Inflation: transitory or persistent?

NCMC Investment Club

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Reaching financial success is a marathon, not a sprint.
Slow and steady wins the race.

1971 Cost of Living

Living

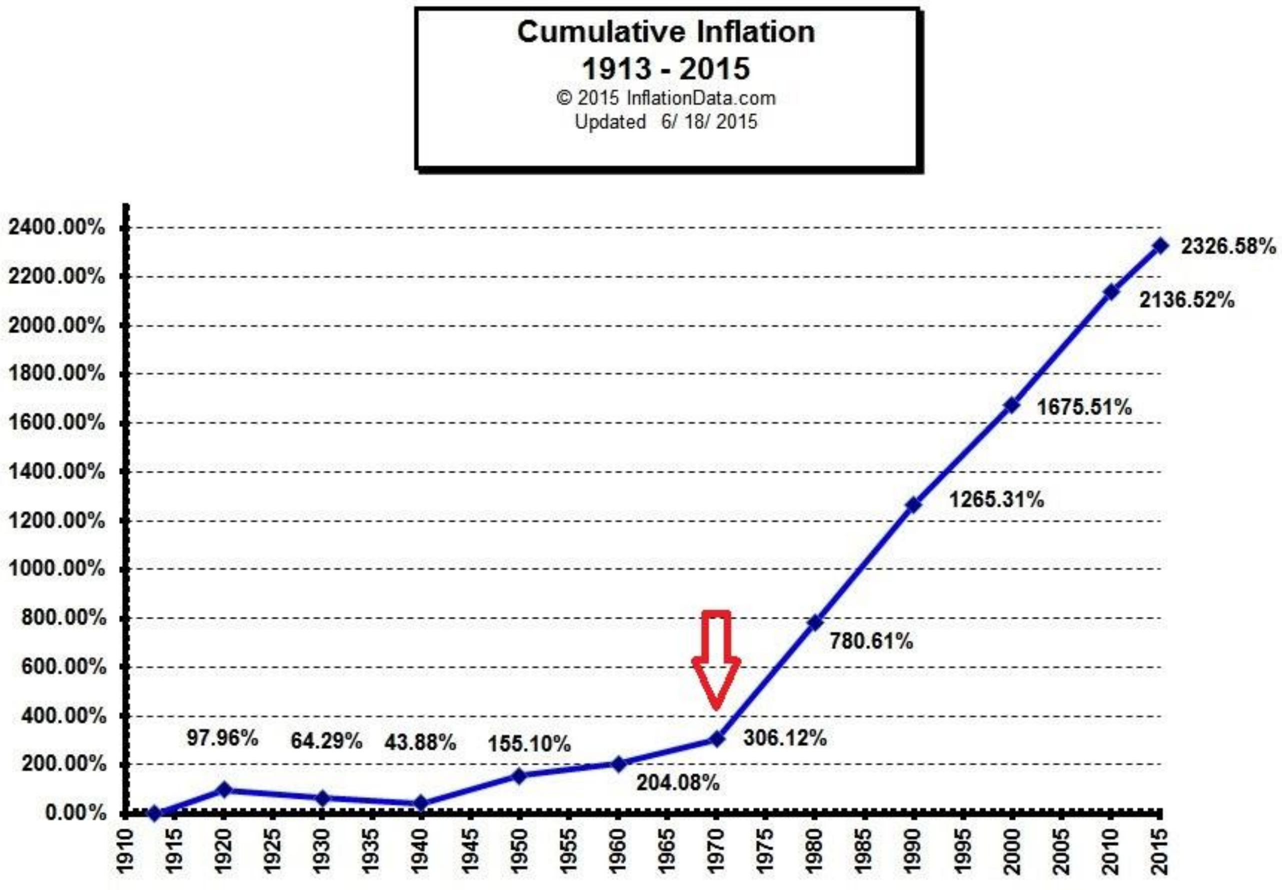
New House	$25,200.00
Average Income	$10,622.00 per year
New Car	$3,560.00
Average Rent	$150.00 per month
Tuition to Harvard University	$2,600.00 per year
Movie Ticket	$1.50 each
Gasoline	40¢ per gallon
United States Postage Stamp	8¢ each

Food

Granulated Sugar	62¢ for 5 pounds
Vitamin D Milk	$1.17 per gallon
Ground Coffee	98¢ per pound
Bacon	80¢ per pound
Eggs	45¢ per dozen
Fresh Ground Hamburger	62¢ per pound
Fresh Baked Bread	25¢ per loaf

