MARCH 22, 2022

AGENDA ITEM 6
INFORMATION ITEM

CALIFORNIA ABLE ACT BOARD

Market Environment Overview

Background

The CalABLE Act Board and its investment consultant, Meketa Investment Group, Inc. (Meketa) monitor all portfolios in the CalABLE (Plan). In this item, Meketa will explore the market landscape, including the impact of inflation on CalABLE account owners.

Attachments

- Attachment #1 – 2022-03 CalABLE Inflation Deck

Presenters

Eric White, Principal, Meketa Investment Group, Inc.

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MEKETA
INVESTMENT GROUP

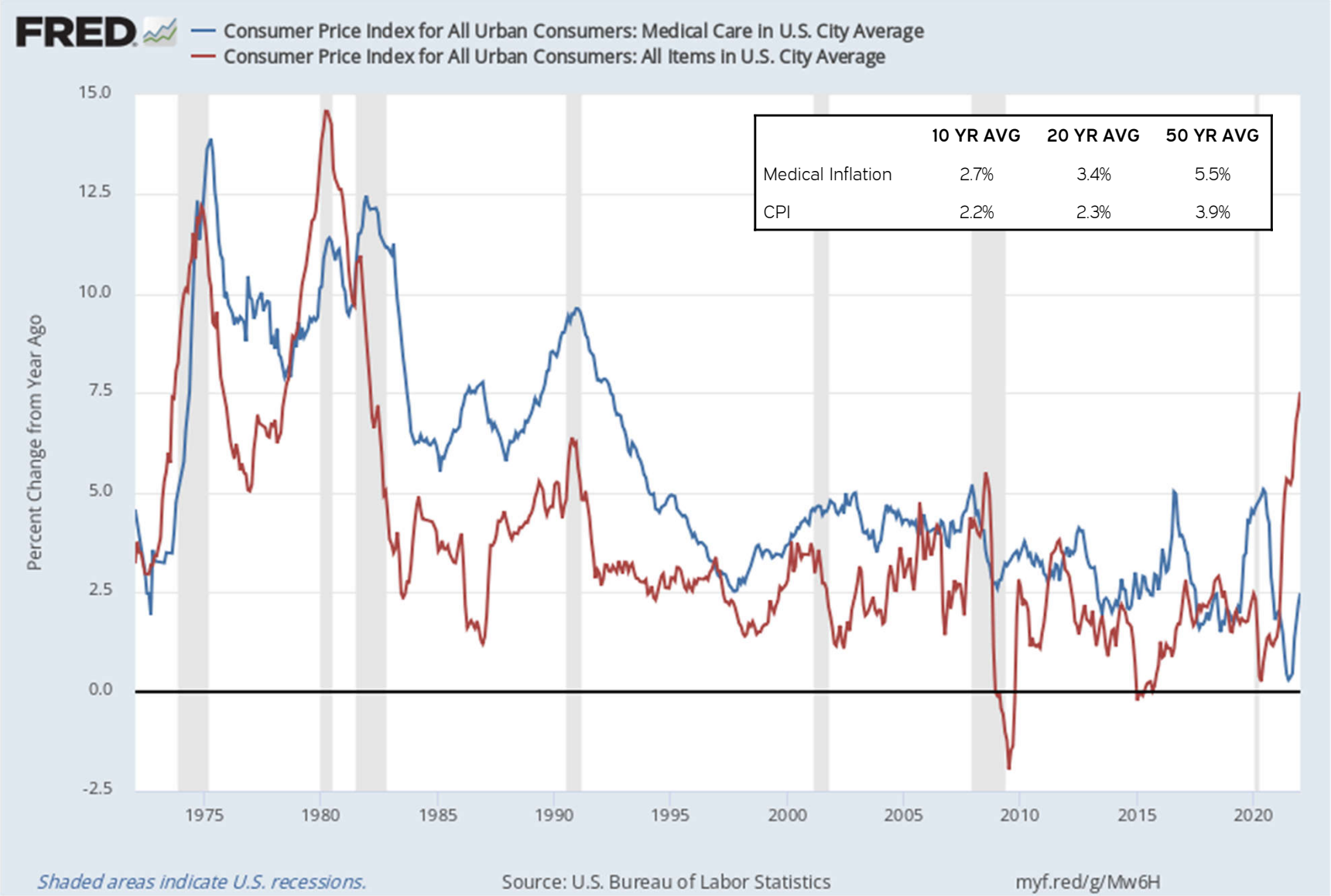
CalABLE Plan

March 22, 2022

Inflation:
Current Environment

CalABLE Plan

College Tuition Inflation



	10 YR AVG	20 YR AVG	50 YR AVG
Medical Inflation	2.7%	3.4%	5.5%
CPI	2.2%	2.3%	3.9%

US Inflation Indicators – Basic Definitions

- Inflation is a rise in the general level of prices of goods and services over a period of time.
- There are two common measures of inflation in the US today, CPI and PCE.
  - Both indexes calculate the price level by pricing a basket of goods.
  - What's included in the basket of goods is different for each index.
  - Indexes follow different methodologies on constructing the basket of goods.
    - PCE adjusts the basket for consumer behavior resulting from price changes.
    - CPI's basket of goods is static.
  - Measured monthly, the market tends to focus on year-over-year price changes.

