IRONWOOD
Investment Counsel, LLC

Ironwood Investment Counsel, LLC constructs and manages customized investment and wealth management programs designed to meet our clients' unique goals and objectives. Our distinctive process maximizes performance through return enhancement, risk reduction, tax efficiency, and cost containment.

Your Ironwood Team
14646 North Kierland Boulevard
Suite 135
Scottsdale, Arizona 85254
480-609-4700
Fax 480-609-4725
www.ironwoodic.com

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Is Inflation Here to Stay?

During the second quarter of 2021, global equities continued to appreciate as improving economic growth, policy support, and strong earnings overcame worries about excess inflation. As government bond yields, again, shrugged off fears of inflationary pressure, U.S. equities – and growth stocks in particular – advanced materially. Domestic equities outpaced global equities with an 8.6% return for the second quarter. Within the US markets, large companies outperformed small companies as the Russell 2000 Index returned 4.3%. International equities overcame a slower recovery and stronger dollar, returning 5.4%. Economic reopening has not been trouble-free, but it has underpinned risk-asset growth.

Throughout much of 2021, the Fed has weighed two policy paths: 1) tighter policy in response to mounting inflationary pressures and accelerating economic improvement; and 2) stay-the-course, easy policy to accommodate gains towards full employment. The Fed chose the latter, weathering a first quarter jump in bond yields, caused by more optimistic economic forecasts. However, as the second quarter unfolded, yields reversed as growth momentum waned and inflation expectations retreated from highs. These yield declines helped fixed income returns rebound in the second quarter as the Bloomberg Barclays Intermediate Aggregate and Bloomberg Barclays 3 Year Municipal indices returned 0.8% and 0.3%, respectively.

What is transitory?

The Federal Reserve has established a benchmark rate of 2% inflation, but until recently has been unable to reach that level. However, with easy money policies and COVID restrictions lifting, economic growth has been significant. Largely as a result of rising demand and subsequent supply chain disruptions, the inflation rate has jumped to almost 4%, twice the Fed target. The question now is whether inflation is still transitory, and likely to come down as fast as it rose, or is it "stickier", and likely to become more engrained?

The recent price of lumber is a classic example of transitory inflation. As the U.S. economy gained momentum, demand for building products soared: lumber rose from $400/ton to over $1,600/ton, before backing off to a price under $800/ton as of the end of the second quarter. Another example: the price for rental cars went from $30/day to more than $130/day due to the limited supply of used cars.

While the increases in lumber and rental car prices appear temporary, the most important driver of sustained price increases is the level of wages. Since wage increases tend to be more persistent, future labor market conditions are key to the economic and inflation outlook. As long as there is “slack” in the labor market, wages are unlikely to increase and push consumer prices upward. However, doing a little back-of-the-envelope calculation, the total US working age population is about 206 million. Given a labor force participation rate of 63%, and an unemployment rate of 6.3%, there are just over 8 million available workers – and 9.3 million job openings! It should be no surprise that wage growth recently hit 4.3%. Additionally, small business hiring plans are surging and more baby boomers are leaving the workforce. Whether or not these conditions are sustainable will have much to do with whether or not inflation is transitory or here to stay.

In summary, the second quarter of 2021 will likely be the peak of economic growth in this cycle, based on the fading impact of stimulus spending. While commodity prices will likely return to more normal levels, a tightening labor market could add some level of persistence to the rate of inflation. Typically, stocks exhibit stronger performance when inflation is falling, unless economic growth is rising faster than inflation. It will be interesting to see.

Our approach is to focus on high quality, cash flow centric investments to achieve our client’s objectives. We strive to utilize diversified portfolios that can thrive in a variety of economic environments, including those characterized by inflation (transitory or not).

We value the confidence that you place in us, and appreciate the opportunity to be of service. Please let us know if you have any questions, or would like to meet to discuss your portfolio in greater detail.

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