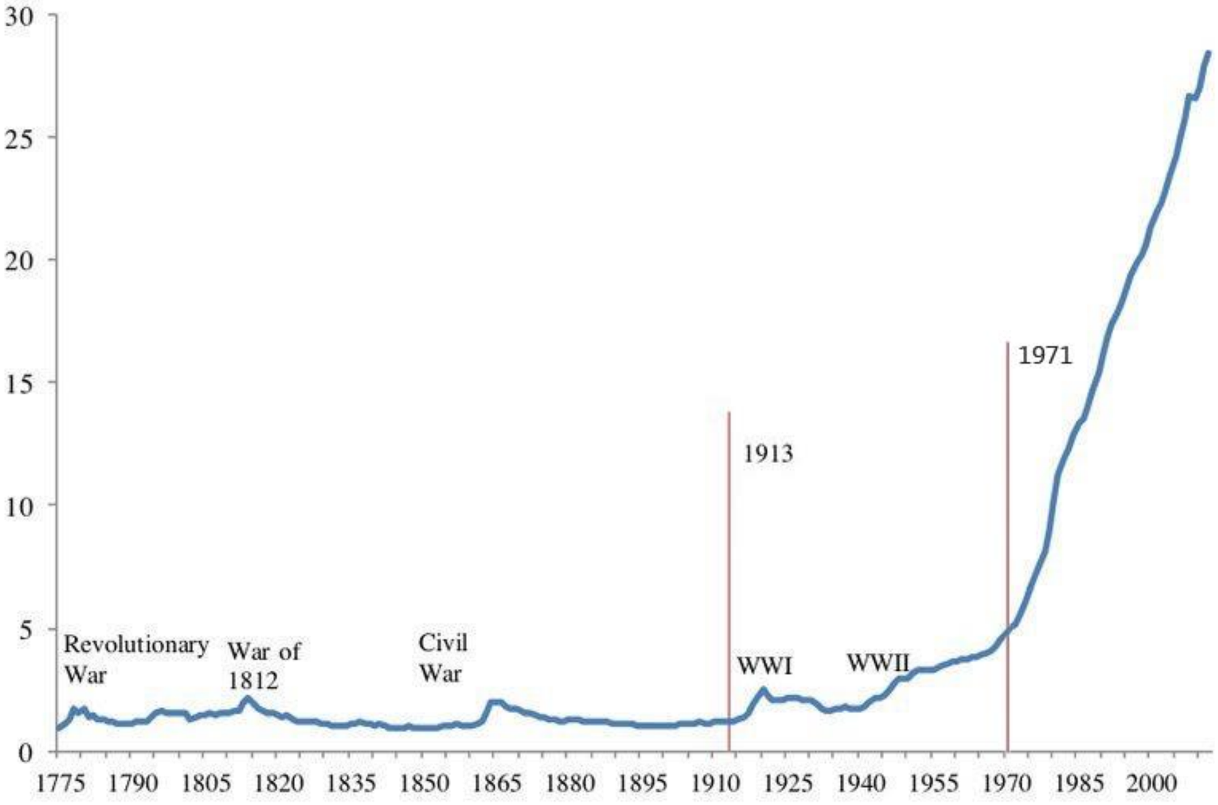
SeekPublishing Remember When 1971

100 years of inflation



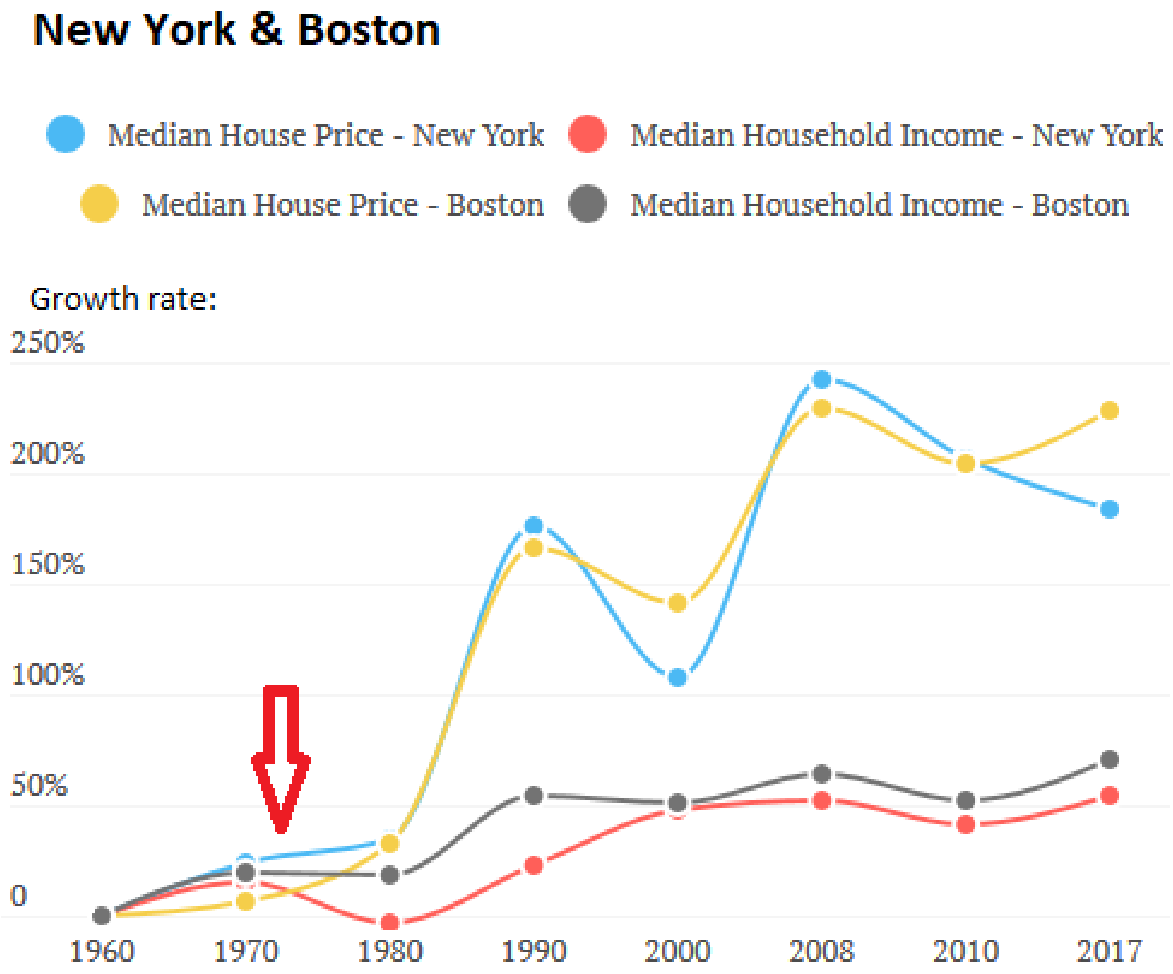
Consumer Prices since Revolutionary War

Figure 1. Consumer Price Index, United States, 1775-2012
(level, 1775=1)

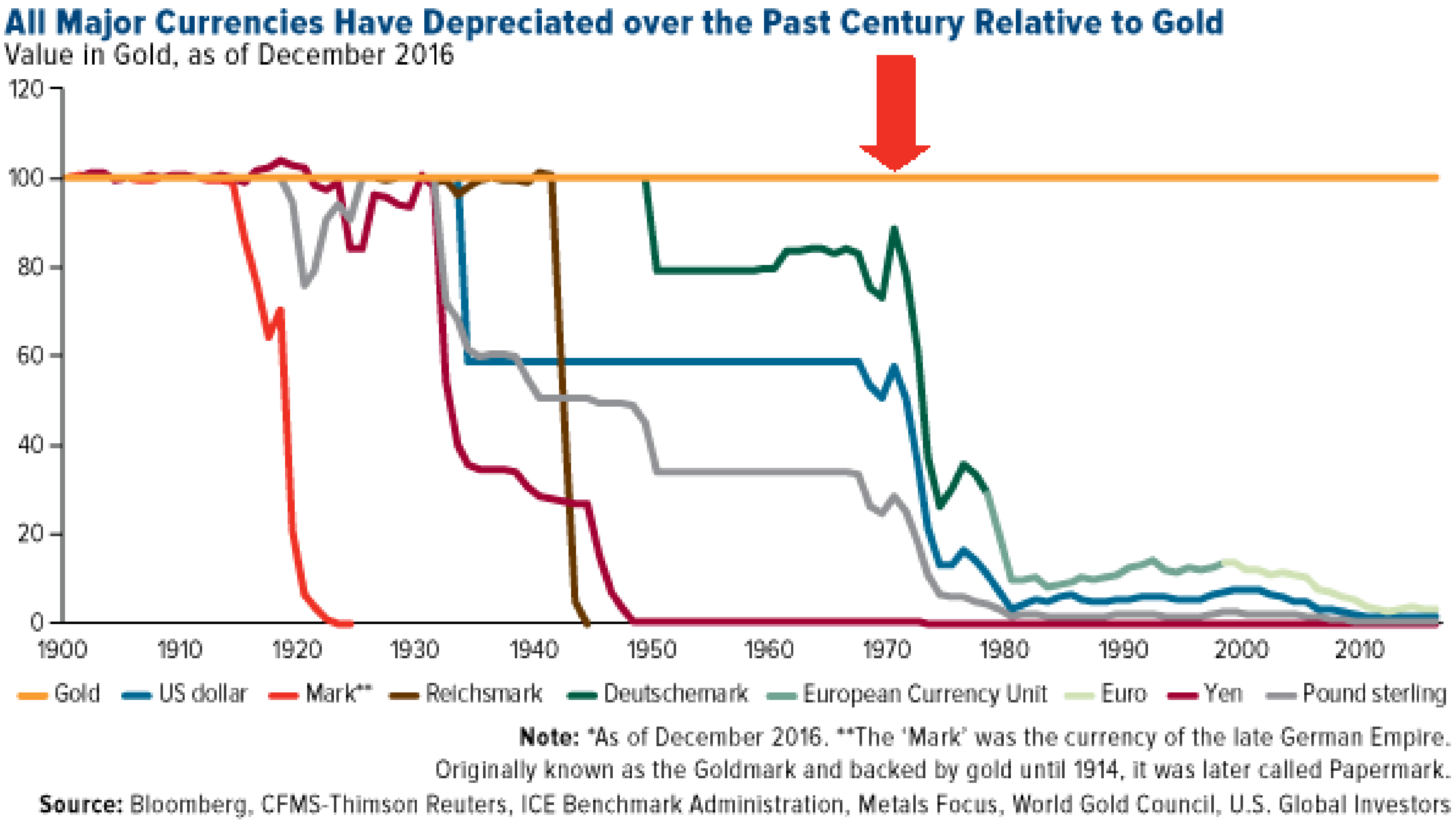


Sources: Bureau of Labor Statistics, Historical Statistics of the United States, and Reinhart and Rogoff (2009).

New York and Boston



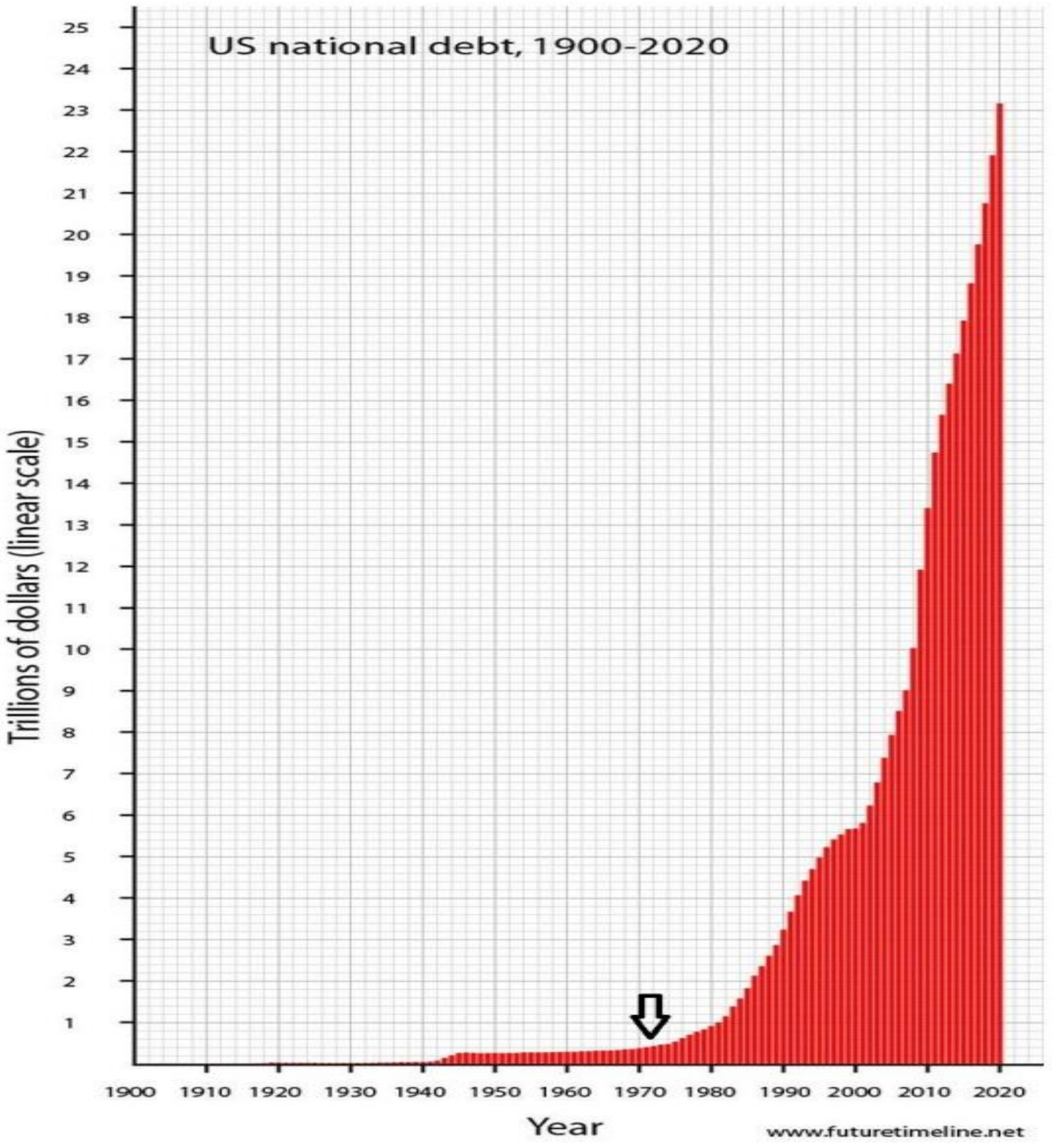
Fiat Currencies have depreciated relative to Gold