Consumer Price Index (CPI)

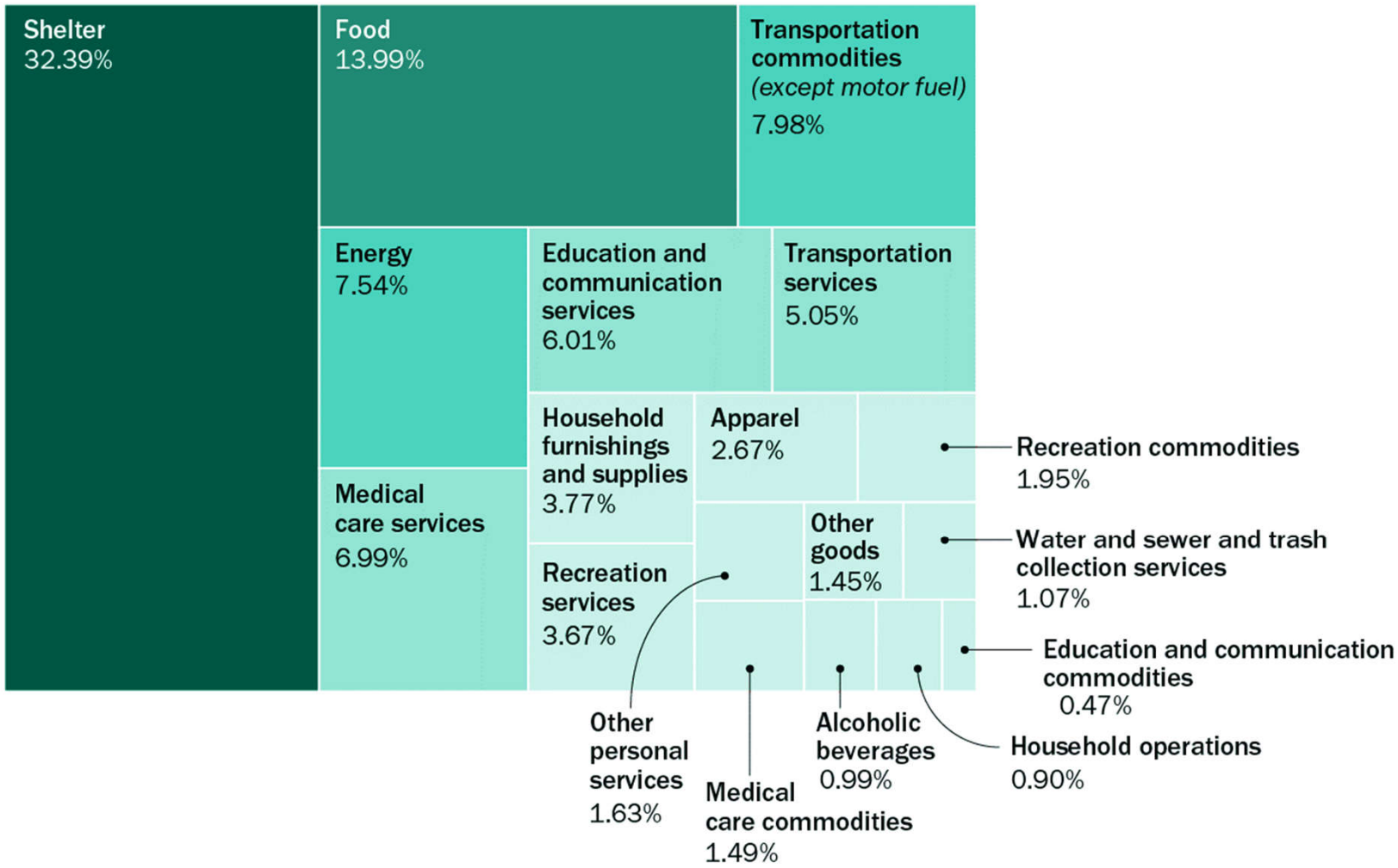
- Bureau of Labor Statistics
- Measures urban consumer prices
- Based on a survey of what households are buying
- Includes out-of-pocket expenses for goods and services
- Excludes expenses not paid directly (e.g., medical care)
- Used to adjust social security payments and the referenced rate for some financial contracts (e.g., TIPS)

Personal Consumption Expenditures (PCE)

- Bureau of Economic Analysis
- Estimate of all household costs
- Based on surveys of what businesses are selling
- Includes out-of-pocket expenses for goods and services
- Includes expenses not paid directly (e.g., medical care)
- Used by The Federal Reserve to state its goal for inflation
- Less volatile than the CPI

What goes into the Consumer Price Index?

Relative importance of different expenditure categories, November 2021



Source: U.S. Bureau of Labor Statistics; PEW Research Center

US Inflation Indicators – Basic Definitions

Headline

- There are eight major components:
  - Food and Beverages
  - Housing
  - Transportation
  - Medical Care
  - Recreation
  - Education and Communications
  - Other Goods and Services

