Our Perspectives: Inflation Update Mid-Year 2021

This commentary was prepared on May 17, 2021, and reflects our view of events at that time. Please visit our website, homesteadfunds.com, for the latest perspectives.

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Mark is responsible for shaping the strategic vision and directing the business activities of the fund company and its related money management entity, RE Advisers. He oversees portfolio management, operations, client services, marketing and sales. Prior to joining RE Advisers in 2018, he was the CEO at Dreyfus Corporation, a subsidiary of BNY Mellon Investment Management.

He is a graduate of Fordham University, where he received a bachelor's degree in finance. Mark received his MBA in finance from Fordham University's Graduate School of Business.

In this paper we present our thoughts on why we are seeing a spike in inflation and view this as a temporary condition consistent with the economy's getting back on a growth track.

There has been a lot of concern about inflationary pressures and a lot written about the potential for rising interest rates. As we pointed out in our market outlook in January and re-emphasized in March, we expected inflation to uptick in the second and the third quarter in 2021.

We previously stated that inflation might go as high as 2.8% in the second quarter due to quite a few different factors but mainly these three:

- Aggressive vaccine rollout
- Aggressive stimulus spending
- Supply chain backlogs as a result of COVID-19

Although we are experiencing an uptick in inflation in the second quarter as predicted, continuing possibly into the third quarter, we believe this will be short-term. Here are the main factors we note in considering the risk of rampant inflation to be low.

Federal Reserve has had a consistent message.

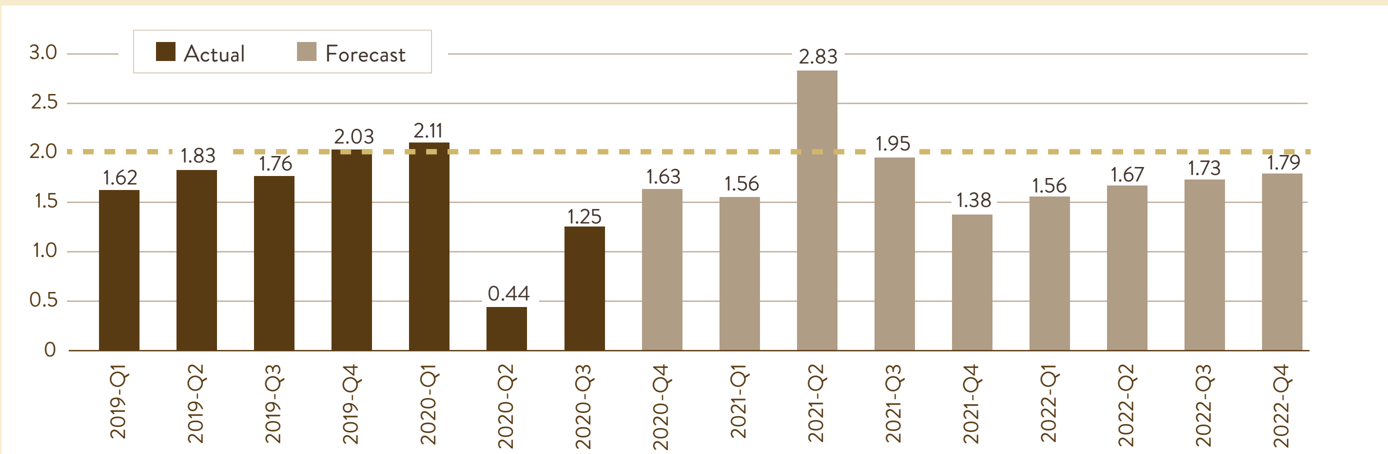
Chairman Powell has stated on numerous occasions that inflation is expected to jump to 2.4%, and the Organisation for Economic Co-operation and Development (OECD) is saying it could go as high as 2.8% in the second quarter of 2021, but emphasizing that this is a temporary 2021 event because of the three factors noted above. Worries that this is a long-term economic trend are minimal because in setting monetary policy the Federal Reserve is also looking to achieve maximum employment. The Fed doesn't view inflation as the sole factor in the adjustment of policy and continues to target a potential move in rates at the end of 2023 when the jobless rate should be back to pre-pandemic levels.

Unemployment remains elevated.