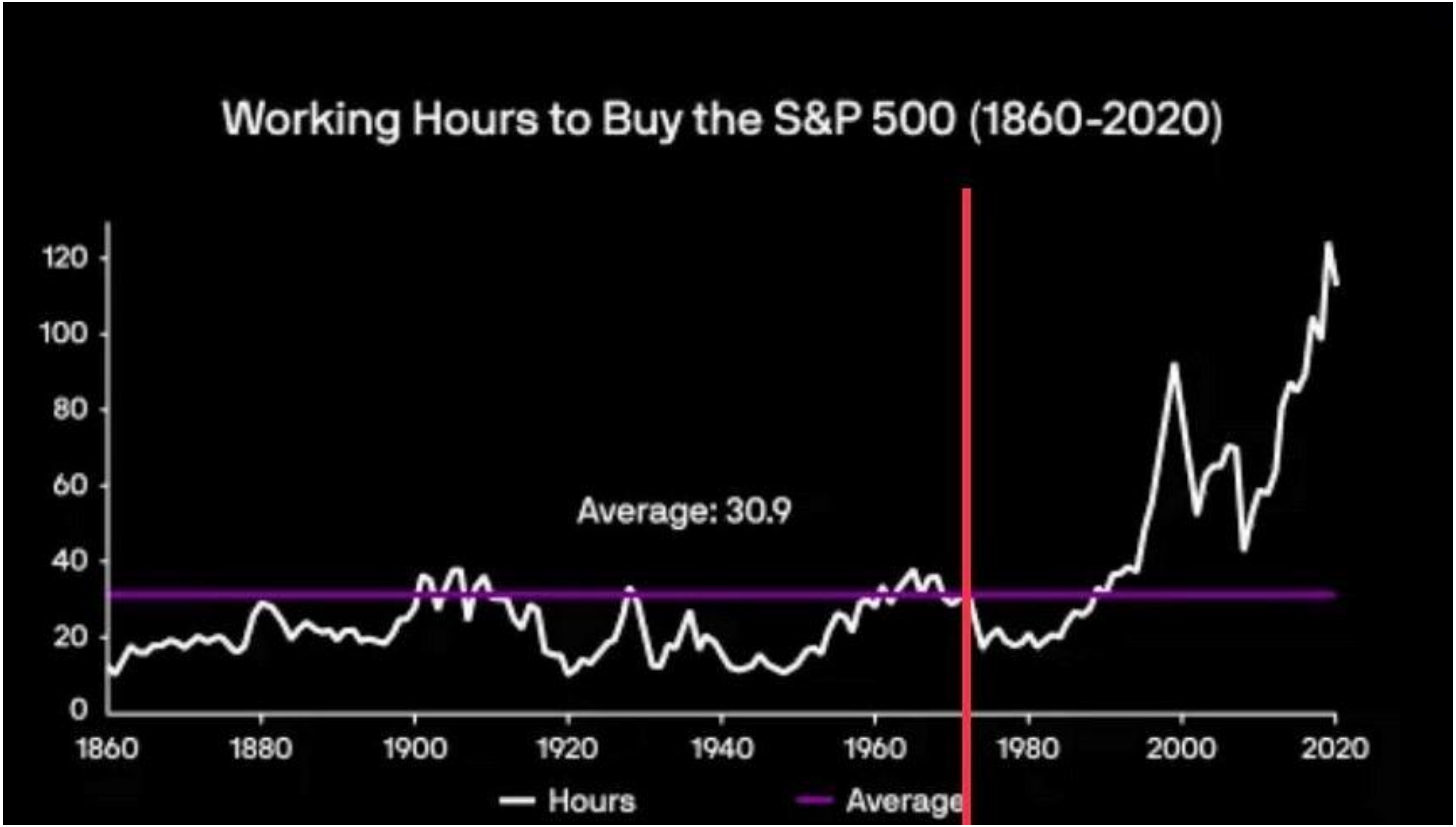


Federal Debt (% of GDP)

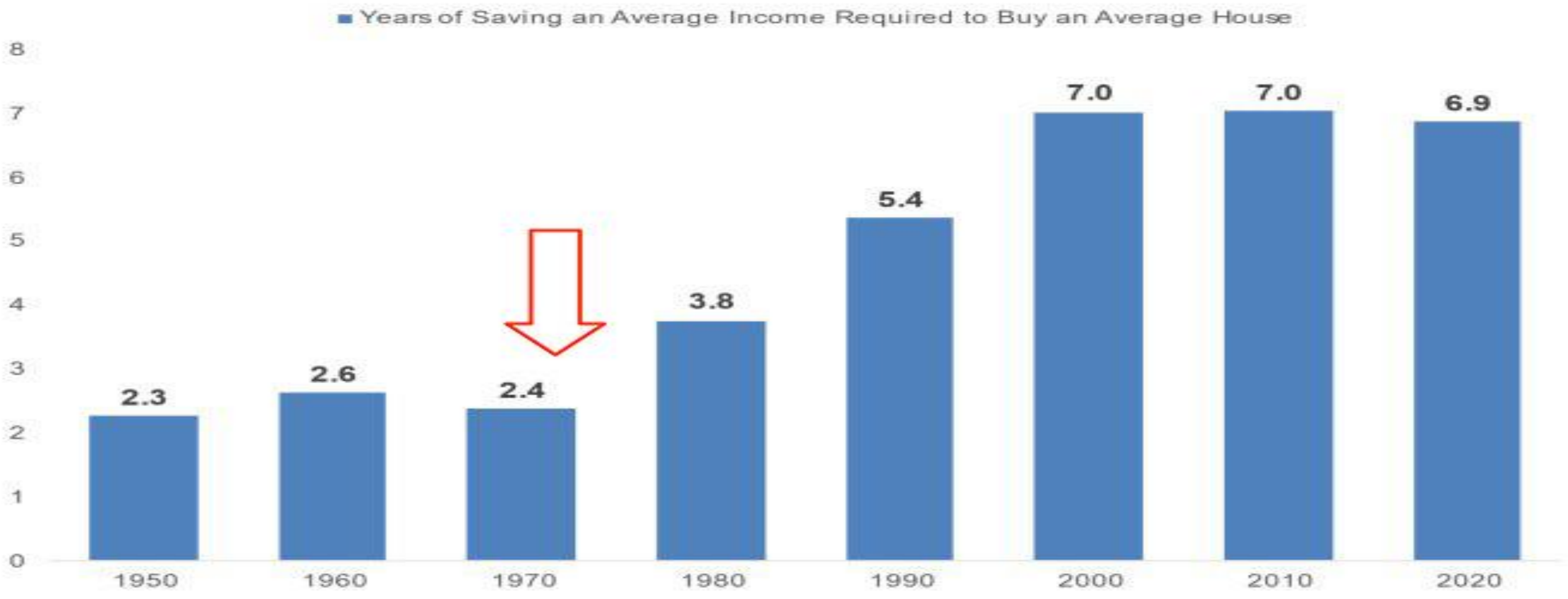
SOURCES: Congressional Budget Office, *The Budget and Economic Outlook: 2020 to 2030*, January 2020; and Office of Management and Budget, *Historical Tables, Budget of the United States Government: Fiscal Year 2021*, February 2020.

