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2021 MIDYEAR OUTLOOK

Inflation: Transitory or Here to Stay?

At-a-Glance

Developed economies continue to ride stimulus tailwinds as vaccine distribution peaks.

Inflationary pressures are building, but central banks are largely dismissing above-trend inflation as temporary.

Stock and bond investors seem to agree with central banks and see temporary inflation as a possible benefit for companies to raise profit margins and reduce debt on an inflation-adjusted basis.

Stocks and bonds both seem relatively expensive, but possibly justified by the good economic backdrop.

Volatility could pick up in the second half of the year as investors continue to assess risks, mainly rising inflation.

We continue to recommend diversifying across and within asset classes, along with a focus on long-term objectives and not getting caught up in day-to-day fluctuations and noise.

The economic recovery continues to forge ahead on a path similar to what we described in our annual Outlook late last year. Fueled by government stimulus and low interest rates, the recovery is gaining steam with many local economies fully opening as a result of vaccine distribution efforts. This past quarter may mark the peak in the rate of economic growth for this expansion, apart from the extraordinary bounce-back in the third quarter of last year.

With the economic recovery in full gear, inflation risks are rising. In our second-quarter Outlook, we considered the prospects of higher price levels and now we are seeing this firsthand. Inflation measures are heating up and the question is whether these price pressures will be temporary or more sustained. The U.S. Federal Reserve (the Fed) insists that it expects the effect will be temporary, and it may be. They don't want to slow the recovery prematurely by overreacting to inflation that is temporary and could just be taking a wait-and-see approach.

Equity investors seem to agree with the Fed. Stock indices continue to hit all-time highs and have lofty valuations on top of high earnings expectations. Inflation fears occasionally seem to bubble up for a trading day or two but subside quickly. Consumers have saved money and are looking to spend it, and businesses need to build inventories, both of which support optimism among stock investors.

Inflation increases generally hit bond investors first, and these concerns seemed to be on bondholders' minds as they demanded higher yields for much of this year. That has started to reverse recently, as bond investors seem to agree with equity investors and the Fed that inflation may not run that hot after all. A moderate amount of inflation would be welcome news for corporations looking to raise prices and profit margins and erode some of their debt on an inflation-adjusted basis. As such, corporate bonds are trading at low yields over Treasury bonds right now, so compensation for taking on additional credit risk may be justifiably low.

Overall, 2021 is progressing as many expected. We won't know if inflation will be temporary or longer-term until after the fact, but we will be watching it closely, especially wage inflation, which has started to pick up. We think there will be more volatility in both equity and bond markets in the second half of this year as market participants weigh inflation risks, high equity valuations, and low bond yields.

We continue to recommend being diversified across asset classes, sectors and countries and adhering to long-term risk and return objectives. We remain cautiously optimistic, but risks are increasing and therefore we are more balanced in our outlook. Your financial professional can help you stay on track and keep your sights on your long-term plans.

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Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

The Russell 1000 index is a stock market index that tracks the top 1,000 stocks by market capitalization in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index. The index, which was launched on January 1, 1984, is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

The Russell 1000 Growth index is a subset of the Russell 1000 as measured by three factors: sales growth, the ratio of earnings change to price, and momentum.

The Russell 1000 Value index is a subset of the Russell 1000 as measured by three factors: the ratios of book value, earnings, and sales to price.