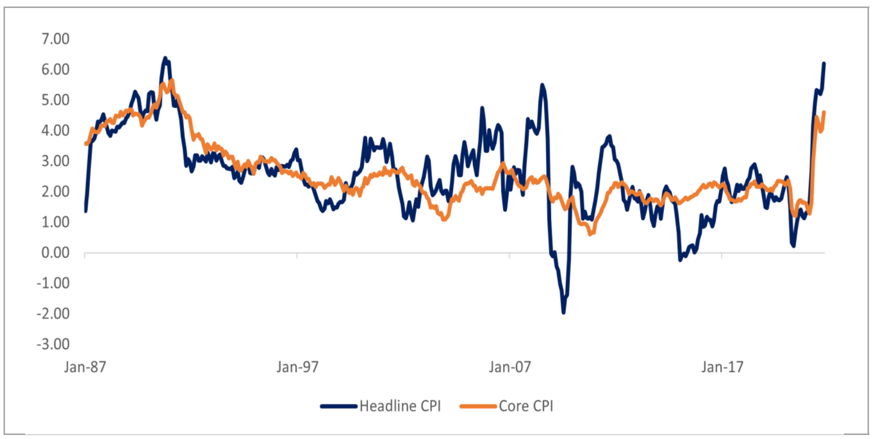
ECF Endowment Management Third Quarter 2021

Is Inflation Still Transitory?

After a decade of muted inflation, prices for almost everything are spiking up—gas, oil, food, lumber, and even housing, cars, appliances, and toys! These increases are evidence that inflation readings are at multidecade highs (see Chart 1). The Consumer Price Index (CPI), including food and energy, is a broad measure of inflation. And it rose at 6.2% annual rate in October, the highest since December 1990. The Core CPI (CPI without food and energy) rose 4.6% as compared to a year ago. Contributors to this gain include new vehicles (up 9.8% YoY), used vehicles (up 26.4% YoY), food (5.3% YoY), shelter (up 3.5% YoY), and energy (up 30% YoY). October's

Chart 1: Headline & Core Consumer Price Index, 1987 – 2021, YoY (%)



Source: Bureau of Labor Statistics, as of October 2021

reading marks seven months of elevated inflation, settling in well above the 2% benchmark target that the U.S. economy strived for years.

What's behind the higher pricing?

Economic re-openings have led to dislocations due to strong consumer demand and limited supply. Stores are wrestling with shortages of goods ranging from lumber to semiconductors to clothing, as supply chain disruptions globally have driven prices higher. In addition, companies large and small are facing worker shortages that have resulted in delayed or canceled orders, driving prices even higher.

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Endowment Tips

How will you plan for your next investment committee meeting?

If you are managing your church's investments, then a large part of your fiduciary responsibility is to oversee carefully the funds entrusted to you. This involves more than discussing the most recent quarter's investment returns. Effective committees periodically step back and *review the purpose* of any long-term endowment or investment funds and :

- Agree again on their investment objectives
- Reassess their risk tolerance
- Recommit to the most important strategic decisions – an overall investment strategy and a specific asset allocation

We encourage you to make this an annual habit, building in extra time to a meeting to address these broader issues.

ECF's fiduciary calendar can help provide a framework for best-practice oversight of your funds throughout the year.

Where the supply chain bottlenecks are:

Shipping bottlenecks. High volume Asian shipping ports experienced temporary closures for-infection prevention measures. In addition, limited US container availability has ultimately led to increased shipping costs.

Labor shortages.
Worker shortages have impacted warehouses, restaurants, and stores. The shortage in truck drivers, loading dock and rail workers have led to slowdowns and increased labor costs. First, workers have stepped aside from work to care for family members or to support children in virtual learning. Second, workers are more reluctant to consider the risk of in-person jobs. Third, workers who moved may no longer be within commuting distance.

Energy costs. Crude oil has risen nearly 70% this year. Natural gas prices have roughly doubled over the past six months. And prices at the pump are up over 50% YTD. In addition, coal prices are at record highs. Factory production requires energy which is now at an increased cost. As a matter of fact, the biggest increase in the CPI is the Energy component, which has experienced a 30% gain YoY. (See Chart 2.)

Is inflation here to stay?

There are two types of inflation – flexible and sticky. Flexible inflation, currently around 15.8%, tends to fluctuate and includes commodities prices, such as lumber and food. These can be driven by weather and natural disasters and even seasonal factors. In contrast, sticky inflation, currently around 3.2% annualized, is characterized by pricing that moves more slowly. Sticky components include housing costs, insurance costs, labor costs, and medical expenses, for example.

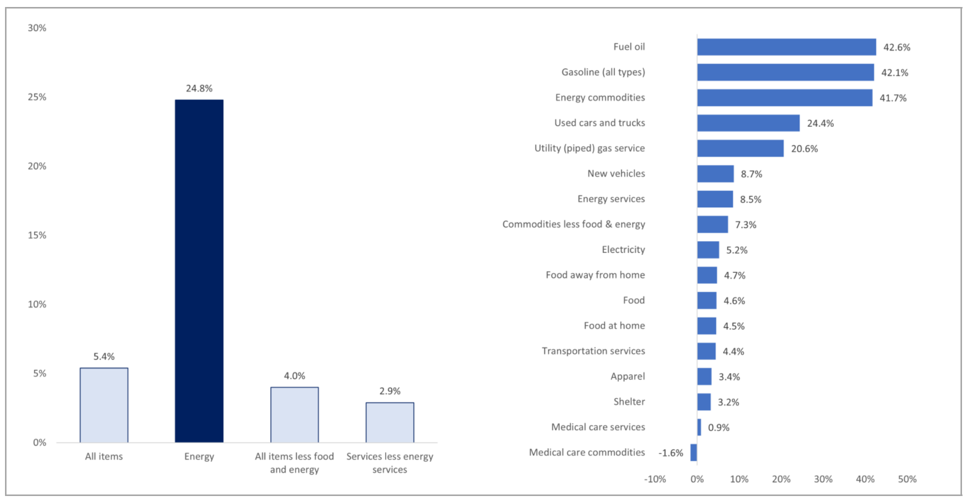
If sticky inflation increases, higher inflation could remain for the long haul. Thus far, sticky inflation has remained relatively contained while flexible inflation has been the dominant factor in the overall bump in CPI readings. (See Chart 3.)