PGPF.ORG


US national debt, 1900-2020
Trillions of dollars (linear scale)
25
24
23
22
21
20
19
18
17
16
15
14
13
12
11
10
9
8
7
6
5
4
3
2
1
1900 1910 1920 1930 1940 1950 1960 1970 1980 1990 2000 2010 2020
Year
www.futuretimeline.net


Working Hours to Buy the S&P 500 (1860-2020)
120
100
80
60
40
20
0
1860
1880
1900
1920
1940
1960
1980
2000
2020
Average: 30.9
Hours
Average

How Long Does it Take to Save for a House?

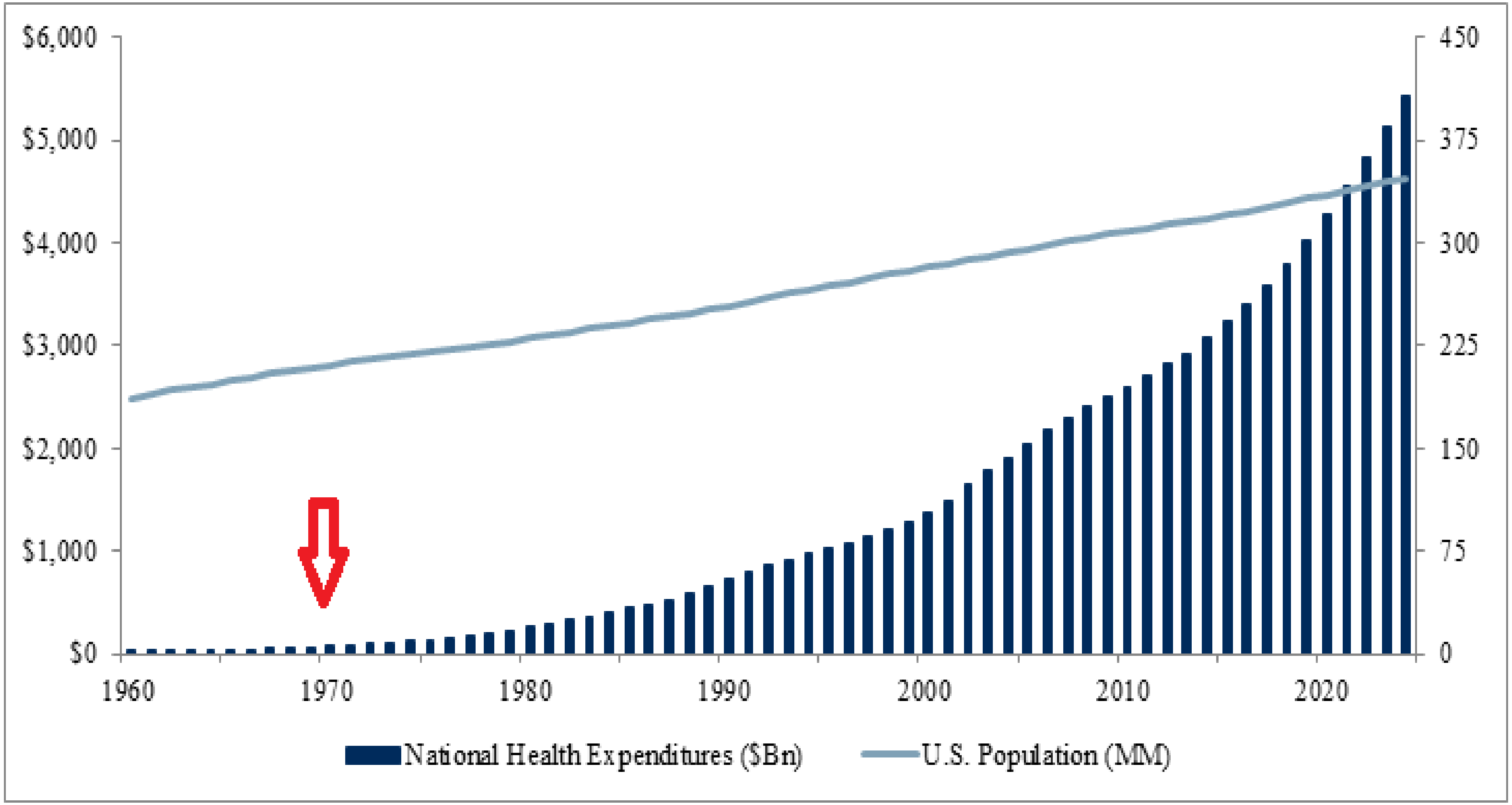


Source: FRED, thepeopleshistory.com

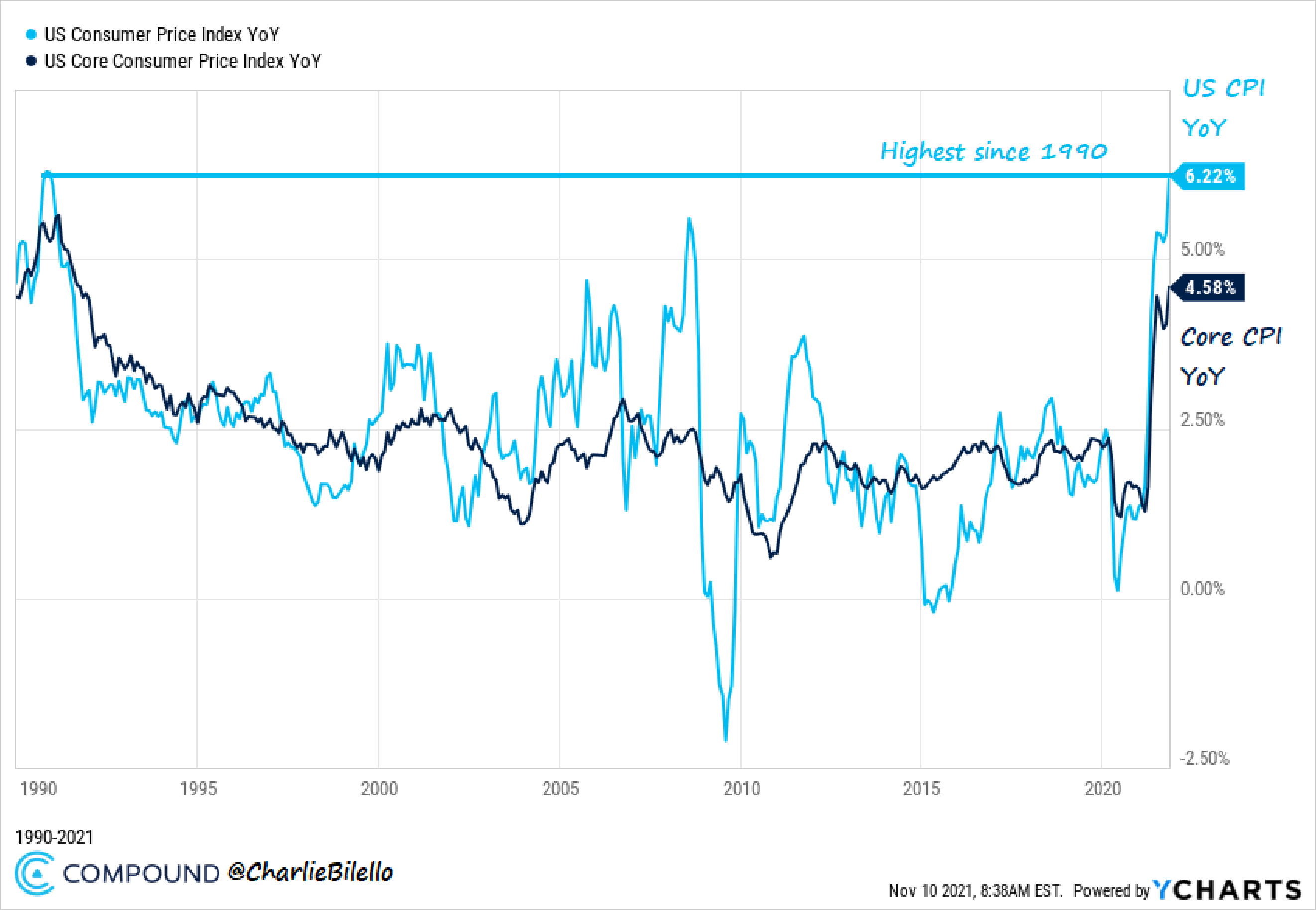
Source: Mark Moss

In 1950, it took 2.3 years of your life, your labor, to save for the cost of an average home. By 2020, that figure ballooned to nearly seven years. The system has stolen that time from you through inflation.

