Inflation 101

Q3 Market Update

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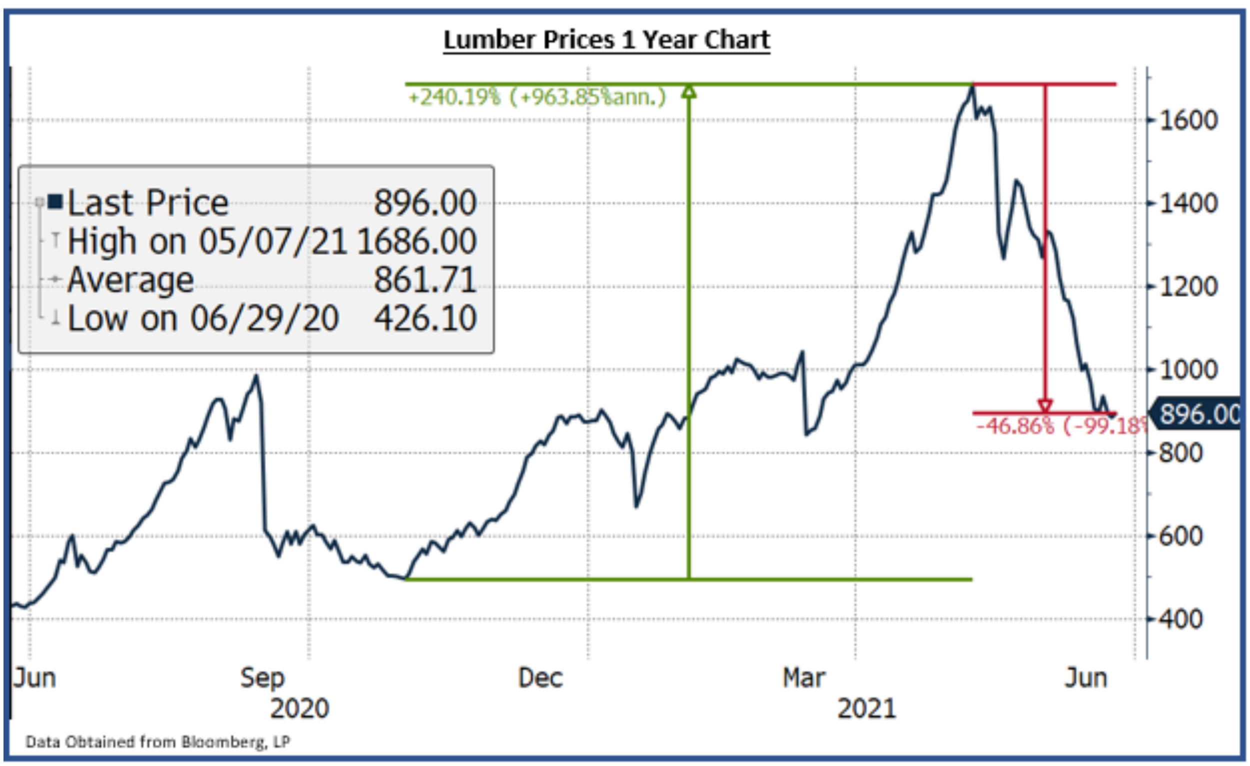
“In spite of the cost of living, it’s still popular.”
– Kathleen Norris

As we look forward to the second half of 2021, the world seems torn between optimism about reopening and economic growth, and despair over inflation and the Fed’s potential courses of action. Like most things, the truth most likely lies in the middle between hope and pessimism. As the world recovers from the pandemic, economies are changing rapidly and causing increasingly swift changes to forecasts and plans. And while this recovery has been supercharged, it does mirror other economic recoveries of the past and I caution against using the 4 deadliest words in finance: *This Time It’s Different.*

