Stephens
Investment Management Group®

The following contains a brief discussion from the Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane.

SIMG Thoughts on Inflation
Part 2

First, a disclosure: We are bottom-up managers. We pick stocks one at a time, based on the merits of that company's fundamental, secular growth outlook. That being said, we spend a fair amount of time and energy thinking about macroeconomic issues as well. Since the Great Financial Crisis, policy makers have been intervening in a powerful way. To be dismissive of the implications and risks of these policies would be foolish. The level of intervention and policy-driven change in 2008 and 2009 pale in comparison to what we are seeing today.

Our top-down analysis isn't so much a prediction as it is an effort to delineate the possible outcomes that stem from these policy decisions and market conditions. We want to be prepared for disruption and change that might result.

In early February 2020, we prepared for the potential for a global pandemic – not trying to predict it, but becoming aware of the possibility, working through the economic and business implications, and then preparing a plan of action in the portfolio should a pandemic ensue. This effort proved to be immensely valuable to our clients.

I have been vocal on my thoughts on inflation risks and potential policy errors on behalf of the Federal Reserve and the recent fiscal stimulus. This is our greatest macro-related concern now.

A second disclosure: My goal is to examine the market and economic implications of policy, certainly not to weigh in on the politics themselves.

Economic analysis, at some point, depends upon defining and making assumptions about preferences. It is important to understand *incentives* in any economic system, as incentives can materially impact preferences. It's straightforward to understand how supply curves are normally upward sloping, and demand curve downward, and that changes in prices move people along those curves. It's clear that subsidies can incentivize people or firms to do more of something, and taxes can incentivize them to do less of a thing. Given the topsy-turvy world we live in today, we should be asking ourselves: what are current policies incentivizing people and firms to do, or not do?

At the beginning of the COVID crisis, Congress moved swiftly to temporarily expand unemployment insurance benefits, upping the amount by $600 per week. As those extra benefits expired, an executive order extended them, and new legislation furthered that again, committing to distribute extra benefits through September 2021. Over that same time, the burden of filing a claim essentially evaporated. States went to online filing systems, and didn't require those filing to prove they were seeking work.

Many people have been making more money on unemployment than they did in their prior jobs. You don't need to be an economist to understand how that preference evolved. For some people, there is a strong economic incentive **not** to work. Obviously, this added incentive won't change everyone's decision to work or not, but on the margin, some will opt out of the job market and accept the unemployment benefits until they expire.

Why does this matter?

With the economy reopening and recovering from COVID-induced recession, pent-up demand is being unlocked. Many consumers are craving a return to normalcy – dining out, traveling, attending a sporting event or concert, and the like. GDP has re-accelerated to 6.4%. Consumer confidence has sharply rebounded. Despite the recession, many consumers have money to spend, in part from expanded unemployment benefits, but also because of other programs like PPP and stimulus checks.

So demand is here, but what about supply? You've probably heard about supply-chain disruptions, very lean inventory levels, and shortages of raw materials or key components. It is clear that we are in a supply-constrained environment. What's unclear is just how long this will last. Can markets ramp up quickly enough to meet demand? If you solve for the equilibrium in a scenario with more demand and less supply, you get higher prices.

We've already seen evidence of this, and the pace of rising prices hasn't slowed since we last wrote on the subject. In this piece, I'd like to stay focused on labor markets. Why? Because many economists, and most importantly, the Federal Reserve has acknowledged that while we will probably see some inflation, they won't become concerned or change their policies until they see inflation in labor markets.

In fact, Chair Powell just spoke on this subject on April 28:

> You know, it may well be—it seems quite likely that a number of the people who had those service sector jobs will struggle to find the same job and may need time to find work and get back to the working life they had. These were people who were working in February of 2020. They clearly want to work. Those people are going to need—they're going to need help.
>
> And so while I would say we haven't seen really highly elevated levels of unemployment for—you know, up in the teens that we thought we might have for an extended period of time, we've still got a lot of people who are out of work. We want to get them back to work as quickly as possible. And that's really one of the things we're trying to achieve with our policy.

Later in the Q&A session, he had a slightly different message:

> So, but clearly there's something going on out there as many companies are reporting labor shortages. We don't see wages moving up yet, and presumably we would see that in a real—you know, in a really tight labor market. And we may well start to see that.