Core

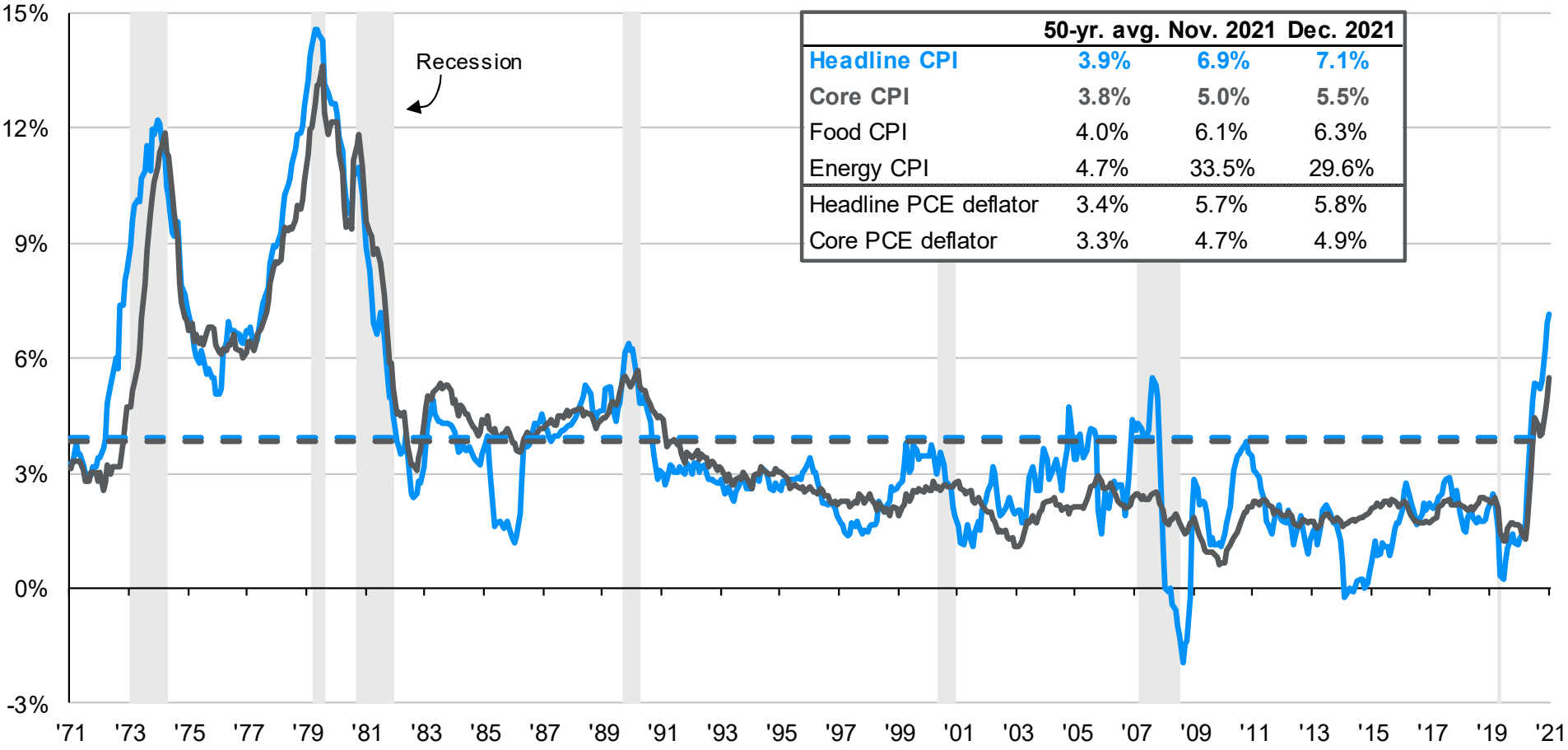
- Subset of Headline, strips out:
  - Food
  - Energy
- These components tend to be highly volatile.
- Represents approximately 20% of household consumption in a developed economy.

History of US Inflation

- US has experienced periods of high inflation.
  - Most of these periods occurred during materially different monetary regimes than current day.
- Since the early 1990s, US inflation has become less volatile, and some explanations include:
  - Advent of inflation targeting monetary policy in the US and other developed markets.
  - Financial market technology and efficiencies.
  - Business technology improvements on supply management.
  - Demographic and labor trends lowering input costs.

