Inflation Surges but the Fed Doesn't Flinch

"For skeptics who have yet to take the Federal Reserve at its word, its response to recent inflation data should be another indicator that policymakers are in no hurry to deviate from their path of easy monetary policy."

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All Eyes Remain on Inflation: What We Said Last Quarter

- Monitoring inflation risk requires context for the uniqueness of the economic environment created by the measures to contain the spread of COVID-19. Inflation will play out differently across different industries just as labor participation and wage trends will play out differently across states
- **The punchline**: The change in the Fed's framework for targeting inflation would lead to higher "cyclical" inflation, but the pickup in near-term inflation will not cause the Fed to deviate from its accommodative policy stance sooner than expected

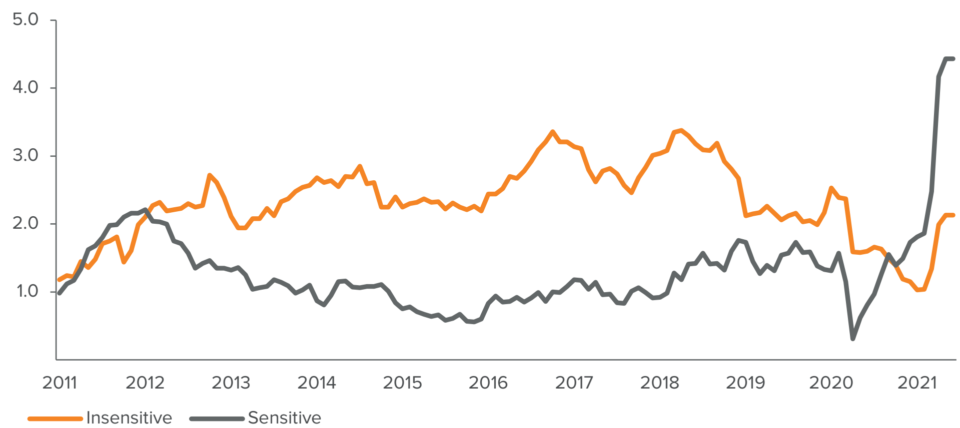
What We Think about Inflation Now (Spoiler Alert: the Punchline Has Not Changed)

- Recall that under the Fed's new inflation targeting approach, after periods of persistently low inflation, the Fed said it would tolerate inflation moderately above 2% "for some time," to allow the economy to solidify a recovery
- Consumer prices increased 5.4% in June and the Fed did not blink. For skeptics who have yet to take the Fed at its word, this response to June inflation should be another indicator that policymakers are in no hurry to deviate from their path of easy monetary policy

What to Watch: Labor Force Participation and Wage Trends

To fully understand and prepare for the potential risk of inflation, we believe it is essential to disentangle price increases caused by the reopening of the economy from the more structural price increases that are part of a new business cycle. In our view, to do this, it is essential to assess trends outside the industries most heavily affected by the pandemic (Figure 1).

Figure 1. Two Tales of Inflation: Covid Sensitive and Covid Insensitive



Source: Bureau of Labor and Statistics, Federal Reserve and Voya Investment Management. Sensitive and insensitive Covid inflation as measured by the U.S. Federal Reserve of San Francisco Covid Sensitive/Insensitive Core PCE Contribution.

As Figure 1 shows, industries that have experienced a greater impact due to Covid also have experienced significantly higher inflation. The surge in Covid sensitive inflation is being driven primarily by supply constraints and a rapid reversion to pre-Covid price levels and trends. The Fed is willing to look through these influences. Evidence of structurally sticky inflation in areas such as housing would be more concerning to the Fed, along with a reinvigoration of feedback loops between wage growth and inflation.

The Fed appears to be acknowledging that pre-pandemic levels of employment may be challenging to attain given an accumulation of structural friction that has developed, i.e., skill set mismatches; and a gradual shift in prevailing attitudes for certain lines of work — notably in the leisure and hospitality sector, where many former workers have chosen not to return to their pre-pandemic jobs.

While there has been higher nominal wage growth across all industries in the private sector on a year-over-year basis, there also has been dispersion. For example, the leisure and hospitality sector currently is experiencing more than 7% YoY wage growth (Figure 2). Much of that growth has been driven by recent months, during which the shortage of workers — coupled with a surge in demand — has led to higher wages. The impact of this industry on the headline number is illustrated by the last row of Figure 2, which excludes leisure and hospitality from the private sector total.

Figure 2. Wage Growth is High across the Board but Highest in Covid-Sensitive Industries

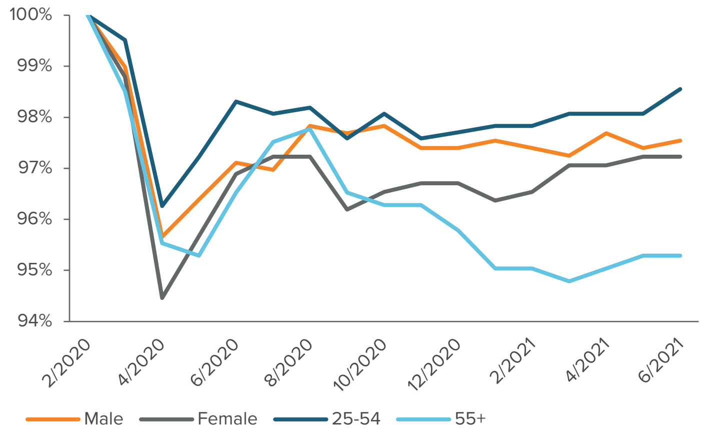
U.S. Wage Growth Dashboard, Monthly YoY Statistics