We are not at pre-pandemic levels yet in the economy. Even though unemployment has been dropping nicely and the OECD is forecasting that it could be 6.1% by year end, several sectors of the economy — specifically, the service industry, restaurants, bars, travel industry and small retail businesses — are still reeling as a result of the pandemic, and it's going to take time for those jobs to come back into the market. Perhaps when targeted pandemic unemployment benefits expire in September, we will see more people re-enter the service economy.

Inflation remained below the Federal Reserve's 2% target through Q1 2021. As the pandemic begins to recede, inflation is projected to surpass the 2% target before settling back at or slightly below that level.

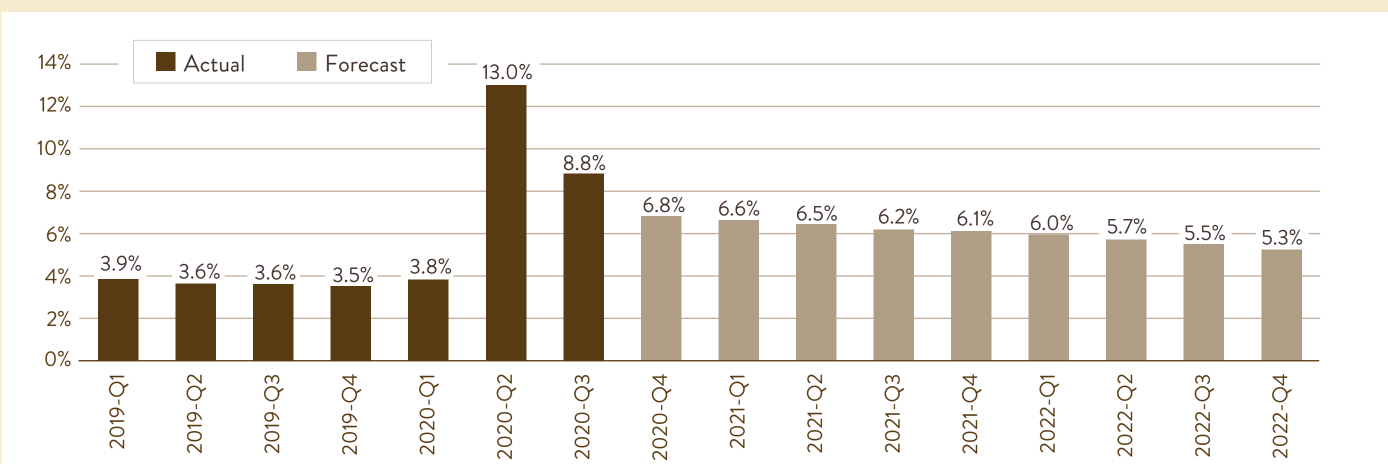
Inflation Rate



Source: The Organisation for Economic Co-operation and Development (2020), Inflation forecast (indicator). doi: 10.1787/598f4aa4-en (Accessed on 17 May 2021.)
There is no guarantee that the forecasted inflation rates are accurate or will be achieved.

The economy is not yet at pre-pandemic levels, even though unemployment has been dropping.

Unemployment Rate (Percentage)



Source: The Organisation for Economic Co-operation and Development (2020), Unemployment rate forecast (indicator). doi: 10.1787/b487f2cf-en (Accessed on 17 May 2021.)
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This is a global response.

The U.S. has been a global leader in rolling out the vaccine and providing much-needed economic stimulus to its economy, but problems still persist in other dependent economies. Those developed countries are several months behind the U.S. efforts and will take time to get to our pace of recovery.

What does it all mean now?

We are experiencing moderate inflation. Prices on certain goods and services have started to creep up due to the supply chain issues, especially for new and existing homes and home repair items where prices have significantly increased. Costs for building materials in 2020 for single-family homes averaged $10,000 (i.e., lumber, wiring, PVC piping, etc.) and are now in excess of $25,000. It's almost two-and-a-half times what they were a year ago due to the COVID-19 era manufacturing slowdown. This, coupled with pent-up demand and interest rates still at attractive levels, has caused the recent surge in all aspects of the housing market, which has added to the inflation fears.

Is there cause for concern?

The good news is small businesses are now starting to open as a result of vaccine rollout, the 2021 stimulus support, supply chain bottleneck easing and warmer weather! These factors are what's causing a short-term rise in prices but are not predicating a move by the Federal Reserve to increase short-term rates, which given their direction, which we believe will quell inflationary fears for the next several quarters into 2023.

Interested in speaking with one of our associates about your long-term investment plan? Call us at 800.258.3030, option 2.

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