And finally:

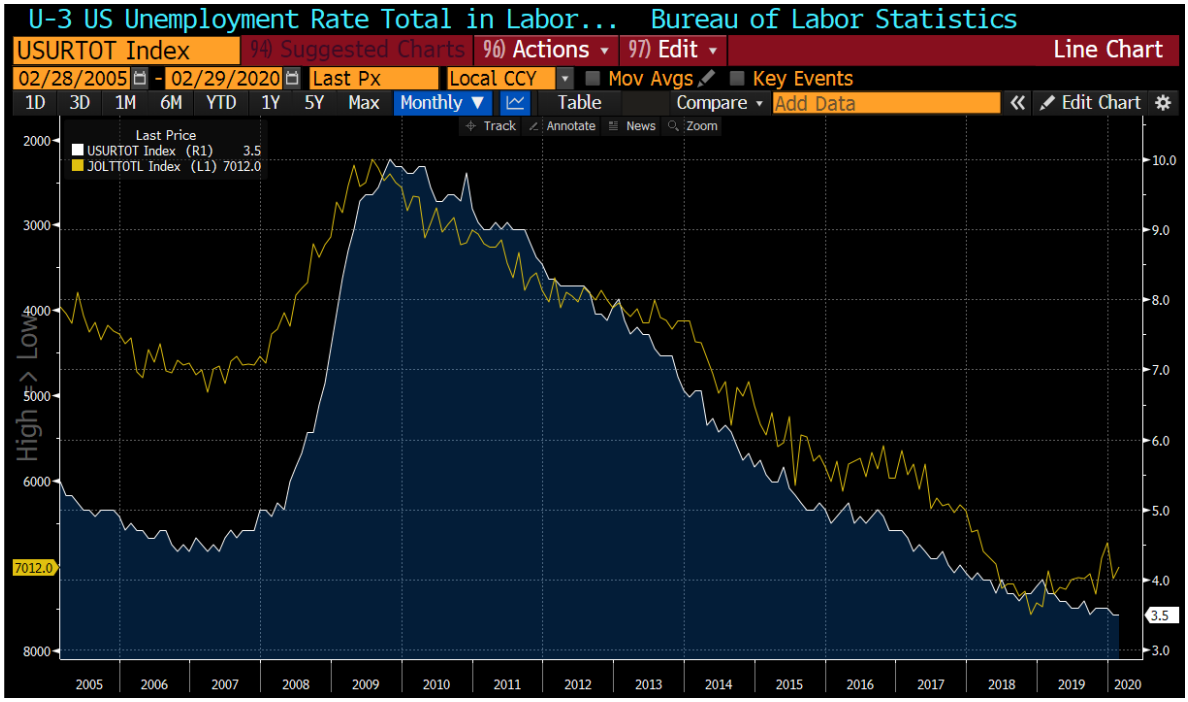
> But I do think that—and I do think also that unemployment insurance benefits will run out in September. So to the extent that's a factor, which is not clear, it will no longer be a factor fairly soon. My guess is it will come back to this economy where we have, you know, equilibrium between labor supply and demand. It may take some months, though.

I respectfully disagree with Chair Powell on this point. I think unemployment insurance benefits are a huge factor, and it is clear.

The Bureau of Labor Statistics publishes a data series called JOLTS (Job Opening and Labor Turnover Survey). The BLS surveys companies and collects data on how many active job openings they have. It is considered a reliable gauge of the demand for workers.

It turns out that the JOLTS data is highly correlated with the unemployment rate. In fact, the correlation between these two data sets is one of the highest I've ever seen. The 10-year period prior to COVID reveals an r^2 of 0.95! Going back to 2005, so that we capture the volatility of the GFC, the relationship remains intact and has an r^2 of 0.72.

Here's what the two series look like. (Note, that I've inverted the scale on the JOLTS data.)