Industry	Weight	21-Apr	21-May	21-Jun
Private Sector	**100%**	**0.3%**	**1.9%**	**3.6%**
Goods-Producing	16%	1.5%	2.4%	3.5%
Mining and Logging	1%	0.7%	0.2%	0.2%
Construction	6%	3.9%	4.0%	3.9%
Manufacturing	10%	0.2%	1.6%	3.6%
Service-Providing	84%	0.0%	1.8%	3.6%
Trade, Transportation and Utilities	22%	1.6%	3.4%	5.5%
Information	2%	1.4%	1.6%	2.3%
Financial Activities	7%	6.6%	6.2%	5.9%
Professional and Business Services	17%	0.9%	2.6%	3.6%
Education and Health Services	19%	3.9%	3.3%	3.6%
Leisure and Hospitality	12%	-0.8%	3.5%	7.1%
Other Services	5%	-2.9%	-1.0%	1.4%
Private Sector ex-Leisure and Hospitality	**88%**	**0.5%**	**1.7%**	**3.1%**

Source: Bureau of Labor Statistics; **Blue** = positive and rising, **Orange** = positive and falling.

Figure 3 illustrates gender and age factors affecting the labor participation rate. Most notable is the sharp decline in participation among those over the age of 55, primarily due to retirements. The graph also shows that women are not returning to the workforce as quickly as men; though not illustrated here, this is particularly true for women with young children, who face challenges with kids out of school and access to day care.

Figure 3. Labor Participation Rate: % Change vs. February 2020

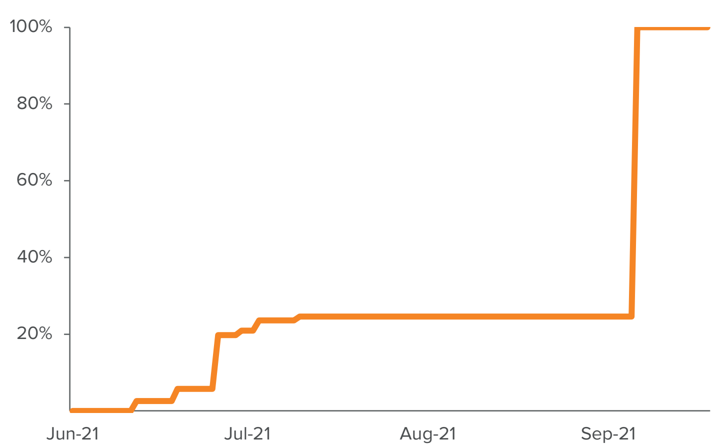


Source: Bureau of Labor Statistics, Federal Reserve and Voya Investment Management. Labor participation % as calculated by the percentage change from the labor participation rate, by cohort, from February 2020.

The Fed is clearly looking for substantial progress in returning the economy to full employment. Progress on the return to full employment can be assessed based on a recovery of the jobs lost and a move back down in various unemployment rate measures towards pre-pandemic levels. A key requirement for this to happen is that labor participation rates need to rebound. If they do not, then the economy could hit full employment earlier than the Fed expects with negative implications for inflation.

In addition to labor force participation and wages, we are closely monitoring unemployment benefits, which are expiring on different schedules across each state (Figure 4). While a decline in excess personal income from the winding-down stimulus is inevitable, we expect an increase in job gains to follow the expiration of these benefits. With this more nuanced perspective, we believe we will be able to better assess the full scope of the inflation threat, and have a better understanding of how wage and labor participation trends are likely to play out over the next several months.

Figure 4. Percent of Workers Seeing End of Enhanced Unemployment Benefits



Source: Bureau of Labor Statistics, Federal Reserve and Voya Investment Management.

Portfolio Positioning

Although a pickup of inflation is usually a late cycle phenomenon, we think we are in the early middle innings of what will become a prolonged phase of growth. Our confidence is largely based on the view that the Fed can control average price level swelling and successfully reduce monetary accommodation when needed, without triggering a deflationary tailspin or market panic — events that have in past cycles plagued several developed market countries as they attempted to exit recession.

Positive growth is one important ingredient in the stock return forecast equation. As we have seen over the last year, expectations and sentiment — both of which seem stretched — are also crucial. Recognizing that high valuations leave a thin margin for error, we still think the supportive macro backdrop and substantial pent-up demand will propel better than expected company bottom lines and keep the bull market running. Therefore, our long-held equity overweight is intact. From a market-capitalization perspective, we think it's time to rotate away from small caps, which we think could continue to be held back by labor availability and are vulnerable to potential tax increases. Instead, we prefer to gain exposure to cyclically sensitive assets with mid-cap equities. From a style perspective, we continue to believe that value can help diversify portfolios in the current environment, as value has historically outperformed in periods when real rates came off their lows and inflation was expected to pick up.

In fixed income, given our generally risk-on posture and expectation for moderate increases of inflation and interest rates, we still prefer credit over duration and high yield over investment grade.

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