WELLS FARGO
Investment Institute

FIRST ANALYSIS
Institute Alert

News or events that may affect your investments

November 15, 2021

Paul Christopher, CFA
Head of Global Market Strategy

Scott Wren
Senior Global Market Strategist

Managing portfolios before inflation peaks

Key takeaways

- We believe inflation will moderate in 2022, but we expect the path to lower inflation to begin with higher inflation in the front half of the year.
- The stickier drivers of inflation are likely to persist, but our base case is that they will not outweigh the improvement we expect in the transitory elements.

What it may mean for investors

- As long as the economy remains strong, the asset classes that we expect to outperform are those factors that drive both the economy and inflation. Our guidance aligns with favoring those sectors that we expect to outperform — and to avoid those that we expect to underperform — as inflation rises.

The U.S. Consumer Price Inflation report for October showed a 6.2% gain from October 2020 and was broad-based across categories according to the U.S. Bureau of Labor Statistics. Index components for food, energy, shelter, and used and new cars and trucks were major contributors to the rise.

We believe inflation is one of the most prominent risks to portfolios today, and questions about inflation frequently ask whether it is temporary or persistent. We do not view the question as either-or, but as parts of both. Some factors likely are temporary while others may be stickier.

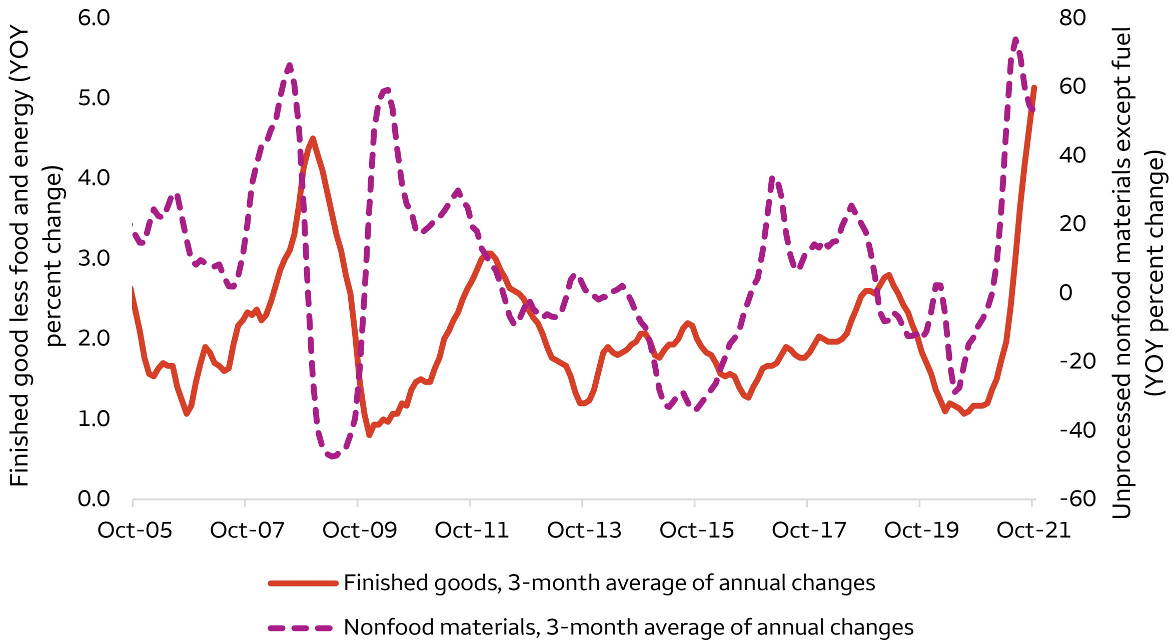
There are transitory elements. Strong demand for food, energy and automobiles has aggravated global supply disruptions. Whether the result of policies in China (to cut coal usage), factory closures that limited microchips for automobiles and electronics, limited OPEC[1] oil supply, or transportation bottlenecks at home and overseas, the supply of goods has trailed demand and aggravated inflation. Most consumers are painfully aware that automobiles, gasoline, and dinner out are dramatically more expensive and may be difficult to find.