CPI and core CPI

% change vs. prior year, seasonally adjusted

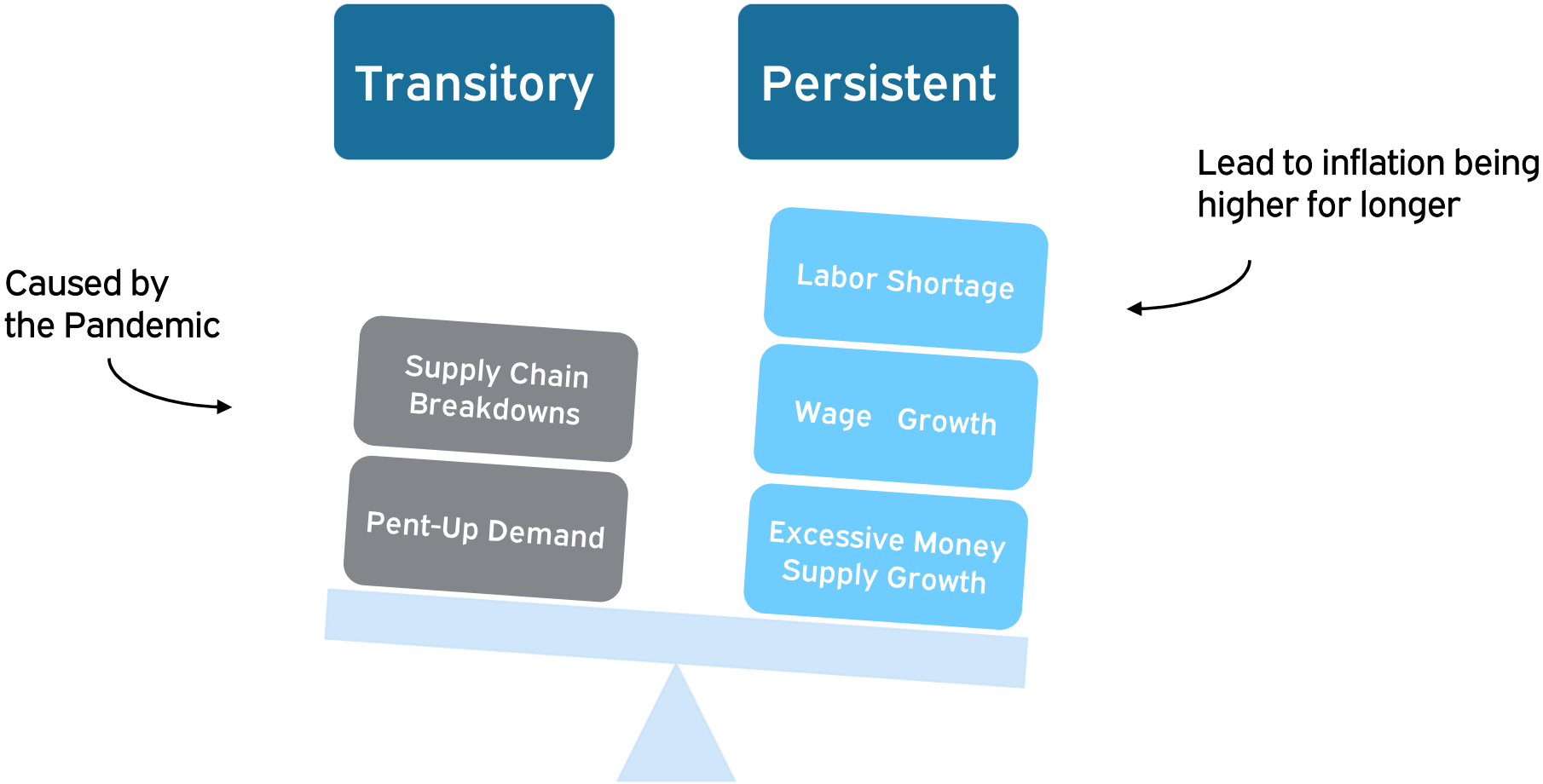


	50-yr. avg.	Nov. 2021	Dec. 2021
Headline CPI	3.9%	6.9%	7.1%
Core CPI	3.8%	5.0%	5.5%
Food CPI	4.0%	6.1%	6.3%
Energy CPI	4.7%	33.5%	29.6%
Headline PCE deflator	3.4%	5.7%	5.8%
Core PCE deflator	3.3%	4.7%	4.9%

Source: BLS, FactSet, J.P. Morgan Asset Management.
CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations.
Guide to the Markets – U.S. Data are as of December 31, 2021.

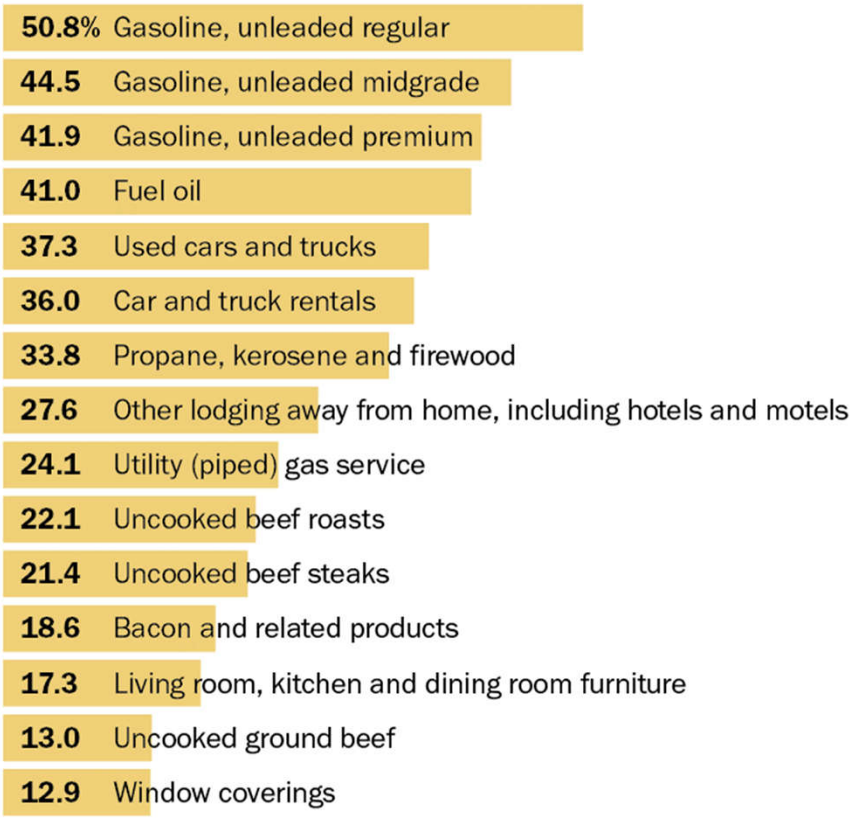
Inflation Expectations

- What does "Transitory" really mean?



