Comments from Joe Terranova, Chief Market Strategist, Virtus Investment Partners
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"In 2021, dispersion prevails in the equity market. The only sector that I would overweight is diversification. Investors should own all the sectors."
– Joe Terranova

Defining "transitory" inflation – and protecting against it

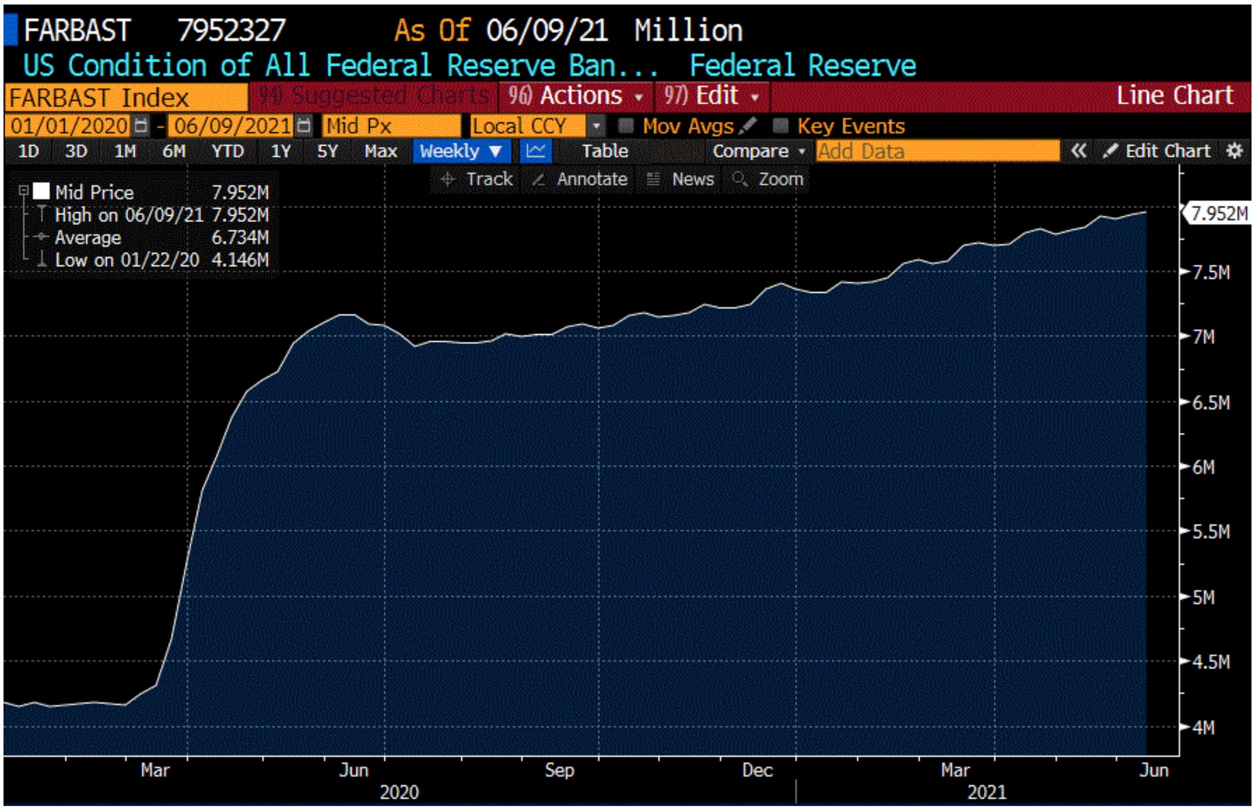
- Lately, we've heard a lot about transitory inflation. But the word "transitory" means different things in different contexts. It has a much looser definition for the markets than it does for day-to-day life. In fact, the word gives us no clue about how long inflation might last.
- What is clear is that we're seeing reflationary recoveries within the economy, and they are sharpening the perception of inflation.
- With some degree of inflation occurring, it makes sense for investors to continue allocating about 10% of their portfolios to assets that offer some inflation protection.
- A basket of inflation protection vehicles could include:
  - Base metals, particularly copper, which is critical for the storage and transmission of electricity in vehicles and power generation
  - Oil and gas companies with strong balance sheets and which can take advantage of distressed assets during a looming and unavoidable consolidation phase
  - Private equity funds that offer position flexibility – an alternative investment solution to replace the underperformance of hedge funds
  - Domestic or global real estate investment trusts (REITs). In the second quarter of 2021, REITs are the leading sector in the S&P 500® Index – up more than 14% as of June 15[1]
  - Senior floating rate notes or bank loans
  - Traditional precious metals such as gold, silver, platinum, or palladium.
- But ultimately, equities provide the best protection in a perceived inflationary environment — certainly more optimal than cash holdings that are depreciating in value.