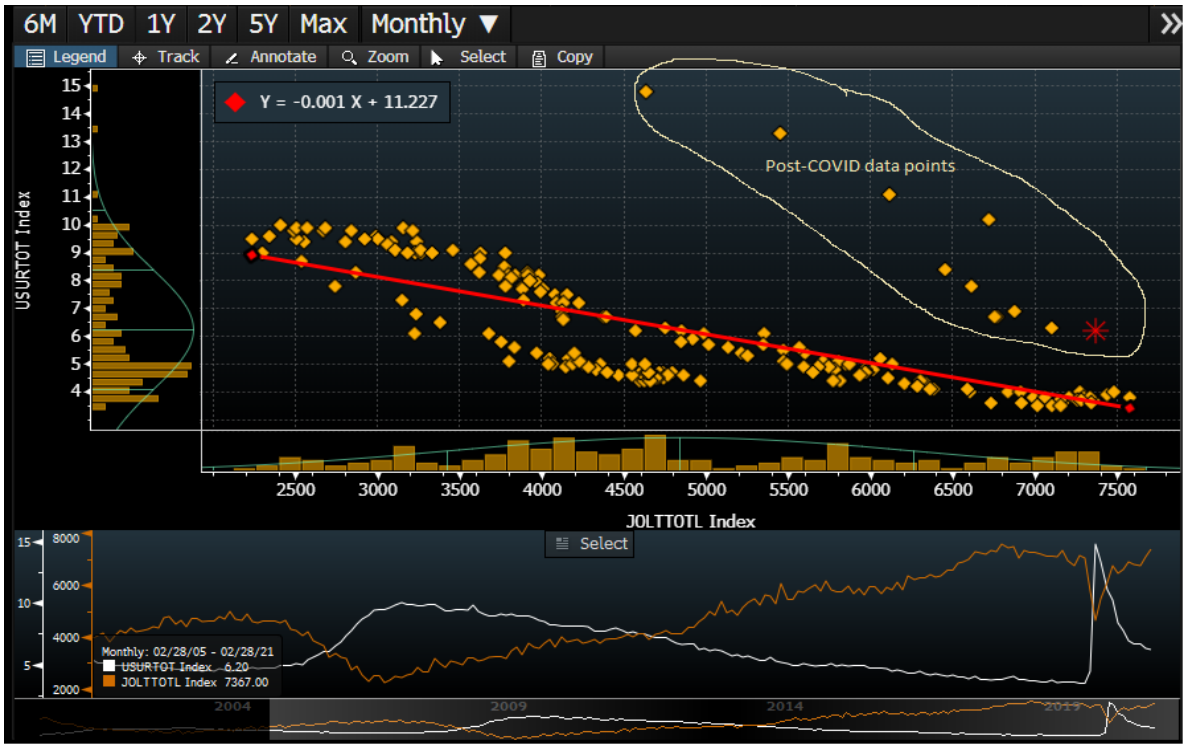


Source: Bloomberg

And here's the regression model, showing the high level of correlation.

Source: Bloomberg

But when we include the post-COVID periods, with the expanded unemployment benefits, the data just don't fit the prior relationship – job openings are nearly at a record level, but unemployment remains elevated.



Source: Bloomberg

So, I would rebut Chair Powell's comments. I think it is clear that expanded unemployment benefits are an important factor affecting the labor market. And on top of that, we can take a stab at quantifying the problem. Given that the pre-COVID relationship was so tight, **the current level of job openings would imply an unemployment rate of only 2.9%, which is a very tight labor market indeed.**

If you listen to what companies are saying, many confirm this analysis. Given our focus on behavioral economics, I'm being careful not to fall victim to confirmation bias – seeking only data that supports my thesis. Given that we are a couple weeks into earnings season, I did a key word search on "labor" and "inflation" for all of our holdings that have reported results recently. I found no mentions of slack labor, or falling labor costs. In fact, it was quite the opposite. If you're in a hurry, feel free to skip all this text, but for the sake of completeness, I've included the results. These are all direct quotes from the company management teams.

Domino's Pizza

I thank our US franchisees and our corporate store operators for the work they are doing to attract and retain great team members in a very tight labor market.

So we're absorbing a piece of that labor increase, versus passing that automatically through, the same that we do with food cost inflation. In terms of store level, certainly, I think everybody right now, you see it the news everywhere is challenged from a labor perspective and a hiring perspective.

Tyler Technologies

And I think lots of parts of the economy right now, they are struggling with labor.

ICON PLC

Oh we're actively hiring right across the spectrum particularly in the clinical ranks project management in CRAs in the major markets. So we are –we have a significant growth planned on the –I can't say this specific numbers but significant growth planned in that in those operational areas where –the market's competitive as I mentioned, I think, everyone's most of our competitors are hiring in the moment. So we're also looking at different ways of bringing people into those positions, training programs, graduate programs, career progression et cetera obviously for the people within our business and that's –we've been–we're looking at that very carefully. But it's a very active market in the –on the hiring front.

Wingstop

Importantly, we were very pleased to see leverage on both labor and other operating expense lines, helping offset some of the inflation in food cost, a demonstration of the strength and efficiency of our model. Until we see a marked change in the availability of labor for poultry producers, a labor shortage that we believe is largely fueled by the amount of government stimulus, we anticipate that wing prices could remain elevated for the balance of 2021.

