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THE CLIENT LETTER

MONTHLY NEWSLETTER

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Inflation

(Is this anything?)

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As a student at Belmont in the late 80's, ***The David Letterman Show*** was a staple at 11:30pm every night - after completing all homework assignments in a timely manner or course. He featured a segment called: ***"Is This Anything?"*** in which he would highlight some weird or odd video or occurrence and would ask the audience if this was worthy of admiration…or just silly.

The rampant inflation of the late 70's is a distant memory and somewhat even folklore at this point, but with recent hot inflations readings, it has many wondering: "Is This Anything?" And for good reason, the latest CPI print showed prices rose 5.4% over the last 12 months, much higher than the 1.5-2.0% previously. Anecdotally, anyone buying gasoline, appliances or lumber knows firsthand how much prices have risen. I've heard contractors tell me they've seen lumber prices triple in some cases. This has caused some to guarantee their "bids" for only a few hours…that's right, HOURS.

Another factor leading to bottleneck shortages is the effect of the port shutdowns from this past February, when 75% of the country was under a deep freeze. My wife and I just returned from a trip to Boston and there are still stacks of cargo trailers on the docks as far as the eye can see. This is why your new oven or washing machine you just purchased at Home Depot will arrive in December! Indeed, supply shortages add to inflationary pressures.

Add to that the difficulty employers are having finding workers. While there are several reasons for this, such as limited childcare and continued fear of workplace infection, much of it is due to sidelined workers receiving both Federal as well as state unemployment benefits. For many this equates to $600/week or more - which works out to at least $15/hour for a 40 hour work week.

So, from an employer perspective, how much do you have to pay someone to entice them to give up 8 hours of their day to work in your establishment? It would logically have to be more than $15/hour - that's just math…and inflationary - at least until the unemployment benefits run out. As one business owner put it recently: "Brick, I never thought my biggest competitor for workers would be the government".

So it is easy to see why fears of inflation have become more prominent lately. In economics, mild inflation is a good thing. It is the sign of a healthy economy in which steadily rising prices lead to steadily higher wages which gets funneled back into the economy at a steadily rising rate. This is why the Fed has an inflation "target" - an attempt to foster a steadily growing economy.

But if prices rise too fast for too long, it is a shock to the economy and can erode the purchasing power of the dollar quickly. In this type of scenario (much like the late 70's), the Federal Reserve might be forced to raise interest rates much faster and higher in order to "cool off" an overheating economy. This would be an unwelcome series of events for financial markets and would likely cause the value of assets to drop initially. Consider this hypothetical impact that a rise in interest rates might have on housing: The 30 year payment for a $500,000 mortgage at 3% is $2,125 (principal and interest only). Let's look at what happens if mortgage rates rise to 5%. Assuming $2,125 is the maximum payment a family could make, the new mortgage they could now support is only $392,000 - a decline of $108,000 or 22% in purchasing power, all due to a rise in interest rates.

Personally, I do not think this will happen, at least not quickly. Fed Chairman, Jerome Powell has indicated that much of the current inflationary pressures are "transient" and should subside as supply chains return to normal and unemployment benefits run out. And while he could be wrong (this has certainly been an economic exercise with very little precedence), the fact is, Chairman Powell has much greater data and experience on which to draw, so I would be inclined to believe him over my own water-cooler fodder, at least until proven otherwise.

But perhaps the most important fact supporting the likelihood of persistently low interest rates is the global bond markets. The current 10 year Treasury bond yield stands at 1.18% as of this writing - and in many other countries that rate is nearly zero if not negative (negative interest rates are a topic for another day). If inflation was expected to be anything but transient, one would expect to see these bond yields rising as a way to forecast or "get in front of" the Fed raising interest rates. We saw this briefly earlier in the year when the 10-year treasury spiked to 1.75%, but just as quickly, yields came back down - an odd occurrence for a market worried about inflation.

Also consider the amount of new debt issued by the U.S. (and the rest of the world) to combat the pandemic - not to mention the likely infrastructure bill many expect to be passed. If interest rates rise too far, it would put tremendous pressure on the Federal government to pay the interest on this debt. For this reason, I believe the Fed will stand pat on interest rates longer than some believe.

Lastly, we have received several questions about the best investments during a period of higher inflation. And while commodities as well as emerging markets are common themes, my research/experience shows that common stocks have historically been a favorable inflation hedge over the long term. Higher prices can lead to higher corporate earnings - which is usually a good thing for stockholders over time.

And while no one can predict financial markets, I continue to believe we are in a secular bull market that started in 2009. According to long-time investment strategist, Jeff Saut, secular bull markets can last 15-20 years (with sharp pullbacks along the way of course). If this is the case, I would use any market pullback or correction as a buying opportunity as well as a possible "inflation hedge".

As always, we thank you for your business, your friendship and the trust you place in us. Feel free to share this letter with anyone you feel may benefit. Edie, Cole and I are in the office daily and happy to answer any questions you may have. Until then, wishing you health and happiness.

Regards,

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