HIGHTOWER

FARR MARKET COMMENTARY

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Ouch!

July 13, 2022

Inflation, Inflation, Inflation

Prices continue to rise at a pace not seen since the early 1980's. In fact, it's been so long since inflation was such a pervasive problem that many folks are living through it for the first time. It appears that the forces that kept inflation at bay for so long – globalization, the coming of age of the baby boomers, the decline in labor-union clout, the price discovery made possible by the internet, the energy renaissance in the US, and automation and other technological advances – are either reversing or losing some of their potency. Everyday Americans are beginning to wonder if their financial security is at risk. Panic has set in.

Inflation has become a hot-button political issue just as everything else is these days. But this is one issue that deserves to be political. Such rapid price increases, especially for food, energy and housing, are creating massive hardship for folks, especially those of limited means. If voters can't rely on their government to protect their ability to provide for their families, not much else matters. But as is usually the case, the issue is complicated, and not all the blame can be assigned to the one who currently resides at the big White House on Pennsylvania Avenue.

In one corner are those who believe the surge in inflation is the federal government's fault. The government enacted multiple massive spending packages designed to provide assistance to those economically impacted by COVID. These support initiatives, some of which came with no strings attached, finally put some excess cash in the pockets of the low- to middle-income Americans who are far more inclined to spend it (as opposed to saving it). And that's exactly what they did, with reckless abandon that nobody predicted. Adherents to this theory believe that the surge in demand created by excessive government stimulus was the overriding cause of the inflation we have today.

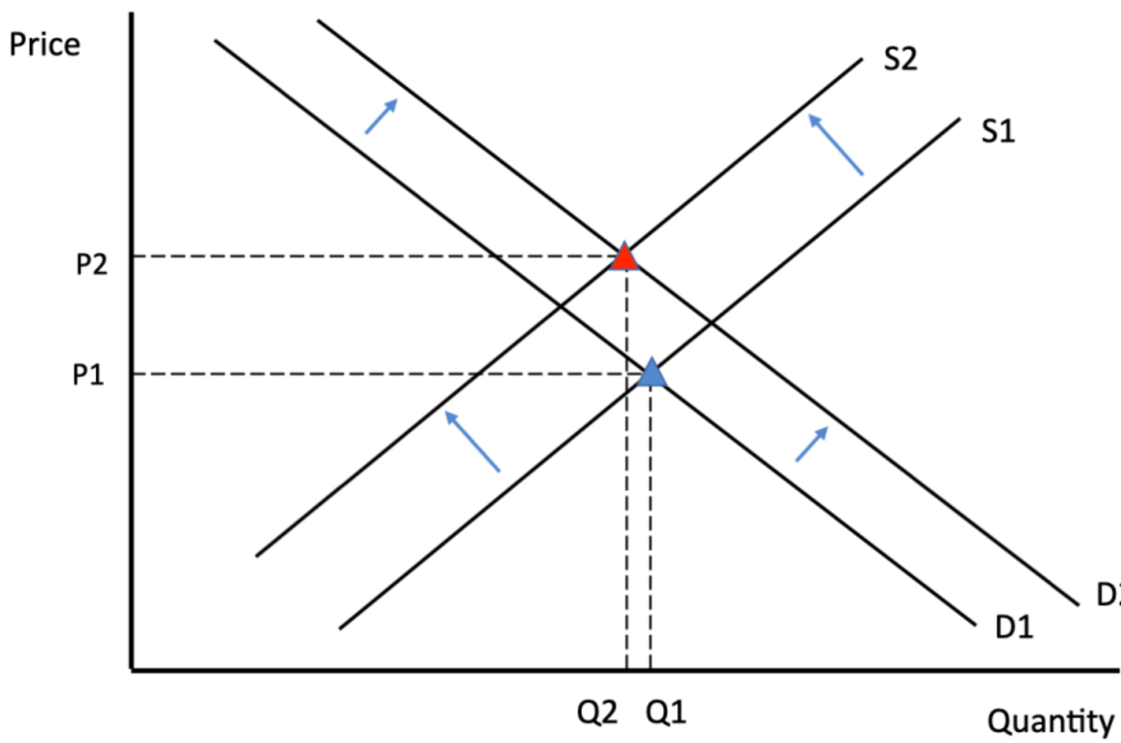
The problem with this theory is that inflation is surging to multi-decade highs in most other countries across the globe as well. While some of these countries did provide financial support for businesses and consumers during COVID, most did not come anywhere close to the level of support offered by the US government. So, I think it's safe to say that, at the very least, the big surge in inflation we're witnessing wasn't caused solely by the US government's COVID response to the exclusion of all other factors.