Yeah, I think for us, obviously, we're going to do everything we can to mitigate the impact of inflation on food costs. Obviously, these are unprecedented times that we're in. And I think the real question for us is around whether or not there's going to be additional stimulus and the implications of that on the labor market, particularly the labor market for our poultry suppliers.

It has as much to do with the impact of the government stimulus and creating an artificially high wage rate that is competitive to the people that are necessary to actually process chicken. And so, the absolute number of chickens that are being processed is down. It's why you see pressure even in the sandwich business and everywhere else on chicken right now. Labor shortages are the real challenge we're dealing with. And so, dealing with that in and of itself would alleviate some pressure on the market on its own because there's just not the volume of product out there before.

Pool Corp.

Second, we previously said that inflation would be in the 2% to 3% range, but now believe it would be in the 4% to 5%, with some products into double-digits. We don't anticipate any of this getting hung up in the channel so that will provide a tailwind for the year. Considering that most of the cost of constructing a new pool or remodeling an existing pool is tied up in labor, we don't anticipate this inflation having a meaningful effect on demand. As it relates to non-discretionary products such as chemicals, inflation has simply passed through again with no real effects on demand.

Third, with demand being so strong and some manufacturers struggling to keep up, we have experienced some product shortages that up to this point, have been managed well by utilizing the strength of our network to keep critical products flowing to our dealers and providing alternative options when certain products are in short supply. Our backorders have certainly increased in those markets, but our team has done a remarkable job taking care of our customers in a very challenging environment.

Fourth, labor is in very high demand across all construction segments and this continues to pressurize the industry keeping demand greater than supply, which we have seen for many years. Crews are working longer and the fair weather has helped expand capacity for the industry, but the labor market tightness is something that we continue to watch.

JB Hunt Transport Services

Other cost pressures in the quarter were primarily related to higher driver cost to attract and retain drivers and higher cost across our various networks and operations due to congestion and the overall labor tightness from increased freight demand and capacity constraints.

Those capacity challenges for our customers remain very present in the current landscape and will likely persist throughout 2021, highlighted by a tight labor market, elevated cost to procure capacity, and overall lack of supply chain fluidity.

And while our view on pricing is a little more elevated today than what we discussed in our last earnings call, the reality is that our cost to serve is also higher. This cost presents itself primarily in our labor costs, as well in the utilization of our assets or equipment terms. We and the industry as a whole are facing meaningful cost pressures to recruit, hire, train, and retain qualified professional truck drivers to meet the capacity needs of our customers. As our future outlook on cost remains fluid, so will our approach to price to ensure that our investments to meet the capacity needs of our customers are supported with our expectations for an appropriate rate of return.

We believe both the rail terminal congestion and the customer unloading challenges are direct results of labor challenges. Inside our operation, driver hiring continues to be a significant challenge and the industry will take on higher wages in order to attract and retain new drivers. We fully expect the same is true for the rail terminal contractors and customer warehouse labor. Demand for Intermodal service remains at incredibly strong levels. The pricing market is performing at a level to cover our cost increases from last year as we honored our commitments, as well as the inflationary cost pressures we are experiencing this year related to driver hiring. Certainly, the increasing driver wage and rail costs are topics with our customers, but we are also highlighting the velocity challenges and the cost of equipment ownership.

Chef's Warehouse

And so, I think it's a unique period where we saw pretty extreme inflation. While we reported 6% to 7% overall average inflation, certain categories in proteins especially, as well as certain specialty categories had double-digit inflation and –that we haven't really seen in a very short period of time. So, I think we're going to go through this period of catching up both the supply chains. I think it's impacting the labor market, in terms of supply and the dynamics there. And then, I think, as we look forward, we expect it to gradually normalize as we get to the back half of 2021.

So, we knew it's going to be difficult. Our customers are having a really hard time getting labor right now. We think it's going to probably continue to at least September. I think that's where unemployment and all the stimulus checks end because right now it's just is very, very hard to get people to want to come to work in some of these jobs. And managers are chipping in and everybody really is helping on the front line.

I know we are gaining market share because of our ability to service. There is a lot of smaller competitors that we've seen even larger that limited service in many areas to many customer bases, trying to –just because they just they don't even have the labor to make the deliveries.

I think we're all scrambling. And maybe we can get some –maybe someone could speak to our elected officials to say this is really hard for the business, especially small businesses, to trying to get labor is really challenging and causing a lot of issues in the recovery. I know that everybody means well. But it's making it extremely hard to get labor back and to allow us to do business and be profitable.