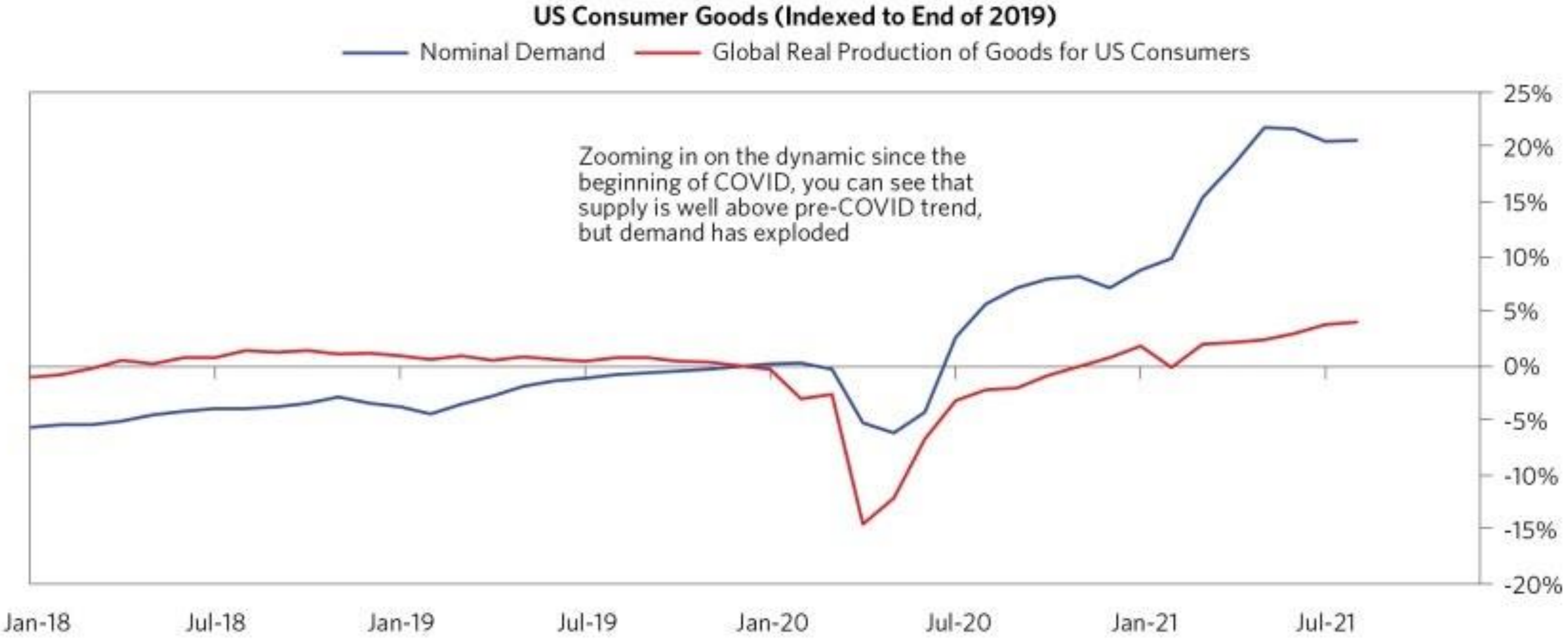
National Health Expenditures exploded



~~**Transitory**~~ **Persistent Inflation** The Inflationary Spiral: At 6.2%, the US inflation rate is now at its highest level in over 30 years…Core CPI + 4.6%.



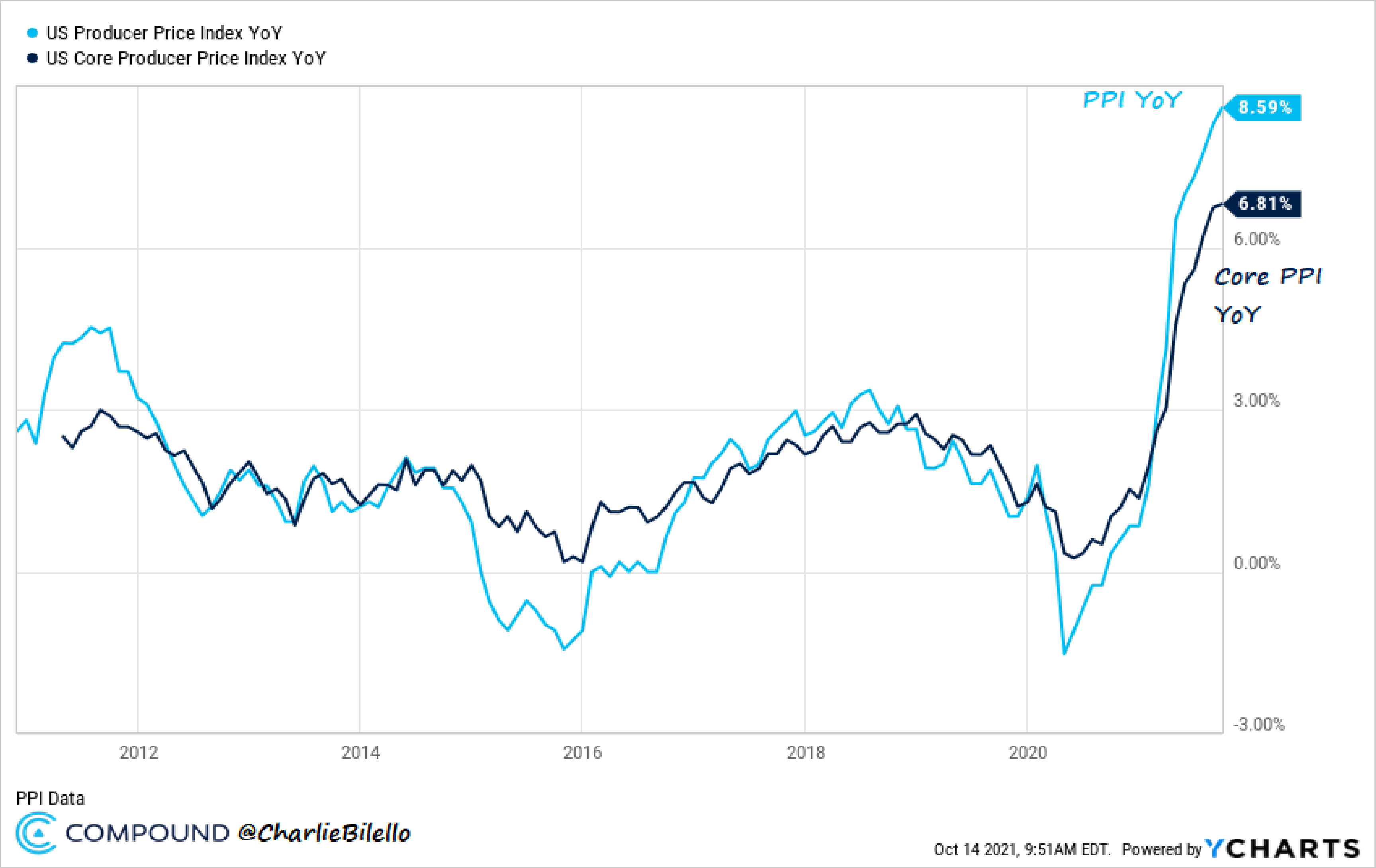
Today, demand is surging, and supply is also growing, but it just can't keep up with demand. There are not enough raw materials, energy, productive capacity, inventories, housing, or workers



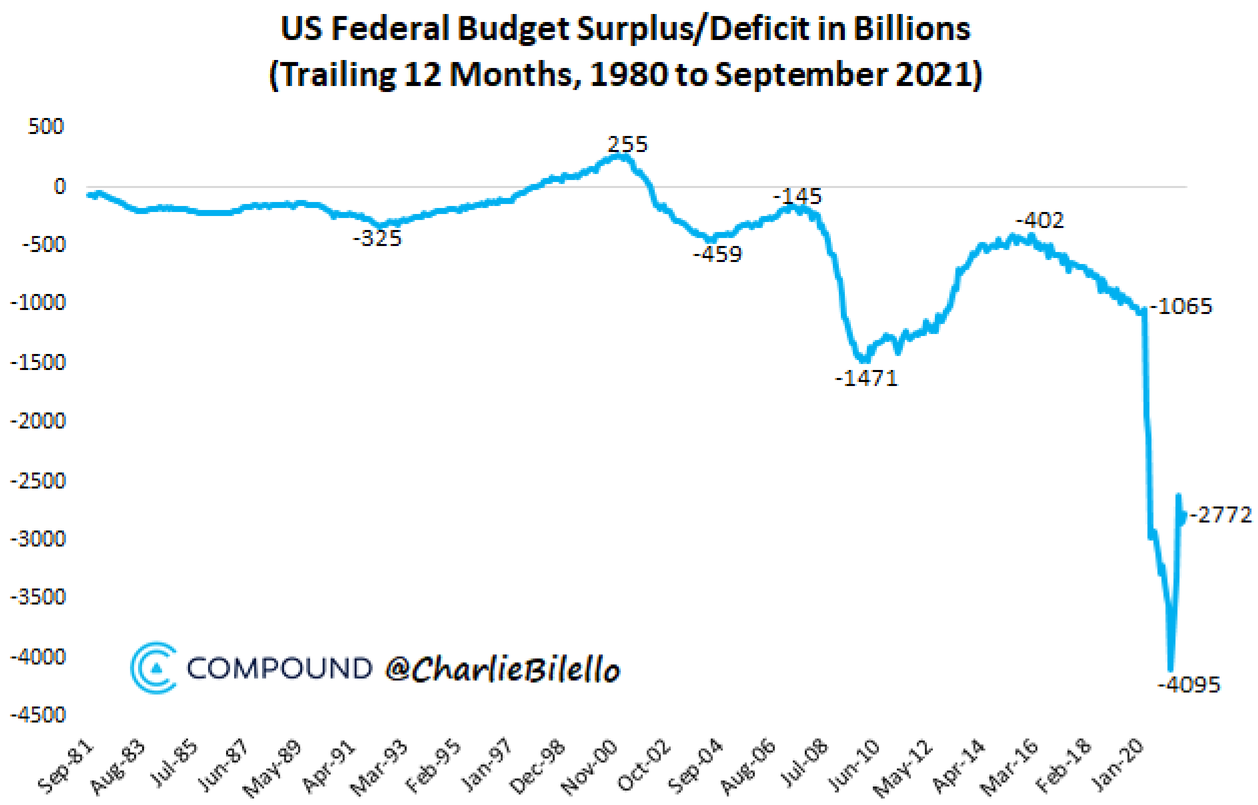
Breakdown of Price Increases in latest CPI Report