In another corner are those who place the lion's share of the blame at the feet of the Federal Reserve, which kept interest rates at close to 0% for ten of the last 13 years, in the process forcing investors into risky assets, creating asset bubbles, encouraging vast amounts of debt, pulling forward future demand and exacerbating economic inequality. Those who have read my commentary for years know that I have more sympathy for this argument. The suppression of interest rates for such extended periods of time was always going to end badly, whether due to rampant speculation and bursting asset bubbles, a financial contagion sparked by accumulated debt, or the inability to normalize interest rates due to the economy's heavy dependence on ultra-cheap money.

The problem with the Fed theory is that the central bank had kept interest rates suppressed at very low levels since the Global Financial Crisis without any measurable increase in inflation. In fact, for much of this time the Fed was more worried about falling prices than rising prices. And despite its Herculean efforts, the central bank was largely unsuccessful in raising inflation to its target rate of 2% over that time. Ergo, it doesn't seem as though the Fed and other central banks, which have clearly made policy mistakes that are now contributing to skyrocketing prices, are solely to blame either.

So though clearly contributing, neither massive amounts of fiscal stimulus nor ultra-accommodative monetary policy were enough to generate the severe inflation we're currently suffering. The real catalysts turned out to be a series of supply-side shocks. The first was the COVID-related economic shutdowns, which created massive shortages (importantly, to include labor shortages), and supply-chain bottlenecks that continue to raise input costs for businesses around the world today. The second was Putin's invasion of Ukraine and the associated shortages in commodities from food to energy to industrial metals. Additional supply-side issues were caused by the shortage in housing, which has been ongoing since the GFC but has recently intensified due to the effects of both COVID and the Ukraine War, and the lack of investment in energy production over the past several years.

My conclusion is, therefore, that the surging inflation we are witnessing today was caused by the confluence of many supply- and demand-side forces. In the graph below we show what happens to an economy that has undergone these types of massive and largely unforeseeable shocks. The starting point is the blue triangle, which represents the price level (P1) at which the total quantity of goods and services (Q1) demanded throughout the economy equaled the total quantity of goods and services supplied. We then shift the demand curve out to reflect the increase in demand, and we shift the supply curve back to reflect the reduction in supply. You can see that the new equilibrium (the red triangle) is at a much higher price level as well as a lower quantity of goods and services – exactly what a central bank does NOT want to see.



Source: Farr, Miller & Washington

Cause for Optimism?

Fed Chairman Jay Powell has made it very clear that he will bring inflation rates way down, with or without a recession. Having said that, there are early signs that the Fed may be able to avoid a worst-case scenario. Demand appears to be moderating as a result of many factors, including inflation that is growing at a much faster pace than wages (especially gas prices and rents); higher interest rates; plummeting consumer and business confidence; the surge in the dollar; the drop in financial asset prices (stocks and bonds); plummeting federal budget deficits; and a rapidly cooling housing market. More concrete evidence of the moderation in demand has come in the form of weaker retail sales and consumer spending. And the recent plunge in savings rates and spike in consumer credit suggest that a rising share of consumers have now depleted their government COVID windfalls (though it should be pointed out that in the aggregate, US households still held a massive $17.9 trillion in cash and equivalents at the end of the first quarter).

On the supply side, China appears to be through its latest bout of COVID, consumers appear to be shifting their spending mix back to services and away from goods, commodity prices have dropped precipitously, and several big retailers appear to have built up sizable inventories, which will need to be marked down.

Each of these factors suggest that the levels of inflation we are now experiencing may not last too much longer. The ongoing areas of concern, at least to me, are the housing and labor markets. But even these markets could soon see some relief. Big increases in input costs, coupled with sagging demand, will cause at least some businesses to scale back the current aggressive pace of hiring. And absent continued strong wage gains, it may not make sense to expect rents to keep rising at the current outsized pace.

To sum it up, we are not in the camp that believes prices will keep rising at a breakneck pace indefinitely. However, the reasons for an expected moderation in inflation are not particularly comforting either. It's becoming obvious at this point that the economy cannot withstand the rise in inflation and interest rates that we've already witnessed. We could be teetering on the brink of economic contraction fairly soon, if not right now. But unless supply disruptions in the oil market persist or even intensify, we expect the economic slowdown will also bring much lower rates of inflation. And a moderation in inflation to more acceptable levels should limit the economic damage the Fed feels compelled to inflict. Still, it may be too late to avoid a recession.

Peace,

Michael

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