ARCAPITA

Exploring US Inflation

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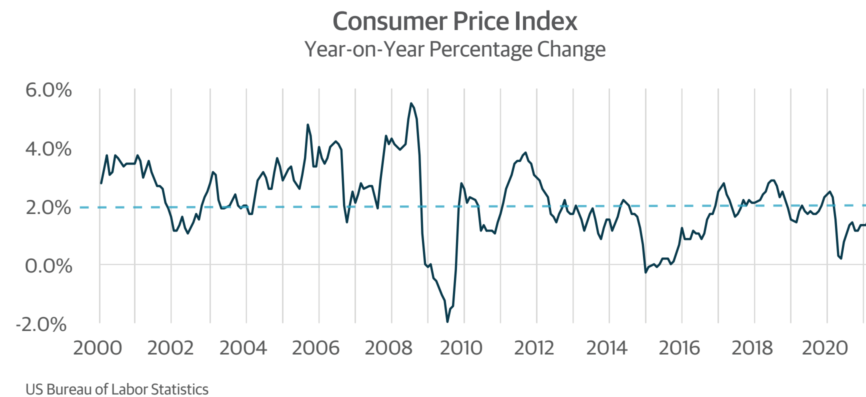
The US economy has been showing signs of recovery since the start of the year. The vaccine rollout program in the US has been successful with 43% of the population fully vaccinated. Annualized GDP growth for the first quarter was 6.4%, signaling the reversal of the slowdown caused by the Covid-19 pandemic. US GDP is currently expected to eclipse its pre-pandemic high in Q3 of 2021. However, market participants continue to debate whether this recovery will be accompanied by transitory or more sustained inflation, and to what degree it will affect businesses and investment decisions in the US over the near to medium term. May figures indicate a marked increase in price levels, with the Consumer Pricing Index (CPI) increasing by 5% year-on-year and Core CPI (which excludes the volatility in food and energy prices) increasing by 3.8% year-on-year.



US Bureau of Labor Statistics

Spending during the pandemic was concentrated on consumer goods as services and other experience-based spending were restricted. As a result, the prices of certain types of goods were disproportionately affected. For instance, a considerable portion of the $153 billion received by homeowners who remortgaged their properties in 2020 was used on home remodeling. As a result, prices of durable goods increased as manufacturers struggled to meet orders. Given the largely one-off nature of such refinancing, demand for durable goods is expected to normalize over time. As restrictions are lifted, consumers are likely to shift their spending towards experiences and travel, alleviating demand on manufactured goods, and distributing their purchasing power more widely.

Commodity prices have also been rising, due to either broader inflationary pressure or shorter-term supply-demand mismatches. As an example, home remodeling and a hot housing market have spurred demand for lumber (processed wood) which has more than quadrupled in price since the start of the pandemic. However, timber (unprocessed wood) continues to be widely available at relatively stable prices. This is because the sudden surge in demand for processed wood drove sawmill production to peak capacity, thus limiting supply and elevating prices.

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Several employers are providing incentives in the form of higher pay to encourage employees to return to work post-COVID. McDonald's will raise its hourly wage by an average of 10% for more than 36,000 employees. Other companies such as Chipotle, Bank of America, and Amazon have also indicated that they will be offering wage increases or bonuses to attract workers. This is mainly due to a shortage in worker availability: many are reluctant to return to work as this would disqualify them from receiving government unemployment and pandemic relief benefits. Higher wages may have an indirect effect on output prices; however, this should not be construed as a permanent increase in labor costs given the almost 10 million people currently unemployed in the US. The government's unemployment benefits are likely to be temporary and are scheduled to lapse as the pandemic wanes and the economy improves. This should help stabilize wage increases.

Over the past three decades, the US Fed has been generally effective at maintaining price levels within target

bounds, with very few instances of inflation breaching the 2% limit. The Fed has, of late, adopted a modified framework through which to manage inflation: it will continue to target an average level of 2%, but will allow inflation to surpass these levels to offset previous periods where it was below target. At the most recent Federal Open Market Committee meeting, the Fed affirmed its intent to keep rates low, to continue quantitative easing, and effectively drive the economy to full employment. Given the Fed's expectation that employment will return to full employment levels by next year, we expect the economy to be allowed to "run hot," even if inflation breaches the 2% target for some time. Ultimately, the Fed will seek to bring inflation rates back to historical levels as the economy re-opens, short term supply-demand imbalances are brought into equilibrium, and fiscal stimulus tapers off.

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Our current investment focus is compatible with a short-term inflationary environment. Investments in real estate are a good hedge against inflation as rents can be adjusted upwards in an environment of rising prices, preserving net operating income (NOI) and capital values. In assessing new investments during this period, two things to consider are lease length and rent escalation clauses. Shorter lease contracts allow landlords to incorporate higher rental rates as leases roll over. For longer-term leases, rent escalations embedded into existing leases should at a minimum reflect the Federal Reserve's long-term inflation target of 2% to better protect investor returns. On the private equity front, our portfolio investments are well-positioned to endure moderate inflation as their revenue models allow for the passing-through of certain costs to customers.

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Continued economic recovery is still dependent on the course of the pandemic and the speed of vaccinations. The start of the year has been positive on both fronts, and we continue to be cautiously optimistic as cases in the US have decreased. As the recovery continues, we anticipate continued accommodative policy from the Fed, allowing the economy to fully recover, even if that results in periods of overheating and higher inflation in the short term.

Arcapita Overview

With two decades of experience, Arcapita's management has built a global investment platform to access the opportunities that exist in our core markets of the US, Europe, Middle East and Asia.

Arcapita is a global alternative investment manager offering diverse investment opportunities, focusing on private equity and real estate. At the center of one of the fastest growing wealth markets in the world, Arcapita's management has been serving an exclusive group of investors in the GCC region over the past two decades. With offices in Bahrain, Atlanta, London and Singapore, Arcapita's management team has completed over 90 transactions with a total value of approximately $31 billion and possesses a footprint to invest on a global scale. Arcapita focuses on defensive and counter-cyclical sectors supported by long-term macroeconomic and demographic trends.

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