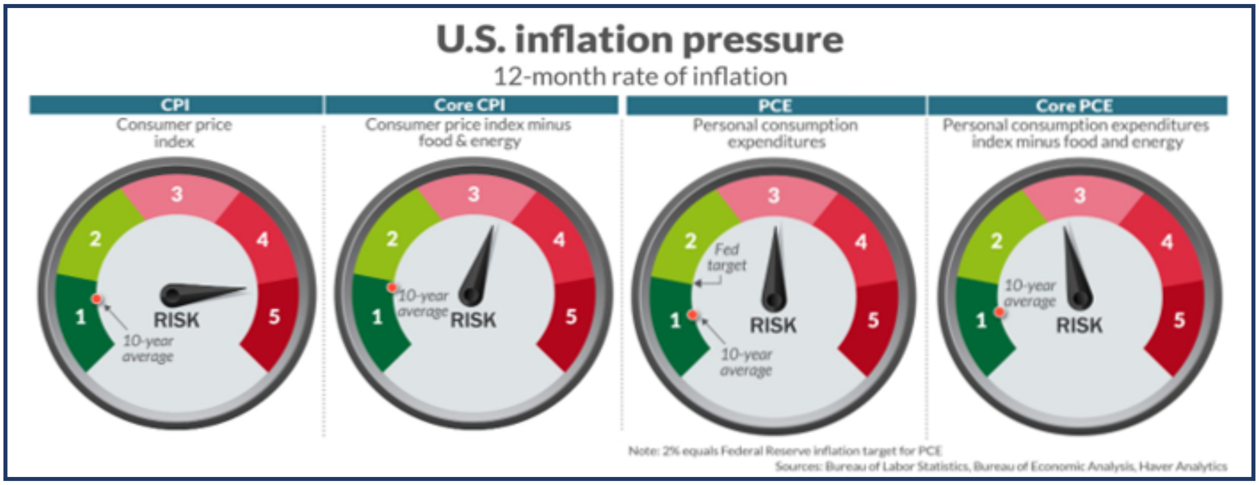
The pandemic not only shut down economic growth, but it rapidly and vastly altered our consumption habits and greatly disrupted highly sophisticated and integrated supply chains. A prime example of this disruption is the current global chip shortage that is now causing delays and increased prices in cars and trucks, as well as used vehicles, and electronics. Most of this shortage was brought on by an unanticipated increased demand during the pandemic for electronic devices since we all were basically glued to our computers and phones for a year. Additionally, increased demand for medical devices as well as the rise of 5G causing consumers to upgrade new smartphones all added to the pressured chip supplies.

Our rapid change in consumption pattern caused many electronic device builders to try and meet demand by ramping up production. Elon Musk recently commented that the chip shortage is akin to the toilet paper fiasco early in the pandemic. Unbalanced supply and demand, as well as a "run on toilet paper" caused an artificial shortage, not an actual one. It will take a while, possibly into 2022, to work through the shortage backlog, however, it is not a shortage that will persist for perpetuity. According to Bloomberg, the number of chips sold in April, 2021 was almost 100 Billion compared to the 73 Billion that shipped in January 2020 pre-pandemic, showing there is already ramped up production to meet this demand.

Another good data point is lumber prices. The past decade we have also been operating in a repressed and underbuilt home market that is trying to normalize now. The 2008 housing crisis led to deep scars and tremendous slowdown in the construction of new homes. The ever-maligned Millennials are now finally getting married and looking for either a first or second home. This is causing an increase in demand in a highly constrained market. Per research by Freddie Mac, there was a supply shortage of 2.5 million units coming into the recession of 2020. For the first time since 2007, new construction on single family homes in 2021 could break 1 million. Due to this increased demand for both existing home remodeling and new home construction, lumber prices shot up to all time highs, however after peaking in May 2021, they are now down now more than 45% off that high. This is because sawmills ramped up supply to meet the extraordinary demand finding the balance between homebuilders and sawmills. So while the chip shortage has not worked itself out, lumber can show us that pricing abnormalities tend to normalize as habits and trends normalize.



I have recently referred to inflation as the Boogeyman; feared by all, but mostly hidden. Inflation has now become the topic de jour with many investors feeling trapped between concerns on a pullback, but awareness about protecting the real value of their assets over the long term. Inflation is a constant in our lives, it has, and will be, around as long as developed economies and capitalism exist. Change is constant in our world and inflation is a part of the economic cycle and a changing global world. The elephant in the room is what is the current cause and duration of inflation? We believe the majority of the rapid upward inflationary pressures is still transitory and will scale back closer to normal once economies are fully recovered. Some of the supply shortages and price pressures, such as, semiconductor chips and lumber, were mostly due to unanticipated changes in consumer behavior and can mostly be blamed on the pandemic and its effect on our habits.



Inflation concerns are not completely unfounded. We are running hot right now and fears of a 1970’s and 1980’s hyperinflationary environment are creeping back into everyone’s minds. Having a mortgage at 19% interest really puts a damper on the housing market and disposable income. Context is crucially important, as inflation is not necessarily a market killer. Why inflation is happening, how long it will remain “hot”, and how the Fed and the US Dollar react will drive markets going forward. But, it’s good to remember we are exiting a period of abnormally low inflation and a concern about a stagnant and potential stagflation environment. Stagflation is a period of slow economic growth, relatively high unemployment (economic stagnation) accompanied by rising prices. While inflation numbers have recently started running higher, so has GDP growth coming off the Pandemic. Many of the numbers referenced are a change over a 12-month period. During June, 2020 we were still in a very locked down and repressed economy. So, while you are seeing higher inflation numbers, you are also seeing very high GDP growth and a rapidly improving job market.