[1] Organization of the Petroleum Exporting Countries.

These categories account for most of the gain in inflation, but they could see more balanced supply and demand conditions by the middle of next year. Demand is set to cool. Federal COVID-19 payments dried up in mid-2021, and households are increasingly likely to run down savings while the prices of food and fuel outpace wage growth. Finally, we believe the slowing in COVID-19 infection rates will hasten the rebalancing into services spending in 2022, thereby easing some of the strength in demand for goods.

From the suppliers' side, factories in Asia are reopening and some transportation costs are peaking.[2] Raw materials prices also are important because their changes have tended to predict consumer inflation 12 months ahead (Chart 1). Lumber, copper, and soybean prices, for example, are significantly lower than they were earlier in the year and holding. If the broad trend continues, we expect consumer inflation to slow somewhat by midyear and materially by year-end 2022.

Chart 1. Inflation in producer raw materials leads inflation in producer finished goods



Sources: Bureau of Labor Statistics and Wells Fargo Investment Institute. Monthly data, October 2005–October 2021. Data shows seasonally adjusted, 12-month percentage changes, smoothed with a three-month moving average to show turning points more clearly. YOY = year-over-year.

Price gains in wages and rents may be more persistent, although this is not our outlook. If workers and landlords can continue to drive their prices higher, the spillover to the rest of the economy could become self-perpetuating and a more serious threat to equity and fixed-income prices. However, the growth in housing prices appears to be peaking, and we expect that to slow rent gains.[3]

We expect wage growth to finally peak as workers return in larger numbers to the work force. Two-thirds of the roughly 10 million open jobs in the U.S. are in relatively low-wage services sectors: retail trade, hospitality and leisure, and health care and education. We believe that today's higher wages and consumer prices will accelerate the reentry of workers into these industries. Labor force participation rates are rising slowly among workers aged 16–54.

[2] According to Bloomberg (November 12, 2021), international dry freight costs appeared to peak in October, and the U.S. cost of transporting grain by truck or barge also peaked in the past two months.
[3] The S&P CoreLogic Case-Shiller 20-City Index of U.S. single-family housing prices appeared to peak in July, according to Bloomberg. We expect the impact on rents to follow.

Our fundamental conviction is that pricing pressures will ease before they drive expectations and become self-perpetuating. That happened in the 1970s, but today is different in important ways. During that earlier era, worker efficiency suffered because businesses lacked technologies to cope with higher commodity prices. Factories closed and corporate earnings struggled while commodity prices drove production costs and expectations for even more inflation. Today, energy prices are rising, but businesses are adding new technologies that increase production capacity to blunt the impact of higher material costs and the labor shortage. We expect profit margins to hold and for corporate earnings to rise with economic output in 2022.

Investment implications

For investors with a primarily long-term investment focus, we believe that trends such as technological change, an aging workforce, and shorter global supply chains will exert downward pressure on production costs. We do not believe that inflation is a long-term issue and favor staying with strategic allocations.

Over a shorter, tactical investment horizon, our preference to position allocations for above-average economic growth also aligns with our view of how best to position the portfolio for above-average inflation. We expect Commodities and cyclical equity sectors (for example, Industrials and Financials) to outperform with growth and inflation near a peak. The sectors we prefer to avoid tactically are those that we expect to underperform under a strong economy, rising interest rates, and inflation that has not yet peaked. One important example is long-term fixed income. We also have an unfavorable rating on short-term fixed income while investors price an eventual Federal Reserve response to inflation.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability or best interest analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon. The material contained herein has been prepared from sources and data we believe to be reliable but we make no guarantee to its accuracy or completeness.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. CAR 1121-02871