Bottlenecks & Pent-Up Demand – Likely Transitory

Largest % Increases in CPI Components
Dec. 2020 – Dec. 2021

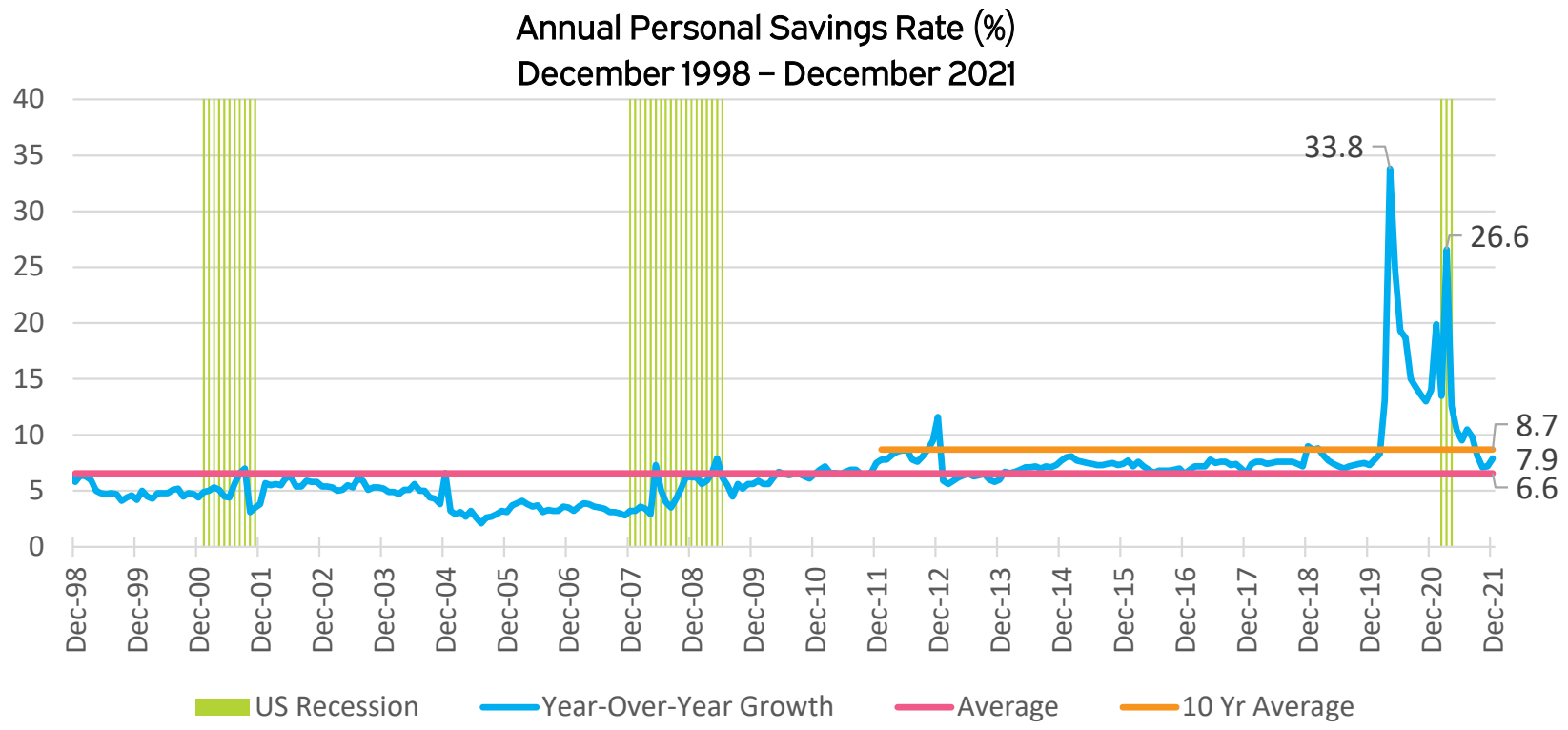


- Inflation fell significantly in the spring of 2020 in response to global lockdowns.
- In 2021, vaccination efforts supported a reopening of the US economy and some components of CPI rose dramatically.
- Some of these items included materials related to housing construction, used cars, and transportation services related to the delivery of goods.
- Some prices have returned to pre-lockdown levels (e.g., lumber) while others have not.