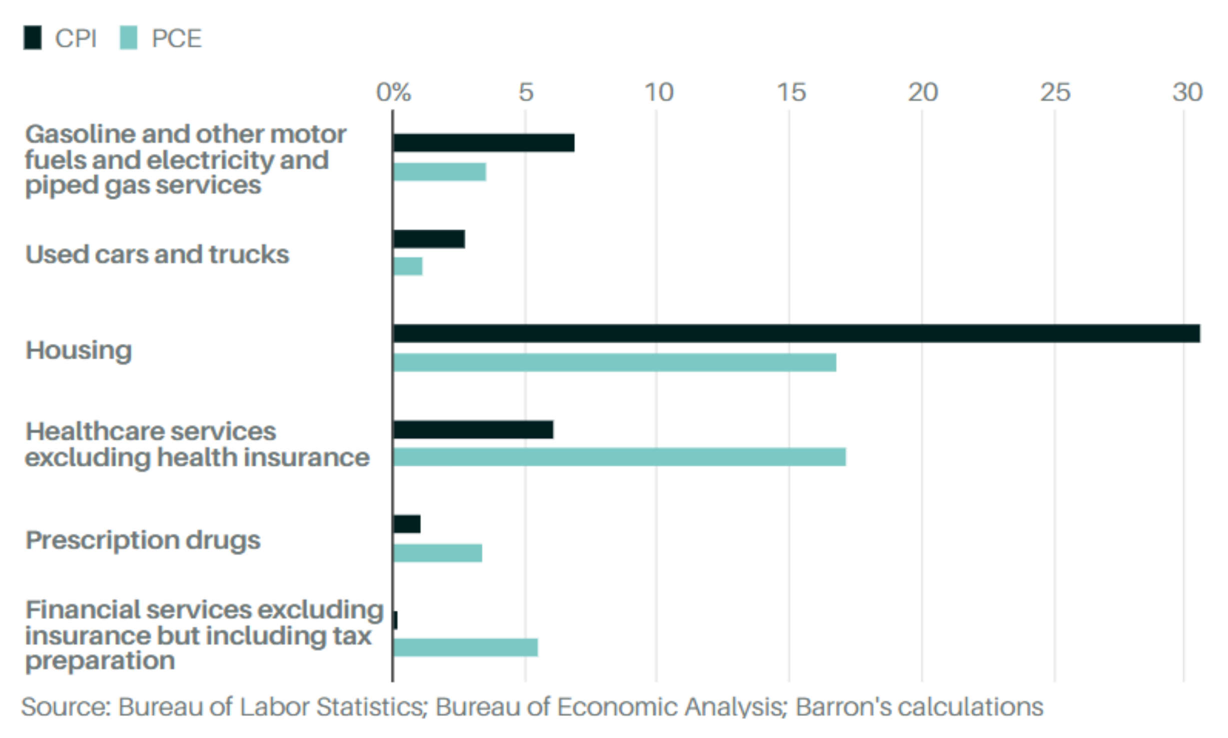
Currently the major category weightings for CPI (Per June 10th, 2021 BLS release)	
1. Shelter: 32.857%	4. Other Personal Services 13.539%
2. Transportation Services 5.20%	5. Medical Care Services- 7.209%
3. Food: 13.928%	6. Energy 6.941%
7. Commodities less food and energy: 20.325%	

MarketWatch Inflation https://www.marketwatch.com/story/inflation-is-surging-how-high-will-it-go-check-out-marketwatchs-new-tracker-11623349730?siteid=YAHOOB

As previously mentioned, inflation is a constant. One of the main mandates of the Federal Reserve is to keep inflation at 2% over the longer run as measured by the annual change in the price index. This fits into the Fed's dual mandate of maximum employment and price stability. There is an interconnectivity amongst the Fed, interest rates, inflation and the US Dollar as all of them depend on the others for direction. It helps to have some more background on what exactly *IS* inflation. Well, dear reader, it depends on the definition you are using. CPI? PPI? PCE? There are multiple measurements for inflation:

1.) Consumer Price Index (CPI): a measure of the average change in the prices paid by urban consumers for a market basked of consumer goods and services. There are further cross-classifications of regions and size-classes. Data is sourced by collecting data from 75 urban areas throughout the country and from about 23,000 retail and service establishments. Data on rents are collected from about 50,000 landlords or tenants. This index effects over 80mm people because of adjusting income payments for Social Security, union beneficiaries, Federal civil service and food stamp recipients. [1] As of May, 2021 CPI has gone up 5.0% over the last 12-months, not seasonally adjusted. With the biggest changes coming to Energy up 28.5% and Used cars and trucks up 29.7%
2.) Producer Price Index (PPI): This program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. [2]
3.) US Personal Consumption Expenditure Core Price Index (PCE): Tracks overall price changes for good and services purchased by consumers in the United States. Captures inflation (or deflation) across a wider range of consumer expenses and for reflecting changes in consumer behavior. Published by BEA (Bureau of Economic Analysis) not BLS (Bureau of Labor Statistics) as the other Indexes are.

