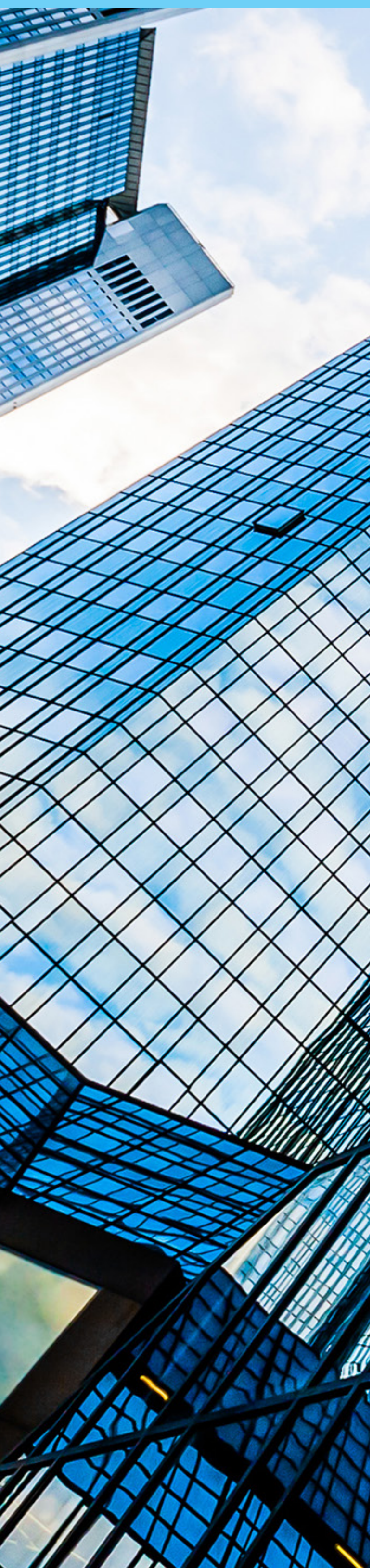

NEPC MARKET OUTLOOK

Should Investors Be Bracing for a Tidal Wave of Inflation?

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NEPC Market Outlook highlights our investment views and recommendations, while examining the key influences driving capital markets.

The economic resurgence in the U.S., powered by a wave of pent-up demand, is sounding the alarm on the dreaded “I” word in the investment world: inflation.

Nearly all economic indicators are flashing green, and GDP in the first quarter grew at the second-fastest pace in over 15 years amid a dramatic expansion of COVID-19 vaccinations and continuing support from domestic fiscal and monetary stimuli. Meanwhile, the Consumer Price Index (CPI), a commonly-used gauge of inflation, increased at the fastest annual rate in more than 13 years; the annual CPI increase in 2021 could be well above 3.5% with consumer demand and global supplies thrown out of whack due to disruptions caused by the pandemic. In addition, market-based expectations of long-term inflation have normalized with current projections estimating an inflation rate of nearly 2.5% over the next 10 years. With the uptick in inflation, long-term interest rates have moved higher this year with Treasury yields increasing over 1% relative to the lows seen earlier on during the pandemic. The question now on many investors’ minds is whether a post-pandemic economic boom could unleash a tidal wave of inflation.

> **We believe higher long-term interest rates and inflation expectations are currently not a cause for concern.**

At NEPC, we believe higher long-term interest rates and inflation expectations are currently not a cause for concern. Instead, they reflect a rational shift in the market outlook amid optimism around improved economic growth prospects in the U.S. We continue to see deflationary forces, for instance, aging demographic trends and innovations in technology, that mitigate long-term inflation pressures. Most important: the consumer psychology required to sustain an inflationary environment is absent. Fundamental to an inflationary period is for consumers to fear a loss of purchasing power and accelerate spending to maximize purchasing power before prices rise. The recent surge in consumer spending is a far cry from the classic inflationary psychology last seen in the 1970s; instead, it underscores a temporary tide of demand let loose by relaxing pandemic restrictions. We believe the near-term inflationary pressures—associated with global supply chain disruptions, rebuilding of business inventories, and recovery in energy prices—are temporary. In our opinion, cyclical price changes and supply-demand imbalances are to be expected as the economy emerges from the pandemic and transitions towards normalcy. To that end, these inflationary price pressures are likely to be transitory and we believe inflation rates over the long-term will trend towards 2.5%.

While our baseline view on inflation is a moderate one, we acknowledge that the probability of inflation breaking out to 40-year highs is greater than it has been in nearly 10 years. In our view, this remains a relatively low likelihood, but raises questions around how to position a portfolio in such an environment. At NEPC, we encourage investors to be aware of the inflation sensitivity of their portfolio to determine the necessity of building an allocation to real assets relative to long-term objectives and assess the need to mitigate potentially negative outcomes associated with inflation.

Despite the currently trending inflation headlines, our key market themes and investment outlook are largely unchanged. We believe our key market theme of *Permanent Interventions* is a dominant force supporting equities as central banks and governments offer unprecedented monetary and fiscal support to bolster market sentiment. As a result, we urge investors to consider higher strategic equity targets and we continue to favor U.S. and emerging market stocks among public market equity exposure. In addition, while the probability of inflation breaking out is higher, so is the potential risk of deflation as the economic stress of the pandemic has increased the likelihood of macroeconomic tail-risks. To that end, we encourage investors to maintain a strategic allocation to safe-haven fixed income to serve as a source of liquidity and to provide downside protection during periods of market stress. Furthermore, we recommend rebalancing safe-haven fixed income exposure back to strategic targets following the recent uptick in interest rates.

Looking ahead, we are hopeful for the economy and equity markets…and for life outside of the investment world. However, it is important to temper our expectations given that the pandemic is the largest economic disruptor of our time. We are likely to see waves of price increases across many sectors of the economy, but the high tide of supply-demand disparities will recede, and we recommend investors look past the inflation headlines. As the U.S. economic outlook improves and COVID-19 vaccination rates continue to rise, we look optimistically to the future and hope the summer brings us all closer to life as we knew it.

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