CITY NATIONAL ROCHDALE
AN RBC/CITY NATIONAL COMPANY

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On the Radar

FAQS ON THE MARKETS AND ECONOMY

Should equity investors be concerned about inflation?

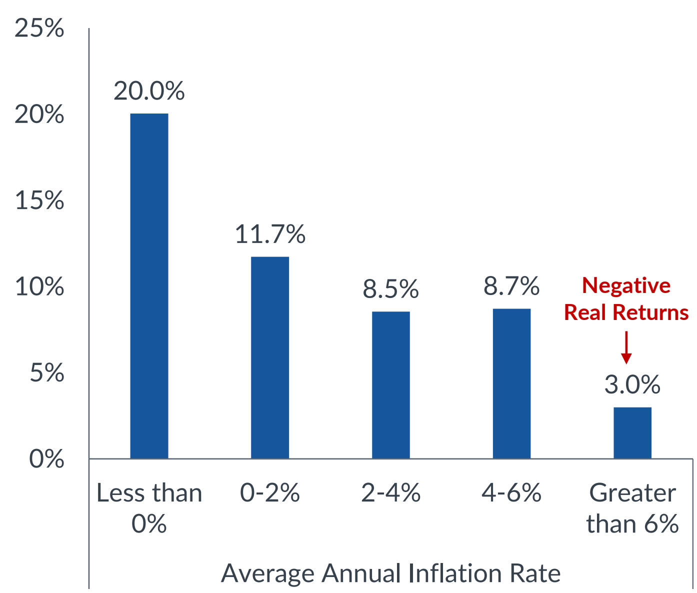
Rising inflation should not be disregarded as a risk for investors. It can erode the value of real investment returns, and too much can spell trouble for equities if it results in higher interest rates and slower economic growth. Still, current market jitters look overblown to us and we think it is unlikely to prove a long-term headwind for stock prices.

Going forward, the question is not whether inflation pressures will firm, but whether the pick-up will be persistent or temporary. We suspect it will be more of the latter. Inflation is currently gaining momentum due to "base effects" from pandemic-depressed prices last year, as well as temporary supply/demand imbalances from the reopening of economic activity that will likely take some time to work out.

A number of factors that have conspired to keep inflation low over the past decade should also help contain a rise in the coming months. Many of these disinflationary forces – globalization, demographics, technology adoption, etc. – are structural in nature, and a sharp recovery from the COVID-19 crisis will not change this.

Historically, equity markets have done well despite rising inflation, especially when emerging from low levels. That's because companies can pass on higher costs to customers and preserve profits. In fact, a bit of inflation greases the wheels of commerce and tends to be associated with a healthy economy and growing corporate earnings.

Average Annual S&P 500 Returns
(1950-2020)



Source: Source: St. Louis Fed, Shiller.

Despite all this, inflation concerns are likely to remain in the near term, and investors should brace for potential headline-driven spikes in volatility. While a sharply improving corporate profit outlook supports further gains ahead, a lot of good news has been priced into the current rally, and even small catalysts can extend a period of market consolidation.

KEY QUESTIONS

Is the consumer still spending a lot of money this year?

Is the housing sector still a driving force of this recovery?

Will the Fed begin tapering their asset purchases soon?

Is the consumer still spending a lot of money this year?

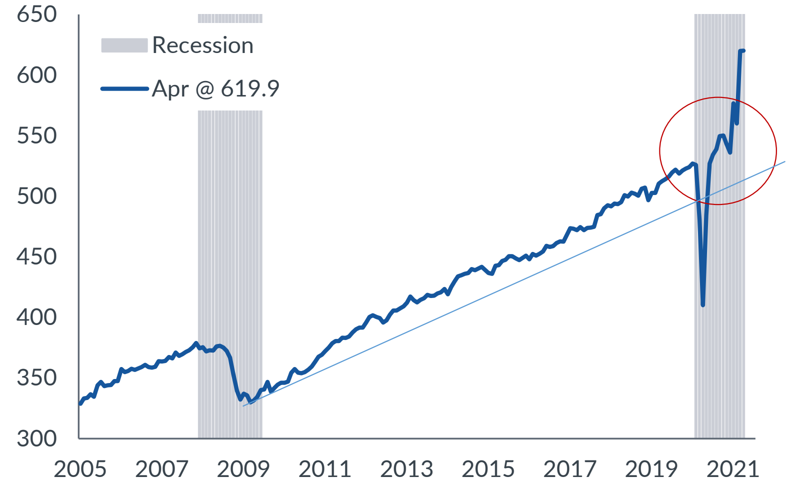
Although retail sales had no growth in April, that is not surprising nor concerning. Consumers have taken a breather following March's unsustainable increase of 10.7%. In the past three months, the growth rate has been 33.7% (annual rate). That is a significant number; the long-term annual growth rate before the pandemic set in was 4.3%.