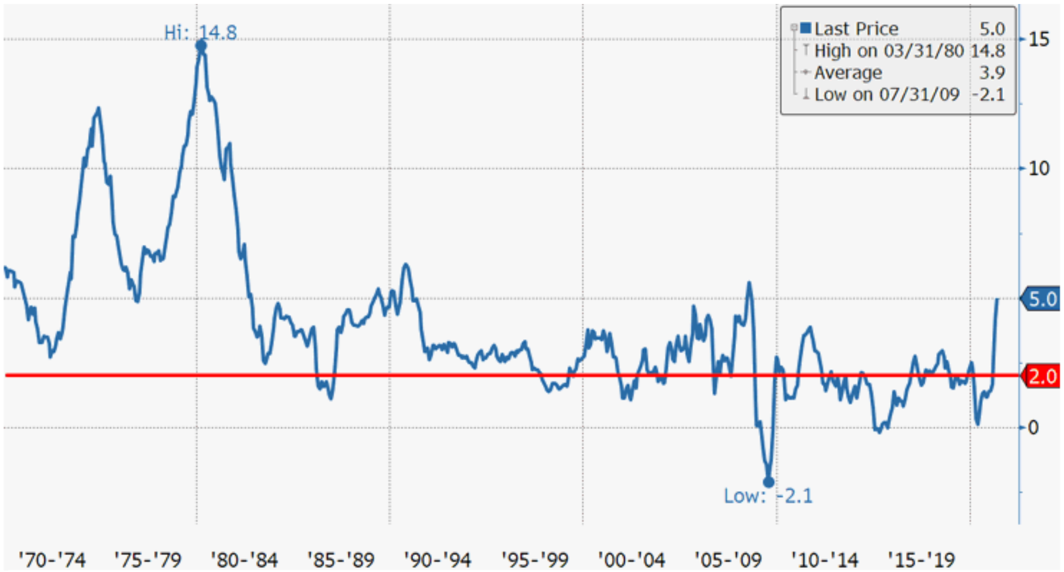
Relative Importance of Select Items in Two Main Price Indices



[1] https://www.bls.gov/cpi/overview.htm
[2] https://www.bls.gov/ppi/home.htm
CPI vs. PCE https://www.barrons.com/articles/inflation-is-in-the-cpi-of-the-beholder-the-feds-favored-gauge-pce-explains-its-policy-stance-51622228401

Let's now take a deeper dive into the 70's and 80's and some of the reasons behind the difficult market environment. The "Nixon Shock" was a series of failed economic measures taken by the Nixon administration in the early 70's that set up the inflation, unemployment and Dollar decline that we saw over the early 70's. In mid-1970 unemployment was elevated at 6.1% and inflation 5.84%- both numbers higher than desired. In response to a stalled economy, he implemented multiple policy changes to help protect: a 90-day wage freeze (to combat inflation), 10% tax on all imports that were subject to duty, suspension of the gold standard, One of the main drivers of the massive inflationary period in the 70's and 80's was a rapid devaluation and decline of the US Dollar when the USA moved to drop the gold standard August 15, 1971. This move was not fully implemented until March 1973 when all currencies moved from a fixed exchange system to the floating exchange system we have now.

CPI Long Term 50 Year History



Data obtained from Bloomberg LP

The Federal Reserve and its monetary policy, as well as other fiscal policy proposed by the government, will have a major impact on the direction of the markets as well as the course of inflation over the coming months and years. As we saw in the 1970's with Nixon, poor policy can be extremely detrimental to the economy and markets. There are major decisions to be made: tax policy, interest rate hikes, social assistance and further borrowing to name a few. However, at risk of putting myself on a limb here, we HAVE learned from prior policy errors. The 2008 & 2020 market interventions were a direct result of failed policy in the 1920's combating the Great Depression. The market refers to the Fed's stance on policy as either Dovish (accommodating, easy money, low rates) or Hawkish (tightening, reduced support, rising rates). Right now, we feel the Fed is actually neither and in a neutral policy stance. They are still Dovish in a sense, as they are keeping rates at the 0-0.25% lowest bound as well as continuing its bond purchase program. However, they are hinting at a more Hawkish turn in their meeting notes with tapering the bond purchase program and rising rates likely in 2022. Being in this current limbo we feel the Fed has turned into a Pidgeon; flapping about, generally annoying people, and eventually will make a mess of it. The typical end of a Bull market is brought on by policy error. We will be watching this Pidgeon flap about in hopes it does find its way and balance the economy without crashing the markets.