Fastenal

Now before moving into Q&A, I wanted to address a couple subjects of current interest. First, we are experiencing significant material cost inflation, particularly for steel, fuel and transportation costs. This did not have a material impact in the first quarter of 2021. Price contributed 60 to 90 basis points to growth and the impact of price cost on margin was immaterial. However, we are instituting broad and material pricing actions in the second quarter of 2021 that will likely lift pricing contribution over the course of the year. Customers never like higher prices, of course, but they are busy in seeing increases throughout the supply chain. Further, the tools and processes we have developed, including data for our customers, has never been more effective. The environment today is receptive.

Second, we are also impacted by tightening global and domestic supply chains. On the sales side, certain of our customers are not operating as fully as they could be due to shortage of components. On the cost and service side, moving product has become increasingly costly, and lead times have lengthened, causing product shortages in our hubs. These shortages have been overcome with spot buys made in the field that have allowed us to sustain service but at lower margins. We believe this dynamic could persist through 2021, though perhaps not quite as intensely in the second half as we are experiencing currently.

And here are a few other recent data points (as of 4/30/21), which all seem to point to more inflationary pressure.

The PCE Deflator edged up to 2.3%

Personal Income jumped to 21.1%

34% of household income is from the US Government. (pre-pandemic levels were in the teens)

The Employment Cost Index came in higher than expected, at 0.9%

Commodities have moved higher YTD:

- Copper +24%
- Lumber +70%
- Crude +31%
- Housing +15%
- Corn +52%

Conclusion

I'm never married to an investment idea. When the facts change, so do I. Frankly, I sincerely hope that I'm wrong, and that the Fed gets it just right. However, every day, the evidence keeps piling up, tilting the odds in favor of a potential inflationary spiral, and what will have been policy error.

The question we all should be asking is: how will we know if this uptick in inflation is transitory or structural? I don't have an answer. I don't think the Fed does either. The typical obfuscation from the Fed doesn't reveal what thresholds they may have in place for tolerating some inflation. For years now, they've desperately been trying to generate more inflation. They've finally succeeded.

How this all plays out is not just contingent on whether the inflation is temporary or something that gets unanchored, but also on how quickly the Fed responds, and how the market interprets the Fed's response. I don't have the answers to those questions either, but my strong suspicion is that the Fed is already late, and the longer they wait to act, the less confidence investors will have that they can fix it.

The Fed has broadcast that they will remain accommodative until we reach full employment. Given the current status of unemployment benefits, that seems almost impossible to achieve until those expanded benefits expire in September. So, we've got at least four more months of standoff almost guaranteed.

Some 40 Democrats in Congress are pushing to make these more generous unemployment benefits permanent. While I understand the intent and the compassion, I fear that it will further distort labor markets, continuing the disincentive to return to work. In the short run, this could fuel inflationary pressures even more, or at least confound the Fed's analysis of the situation. In the long run, it could cause companies to accelerate their plans for automation and robotics, perhaps permanently displacing low-skilled workers in some industries.

These labor-constrained companies face a difficult choice – pay up for labor and risk permanently affecting their cost structure and thus sacrificing profitability or choose to remain operating at reduced levels. It is becoming clear that *some* businesses are opting to reduce hours of operation or capacity or both; in this case, they forego revenues and market share. If this course of action becomes widespread, it could limit GDP and prove to be disinflationary.

Make no mistake, we are in unchartered territory on many levels. There is no playbook on how to handle this situation. I suspect that the uncertainties (as opposed to risks which I addressed in our Q1 commentary) are all the more likely.

COVID was a terrifying development. It still is. We have all been negatively impacted by it, many of us in very tragic ways, and probably to an extent that we still aren't fully aware of. Yet, as troubling and saddening as it has been, the disruption created many opportunities for us as portfolio managers, and we were able to generate some meaningful alpha during the turmoil.

Right now I feel the same way about this potential inflation problem. It will almost certainly be painful economically – inflation can be insidious. However, I also believe that it will create significant opportunities for investors. Stock picking will matter. There will be real winners and real losers.

Again, I don't want to imply that we have changed our bottom-up focus – we haven't. Just as we built a contingency plan for COVID last February and implemented it on March 1, we have built a similar plan for inflation and higher interest rates. Admittedly, inflation has been a concern for us for over a decade, and that is already reflected in today's portfolio to a large extent.

Ryan Edward Crane

Chief Investment Officer