Although higher inflation is now expected to linger well into 2022, inflation is still considered transitory for these reasons:

- **Base Effect**. The annual inflation measurements are being boosted by comparisons with figures from last year during pandemic-related lockdowns, when prices plummeted because of collapsing demand. This lower comparison level is often called base effect and is expected to dwindle into mid 2022 as the comparison will be against those from mid 2021.

- **CPI moves driven by transient factors**. Inflation in 2021 was driven by increases in the prices of energy, food, shelter, and auto sales. These have been driven by supply chain disruptions, including challenges related to freight and labor shortages. They are expected to ease as more countries fully participate in an economic re-opening and labor force participation rates regain ground. As a matter of fact, the latest U.S. labor readings show some labor shortages easing. Approximately 180,000 female workers (during Sept 2021) have re-entered the workforce as the health situation eases and schools return to full-time in-person learning.

Chart 2: Consumer Price Index by sector, YoY



Source: Bureau of Labor Statistics, as of October 2021

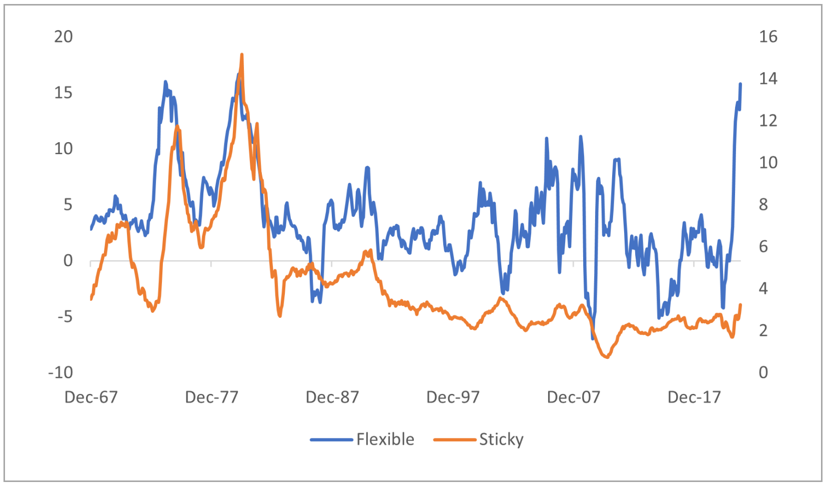
- **Structural forces**. The factors that have kept inflation at bay for the past decade are still in place. Technology, globalization, the Amazon effect, automation, and high debt (dampening inflation) are among the forces applying the brakes and could continue to do so.

Nonetheless, there _are stronger signs of rising sticky inflation_. Although average annual rates of inflation will likely be lower in 2022 than in 2021, inflation isn't likely to return to historically low pre-pandemic levels. Signs of rising "sticky" inflation include *Cont'd on Page 3*

wage increases. Not only are prices for consumer goods higher, wages are climbing quickly as well —average hourly earnings rose at 4.9% (YoY, as of October 2021). This adds to production costs and puts consumer prices at risk for price increases.

Also on the watch are housing costs: Housing prices tend to move slowly and once they go up, they tend to stay higher. Higher home prices are beginning to filter into CPI data. In October the Owner's Equivalent Rent – the amount a homeowner would receive from renting their residence – rose 0.44% (MoM). And rents of primary residences rose by 0.4%. Shelter costs make up one-third of the CPI index and increases could provide a tailwind to inflation in 2022.

Chart 3: Sticky vs Flexible Consumer Price Index, YoY (%)



Source: Atlanta Federal Reserve, as of September 2021

Finally, supply chain bottlenecks are also a concern. While these are expected to subside, a quick resolution doesn't seem to be on the horizon. The longer this drags on, the more likely higher pricing could stick.

Financial Market Implications

One risk to higher prices is the need for the Federal Reserve to raise interest rates to keep inflation at bay. The Federal Reserve's "dot plot" shows projections for the Fed Funds rate, a rate the Fed policy makers adjust during inflationary periods. Markets generally focus on the median "dot" or projection which currently shows the likelihood of two interest rate hikes in 2022. Inflation that remains high could increase this to three or more hikes next year.

Higher interest rates can filter through the economy in a couple of ways:

- First, financing costs for the individual may increase. The consumer could feel the pinch through credit card rates and mortgage rates. And corporations could also pay more for the cost of borrowing.
- Secondly, increased interest rates would lead to higher discount rates, a measure used in calculating present value for the future pricing of a company. This typically erodes the future value of a company.
- And finally, bond prices move inversely with interest rates – higher interest rates could lower the value of a bond. But perhaps equally as important to note is maturing corporate bonds are often rolled-over into new debt. In an era of higher interest rates, the new debt would carry a higher interest rate.

ecf Endowment Management

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New Lower Fees

ECF announced effective October 1, 2021a ***significant reduction*** in fees for its endowment management program. Please let us know if you would like additional detail.