Source: Bureau of Labor Statistics; PEW Research Center

Personal Savings Rate – Likely Transitory

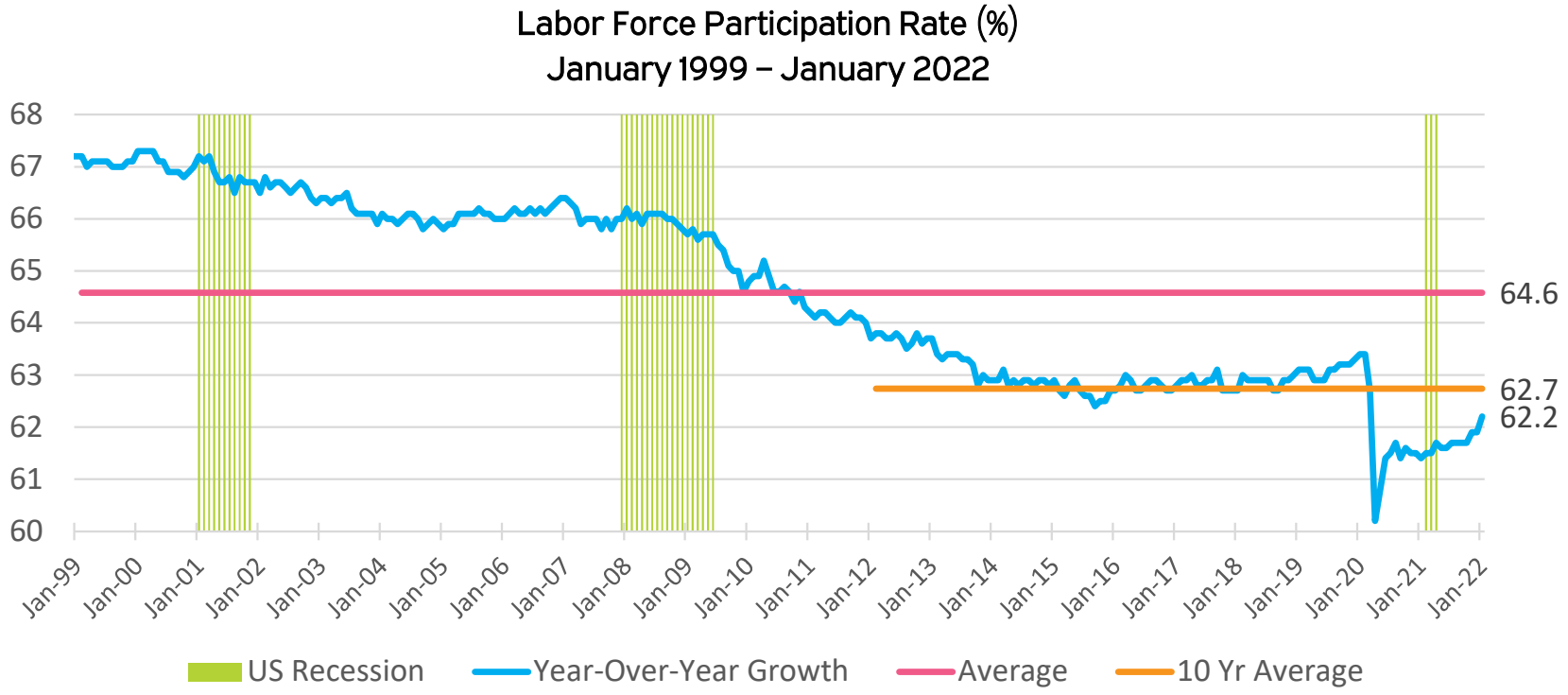
- Personal savings rate skyrocketed as the world locked down due to the pandemic.
  - Hitting 33.8%, a historic high, in April 2020.
- The personal savings rate has retreated to pre-pandemic levels, as enhanced employment benefits and child tax credits end.



Source: Bureau of Economic Analysis. Monthly, Seasonally Adjusted.

Labor Shortage – Transitory or Persistent?

- Labor force participation remans below the longer-term and 10-year averages.
  - Demand for employees continues to outpace supply.
    - Weighing down potential economic growth.
    - Wages are bid up and those cost increases are likely passed onto consumers.
    - Feeding inflation pressures.

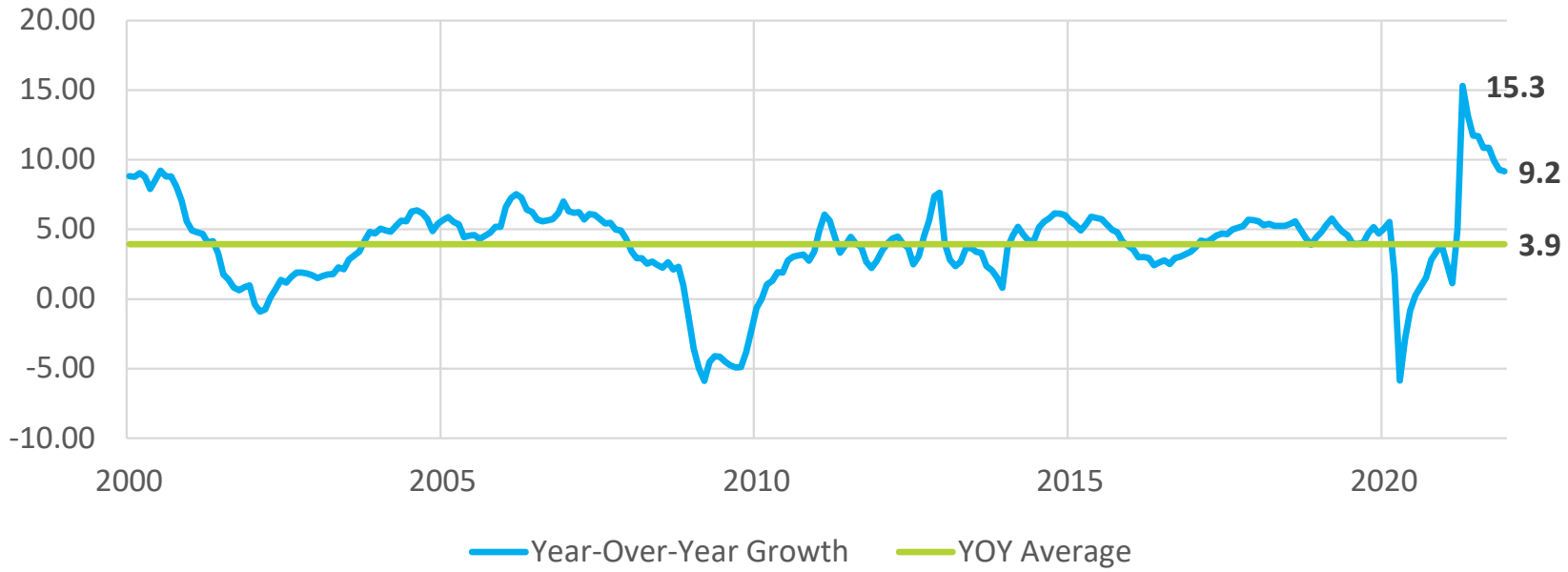


Source: FRED. Monthly, Seasonally Adjusted.