The Fed will determine whether inflation is transitory or persistent

- The balance sheet of the Federal Reserve (the Fed) continues to grow as the central bank provides abundant liquidity to the economy.
- The Fed's balance sheet reached an all-time high of $7.95 trillion on June 9, 2021, up 8% from the start of the year. Pre-pandemic, the Fed only had about $4.1 trillion on its balance sheet.
- At this point, they are not even talking about reducing liquidity or normalizing rates.
- Ultimately, the Fed will share a timeline for tapering its asset purchases, but investors shouldn't be adjusting their portfolios ahead of understanding that timeline.

[1] Source: Bloomberg. **Past performance is not indicative of future results.**

- The Fed is currently buying $120 billion of assets each month. Even if they announce that they plan to taper purchases by $10 billion, or $25 billion per month, they will still be buying assets, just not at the same level.
- Investors should take the Fed at their word that they are maintaining a highly accommodative policy for the time being.



Source: Bloomberg. **Past performance is not indicative of future results.**

The Fed is keeping an eye on fiscal conditions and employment numbers

- As the Fed tries to decide whether inflation is transitory or persistent, they are watching fiscal conditions and employment numbers.
- We're seeing fiscal tightening in China, one of the world's largest economies.
- As China reduces liquidity to dampen excessive speculation, there has been a bit of a pullback in commodity prices.
- In the U.S., the Fed is waiting to see what will happen in Congress with President Biden's proposed tax increases.
- Whether the new legislation raises corporate, individual, or capital gains taxes – or a combination of all three – the hikes will be tightening in nature, and will contract potential economic growth.
- In determining how to respond, the Fed has a recent example to study: the period from 2017 to 2018.

- During 2017, the Trump administration fostered a pro-business environment, with lower corporate and personal tax rates. This positively impacted economic growth, encouraging the Fed to remove some of the liquidity by reducing the size of its balance sheet.
- But the administration then imposed tariffs, which slowed growth, and the Fed didn't react quickly enough to pause the removal of liquidity. That experience suggests the Fed will first gauge the impact of potential tax increases on the economy before aggressively removing some or all of the abundant liquidity.

An incomplete job recovery is keeping the Fed on hold

- The steep job losses during the pandemic were followed by an initially strong V-shaped recovery, but that recovery has slowed.
  - From March to April of 2020, the U.S. economy lost 21.5 million jobs
  - From May through August 2020, we recovered about 10.6 million jobs
  - From September through December 2020, 1.39 million more jobs were recovered
  - From January through May 2021, there was a gain of 2.24 million jobs
- The bottom line: For the nine months through May of 2021, the economy recovered only 3.63 million jobs.
- We are still short 7.27 million jobs from the losses during the pandemic – a third of the jobs have yet to be recovered.
- The Fed is observing that, and is likely to remain highly accommodative until the economy approaches full employment.

NFP TCH 559k For May Next Release 02 Jul 08:30 Survey 750k
US Employees on Nonfarm Payrolls Total ... Bureau of Labor Statistics

NFP TCH Index | Export | Settings | Page 1/7 Historical Price Table

US Employees on Nonfarm Payrolls Total MoM Net Change SA

Range	06/30/2001 - 05/31/2021	Period	Monthly	High	4,846 on	06/30/20
Market	Last Price / First Revision	Currency		Low	-20,679 on	04/30/20
View	Price Table			Average	52	54
				Net Chg	673	590.35%

Date	Last Price	First Rev...	Date	Last Price	First Rev...	Date	Last Price	First Rev...
12/31/21			12/31/20	-306	-227	12/31/19	161	147
11/30/21			11/30/20	264	336	11/30/19	234	256
10/31/21			10/31/20	680	610	10/31/19	195	156
09/30/21			09/30/20	716	672	09/30/19	221	180
08/31/21			08/31/20	1,583	1,489	08/31/19	195	168
07/31/21			07/31/20	1,726	1,734	07/31/19	193	159
06/30/21			06/30/20 H	4,846	4,791	06/30/19	175	193
05/31/21	559		05/31/20	2,833	2,699	05/31/19	63	72
04/30/21	278	278	04/30/20 L	-20,679	-20,687	04/30/19	219	224
03/31/21	785	770	03/31/20	-1,683	-870	03/31/19	168	189
02/28/21	536	468	02/29/20	289	275	02/28/19	-50	33
01/31/21	233	166	01/31/20	315	273	01/31/19	237	311

Source: Bloomberg. **Past performance is not indicative of future results.**

It's too soon to make a prediction about inflation

- The fiscal situation and the labor market are the two conditions that must be monitored in order for the Fed to decide how to proceed.
- While "transitory" means "very short term" in the real world, it can't be defined in the capital markets until we know the outcome of the taxation legislation, and until we know whether we'll be able to recover those missing jobs.
- Unfortunately, there is a chance that those jobs are never coming back. The U.S. remains an intangible asset economy that values the algorithm, the artificial intelligence, and the software program more than it values the machinery, the automobile, or the airplane.
- That could hollow out the job force and make those losses permanent.
- Until transitory is defined within the capital markets, investors should remain invested in a fully diversified manner, with a small portfolio allocation toward inflation protection, whether the threat of inflation is perceived or real.