- Gasoline: +49.6%
- Gas Utilities: +28.1%
- Used Cars: +26.4%
- Meats/Fish/Poultry/Eggs: +11.9%
- New Cars: +9.8%
- Electricity: +6.5%
- **Overall CPI: +6.2%**
- Food at home: +5.4%
- Food away from home: +5.3%
- Transportation: +4.5%
- Apparel: +4.3%
- Shelter: +3.5%

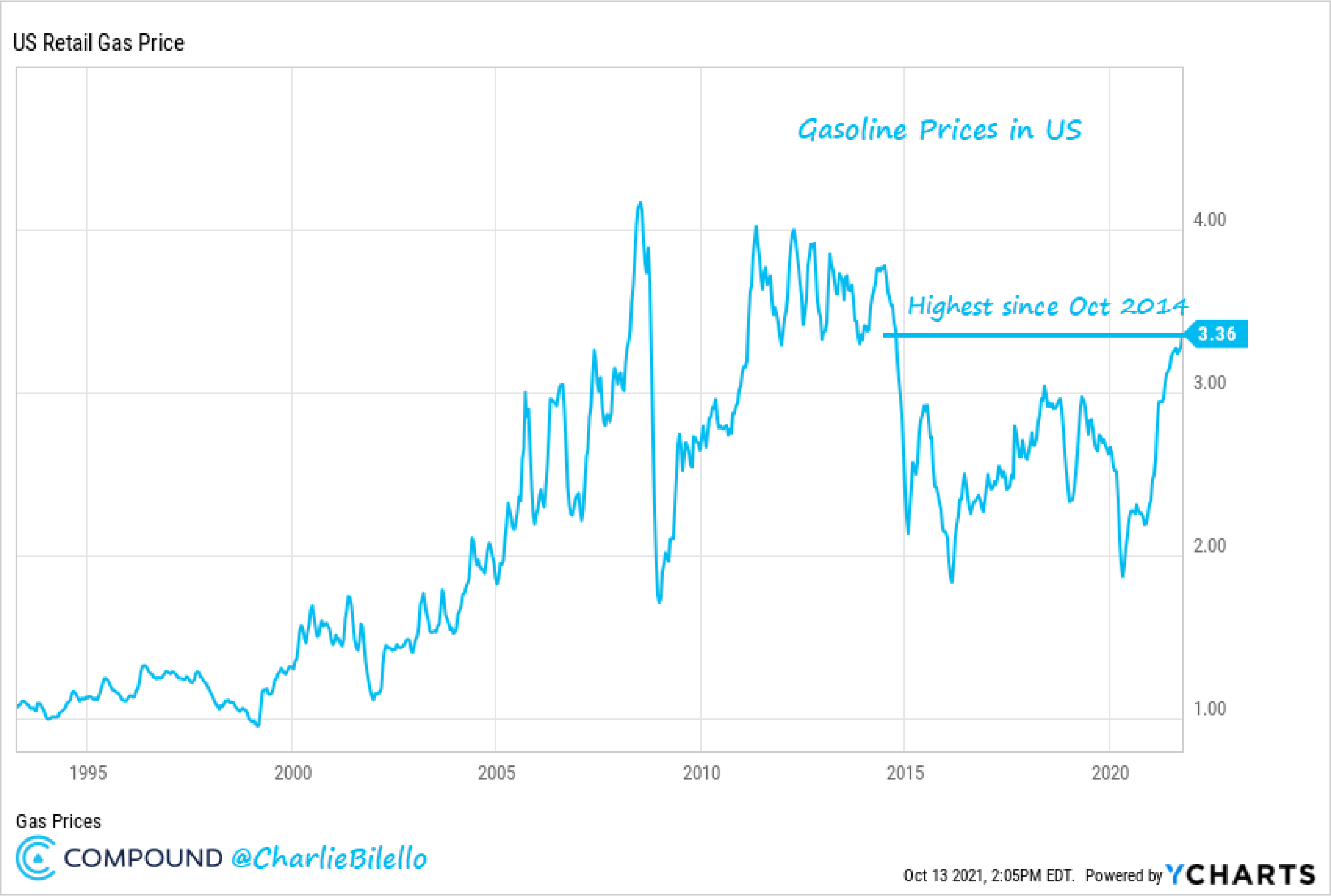
Producer prices also continued their upward trajectory, up 8.6% over the last year (October); Core PPI + 6.8%.



Deeper in Debt - Undeterred by rising inflation, the Federal Government continues to spend money like a drunken sailor. The US National Debt has once again hit the "debt ceiling limit" ($28.9 trillion) and the deficit for the latest fiscal year of $2.772 trillion was the second largest in the nation's history, trailing only 2020.



Meanwhile, Crude Oil prices rose to their highest levels in 7 years, and Gas prices did as well (average of $3.36 per gallon in the US).