Wage Growth – How sticky is it?

- A sharp and sizeable rise in wages is contributing to worries over inflation.
- Wage growth reaches record high (15.3%) in April of 2021.
  - Change primarily driven by composition and base effects.
- What could cause wage growth to remain elevated?
  - "Help Wanted" … millions of workers staying on the sidelines.

US Wages and Salary Growth (%)
January 2000 – December 2021

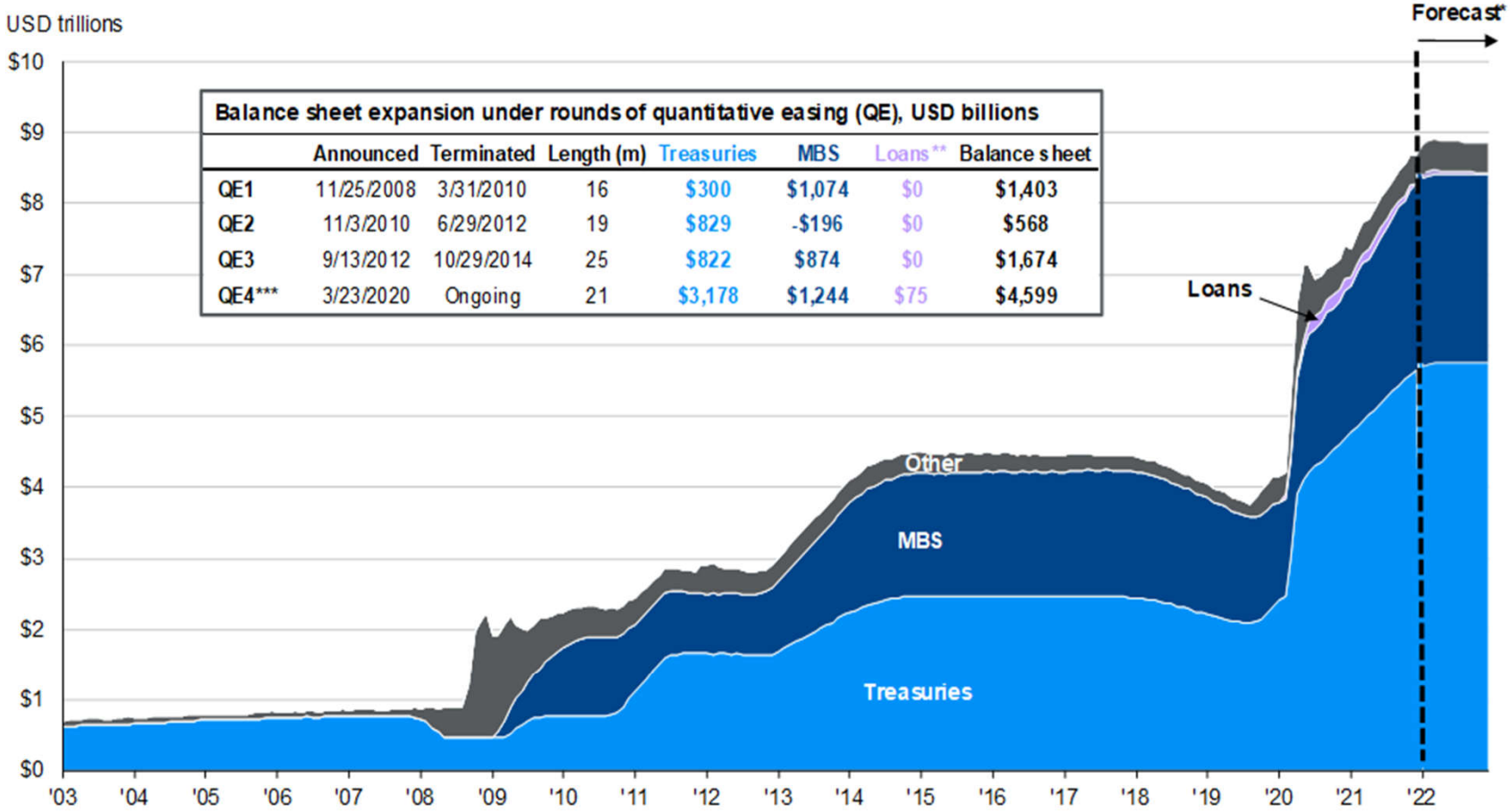


Source: TRADINGECONOMICS.COM | U.S. BUREAU OF ECONOMIC ANALYSIS.

Money Supply Growth – Transitory or Permanent?