On a percentage change, there was no gain, but in absolute dollar terms, retail sales remain at very elevated levels, well above long-term trends (chart). Consumers remain flush with cash from the stimulus checks; the most recent check was for $1,400 and was paid in March. Over the past year, with three checks being sent to most households, there has always been the same month surge in retail sales.

For the next few months, we anticipate the pace of retail sales to stabilize and grow at sustainable levels. It will be aided by a growing economy that continues to re-open.

Retail Sales

monthly value, seasonally adjusted, $, billions



Source: U.S. Census Bureau as of April 2021.

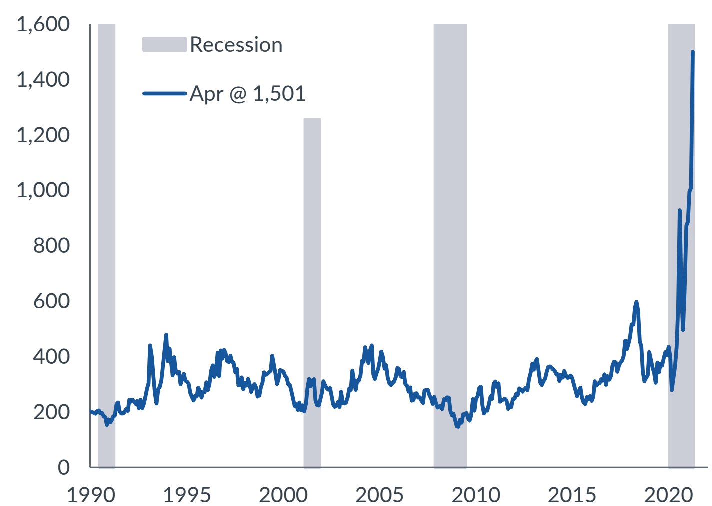
Is the housing sector still a driving force of this recovery?

The housing sector is still strong but faces many of the same supply/demand imbalances found in the rest of the economy.

Builders are having difficulty getting ahold of the basic components for building a home: lumber, steel, copper, and many appliances. These shortages are so extreme that lumber prices have more than tripled in price since the pandemic started (chart). Not only are prices high, but some shortages are preventing the completion of homes. There is also the problem of finding skilled labor. Housing demand has been muted for more than a decade, and there are not enough experienced craftsmen.

The housing fundamentals remain strong. There has been a generational shift to homeownership, brought on by the pandemic. It is supported by low mortgage rates, a strengthening economy, and healthy balance sheets of home buyers.

Lumber: Random Length Futures (Px)



Source: Chicago Mercantile Exchange as of April 2021.

Will the Fed begin tapering their asset purchases soon?

For about a year, the Fed has been purchasing Treasury and mortgage bonds to help keep longer-term interest rates low. Their purchases amount to $120 billion per month (chart).

In the minutes of the April FOMC meeting that were just released, a few members suggested that if the economy continues to make rapid progress, it might be appropriate at some point to begin discussing a plan to reduce the amount of assets the Fed purchases.

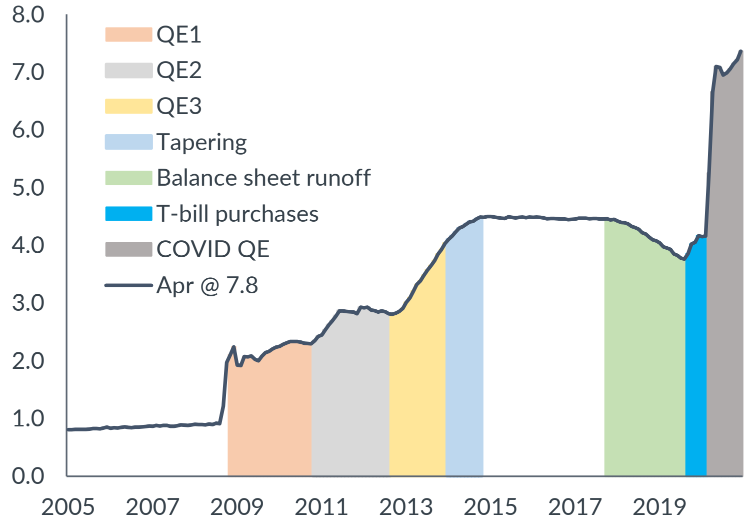
It is important to note that "a few members" is different than "Fed leadership." At the press conference following that April meeting, Fed Chair Powell made it very clear that it was premature to start talking about tapering the asset purchases.

Since that meeting, other senior policymakers have echoed Powell's comments.

We think it boils down to this: some members of the FOMC want to start talking about reduced asset purchases, but senior leadership does not. As a result, it will probably be several months before the Fed seriously considers a plan for reducing asset purchases, which will probably not start until next year.

Fed Balance Sheet

$, trillions



Source: Federal Reserve as of April 2021.

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