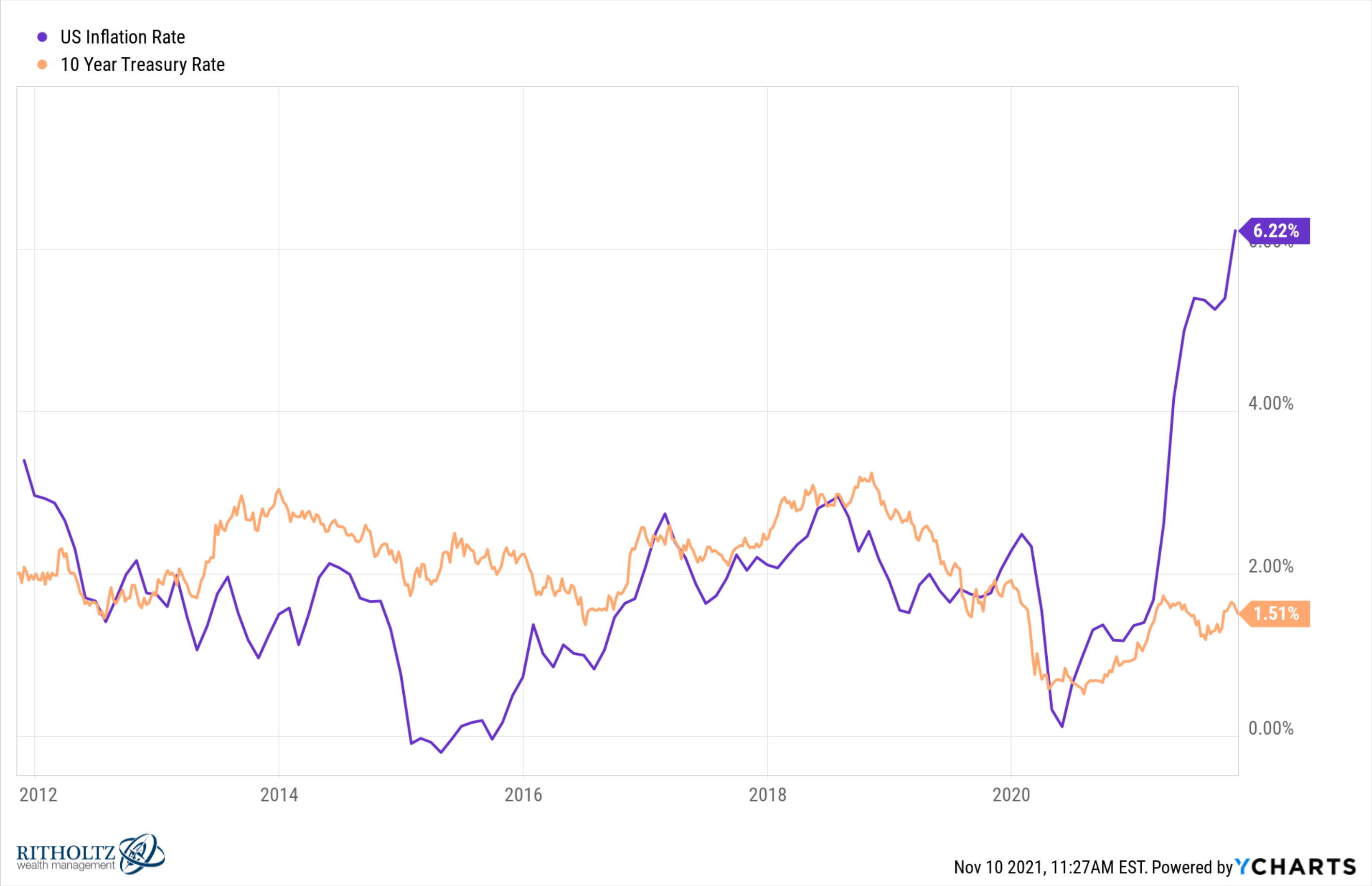


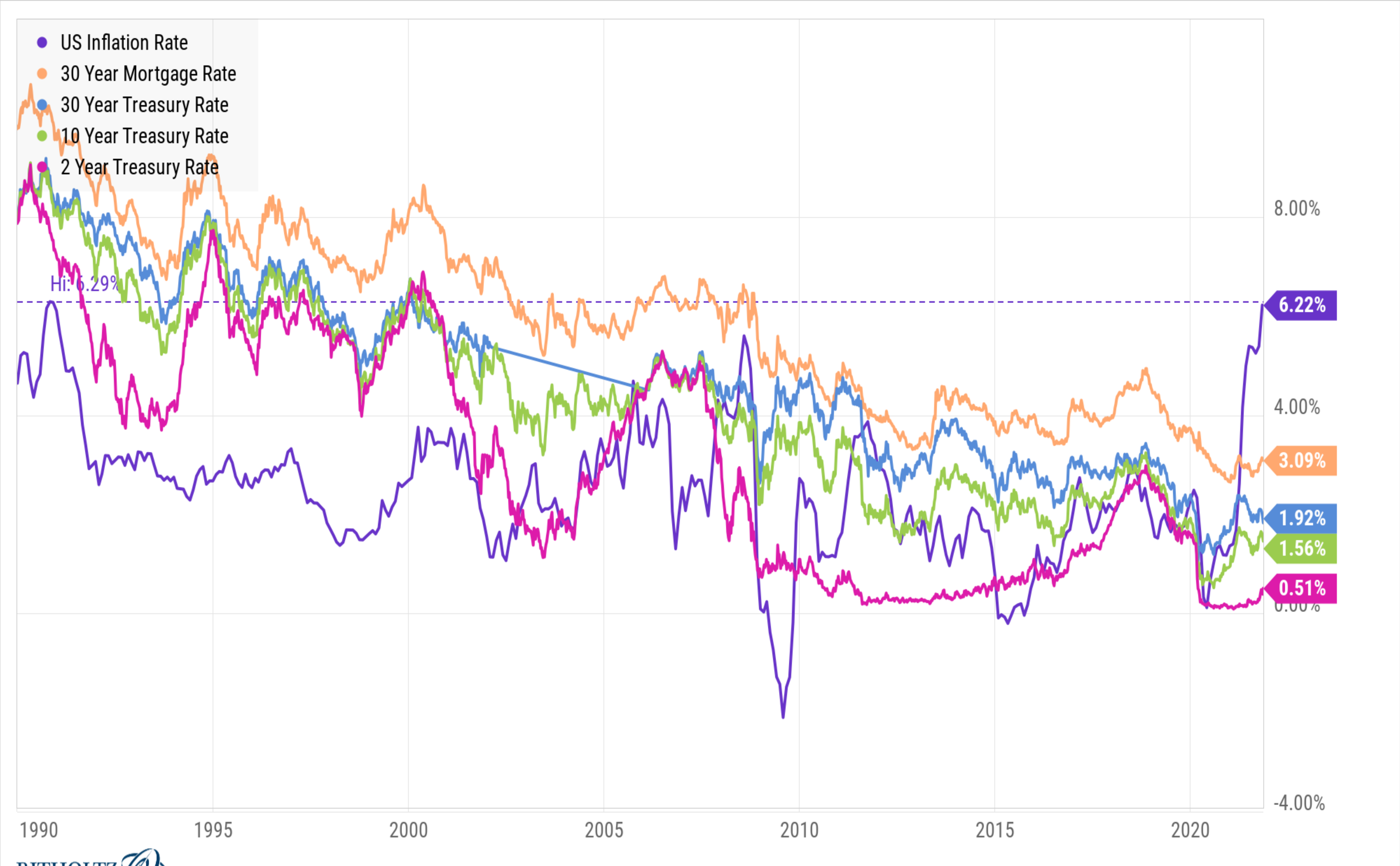
The 65 million Americans receiving social security benefits are about to see the largest increase in their benefits since 1982.
Calculated based on changes in CPI, the Social Security Administration announced a 5.9% bump up in monthly payments starting in January 2022.

Social Security Cost-of-Living Adjustments			
1975	8.0%	1999	2.5%
1976	6.4%	2000	3.5%
1977	5.9%	2001	2.6%
1978	6.5%	2002	1.4%
1979	9.9%	2003	2.1%
1980	14.3%	2004	2.7%
1981	11.2%	2005	4.1%
1982	7.4%	2006	3.3%
1983	3.5%	2007	2.3%
1984	3.5%	2008	5.8%
1985	3.1%	2009	0.0%
1986	1.3%	2010	0.0%
1987	4.2%	2011	3.6%
1988	4.0%	2012	1.7%
1989	4.7%	2013	1.5%
1990	5.4%	2014	1.7%
1991	3.7%	2015	0.0%
1992	3.0%	2016	0.3%
1993	2.6%	2017	2.0%
1994	2.8%	2018	2.8%
1995	2.6%	2019	1.6%
1996	2.9%	2020	1.3%
1997	2.1%	2021	5.9%
1998	1.3%		

COMPOUND @CharlieBilello

The bond market still doesn't care - With inflation surging, the real interest rate is a record low.





US Inflation Rate
30 Year Mortgage Rate
30 Year Treasury Rate
10 Year Treasury Rate
2 Year Treasury Rate
Hi: 6.29%
8.00%
4.00%
0.00%
-4.00%
6.22%
3.09%
1.92%
1.56%
0.51%
1990
1995
2000
2005
2010
2015
2020

Inflation was similar but yields on everything were way higher.

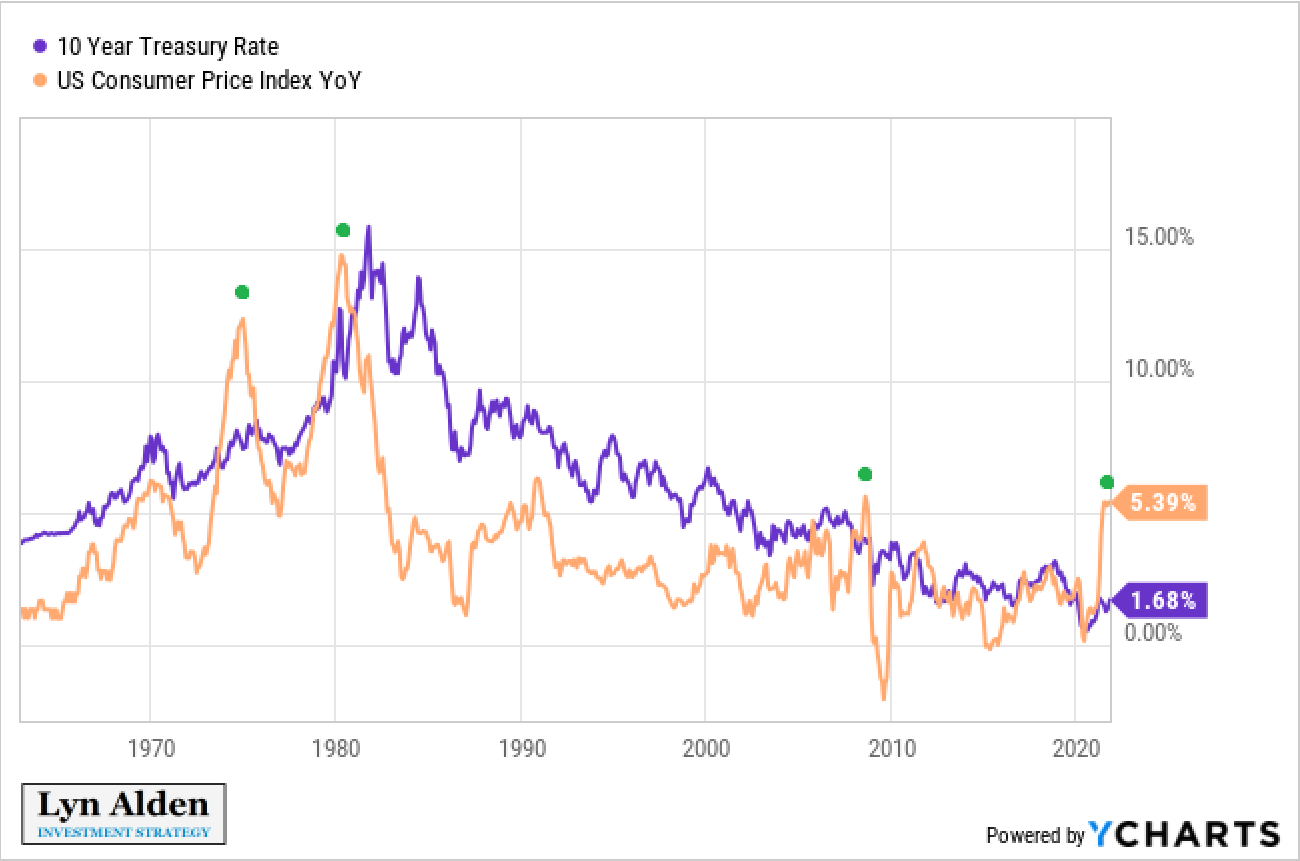
Yields	November 1990	November 2021
Inflation Rate	6.3%	6.2%
30 Year Mortgage Rate	9.9%	3.1%
30 Year Treasury Rate	8.4%	1.9%
10 Year Treasury Rate	8.3%	1.6%
2 Year Treasury Rate	7.5%	0.5%