The Federal Reserve balance sheet

USD trillions



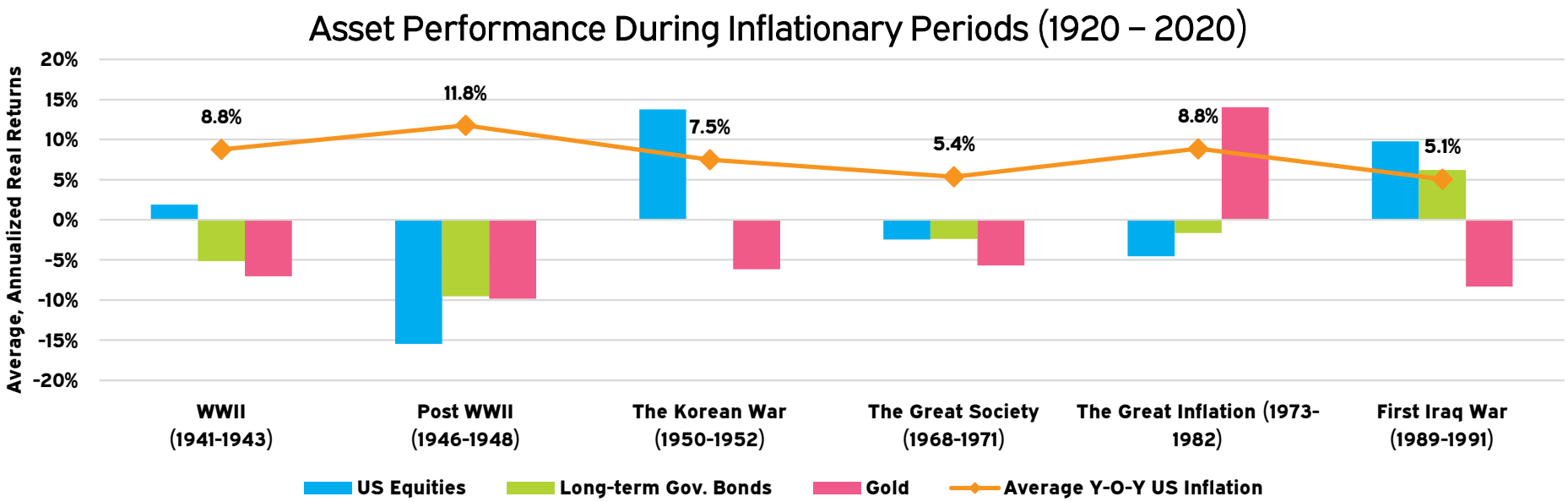
Balance sheet expansion under rounds of quantitative easing (QE), USD billions

	Announced	Terminated	Length (m)	Treasuries	MBS	Loans**	Balance sheet
QE1	11/25/2008	3/31/2010	16	$300	$1,074	$0	$1,403
QE2	11/3/2010	6/29/2012	19	$829	-$196	$0	$568
QE3	9/13/2012	10/29/2014	25	$822	$874	$0	$1,674
QE4***	3/23/2020	Ongoing	21	$3,178	$1,244	$75	$4,599

Source: FactSet, Federal Reserve, J.P. Morgan Investment Bank, J.P. Morgan Asset Management.
Currently, the balance sheet contains $5.7tn in Treasuries and $2.6tn in MBS. *The end balance sheet forecast assumes the Federal Reserve reduces the pace of purchases of Treasuries and MBS by $30bn per month, beginning January through mid-March, as suggested in the December 2021 FOMC meeting. **Loans include liquidity and credit extended through corporate credit facilities established in March 2020. Other includes primary, secondary and seasonal loans, repurchase agreements, foreign currency reserves and maiden lane securities. ***QE4 is ongoing and the expansion figures are as of the most recent Wednesday close as reported by the Federal Reserve. Forecasts are not a reliable indicator of future performance. Forecasts, projections and other forward-looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections or other forward-looking statements, actual events, results or performance may differ materially from those reflected or contemplated.
Guide to the Markets – U.S. Data are as of December 31, 2021.

Asset Class Performance in Inflationary Periods 1920 - 2020

- US equities, US government bonds, and gold have very long performance histories.
- Past performance may not predict future performance but examining historical behavior can be informative.
- Equity performance during inflationary periods may be lower due to rising costs of goods and services as well as higher borrowing costs.
- Interest rates tend to rise with inflation that erode bond prices and increase yields.
- Gold performed well in the 1970s but did not perform well in all inflationary periods.



Source: FRED Periods of extended elevated inflation above 2%.

Complex topic with no easy answers

- Inflation is impacted by, and-also directly impacts economic growth, monetary policy, interest rates, etc.
- The acceleration in inflation stemmed from the global shut-down due to the pandemic, creating a domino effect where transitory problems have contributed to persistent issues.
  - Higher energy prices
  - Wage growth
  - Labor shortage
  - Excess debt and money supply growth

Potential impact to portfolios

- Investors with long time horizons, protecting (or hedging) against short-term inflation can lower long-term real returns.
  - Generating a long-term real rate of return should be the ultimate goal.
- Nearly all assets that rely on economic growth and corporate profitability (real return metrics), are expected to produce positive real returns over the long-term.
- Portfolios are often more susceptible to the "cure" for high inflation (higher interest rates) than the inflation itself.
- The more "conservative" an investor is the more at risk they are from inflation and its cure.

Potential impact to participant behavior

- Higher inflation could impact participants ability to save.
- May lead to higher risk taking.

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