Source: YCharts

Which situation looks worse?

- That depends if you’re more of a saver or a borrower.
- Today is clearly a much better market for borrowers. If inflation is higher than your borrowing rate, every mortgage payment is being paid back with dollars that aren’t worth as much.
- On a real basis, your mortgage right now is trading at a negative interest rate. Not bad.
- But consumers get hurt by rising prices at the grocery store, gas pump or car dealership.
- Back in 1990 savers were protected against higher inflation because yields were much higher than inflation across the board.
- If you own financial assets, especially in the stock market, you have a decent hedge against higher prices. So far, corporations can deal with higher inflation since they have pricing power, but for how long?
- Stocks are a good long-term hedge against inflation.

If inflation remains sticky at 3-6% or more for a while, then 10-year Treasury yields could very well try to keep pushing up from current super-low levels. Their yields are currently far below the inflation rate, which has only happened a few times in the past sixty years:



Stocks remain a good hedge against inflation

- Profit margins remain near all-time highs despite rising input costs and supply chain issues.
- *According to Factset, the net profit margin for the S&P 500 during Q3 is tracking at 12.9%. This is well above the five-year average of 10.9% and just barely below the record high of 13.1% in Q2.*
- How is this possible? Companies are passing along their higher prices to consumers.
- You could argue there has never been a better time to borrow money at very low rates. And inflation is slowly eroding the debt you are paying back.

What if this higher inflation is still temporary?

- The supply chain bottlenecks are not going to sort themselves out overnight. Commodity prices aren’t going to immediately fall back to pre-pandemic levels. It could take some time to work through this stuff.
- Critics say that generous stimulus measures are to blame for rising prices, and more spending will make inflation even worse.
- As a general rule, government spending tends to bolster economic growth, and, as a result, inflation.
- Rent and owner’s equivalent rent were key drivers of October’s inflation print, while other things remained elevated as well. This rent and owner’s equivalent rent CPI is just getting started, so overall high official CPI should be sticky for the remainder of Q4 2021 and Q1 2022

Global Supply Bottlenecks

- A worldwide shortage of semiconductors forces companies making anything from cars to mobile phones, laptops or TV sets to cut production.
- Major ports such as Los Angeles and Long Beach, CA, are congested and the traffic jams are likely to continue well into 2022.
- Producers and transporters are struggling to keep up with the strong demand from households.
- Shipping rates have more than doubled between January and August, amid signs of a shortage of container transport capacity.
- **Turkey Troubles -** Finding a turkey for Thanksgiving dinner this year is going to be harder than ever before. At the end of October, turkeys were 60% out of stock, with labor and supply chain issues to blame.

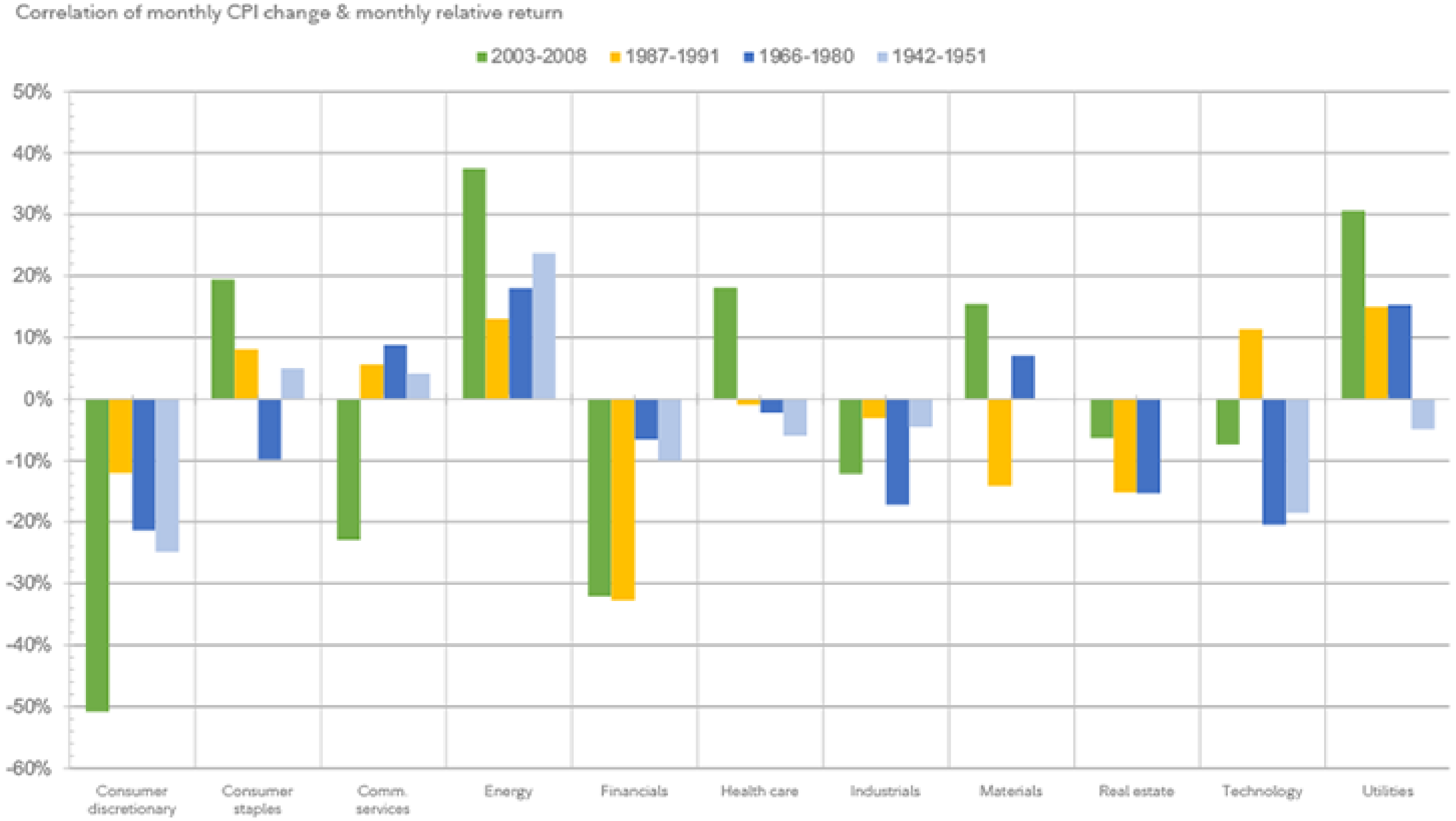
Is the Fed behind the curve?

- The Underlying Inflation Gauge (UIG), created by the New York Fed, provides a measure of persistent, sticky, inflation
- The UIG has been soaring since February and stands at a record high of 4.3%, well above the Fed target of 2%.
- Transitory inflation components account for close to 1.5% of core CPI.
- The latest surge in inflation has occurred at a time when debt has ballooned, making the prospect of higher interest rates problematic.

the Biden administration is working to address rising prices in both the short and long-term.

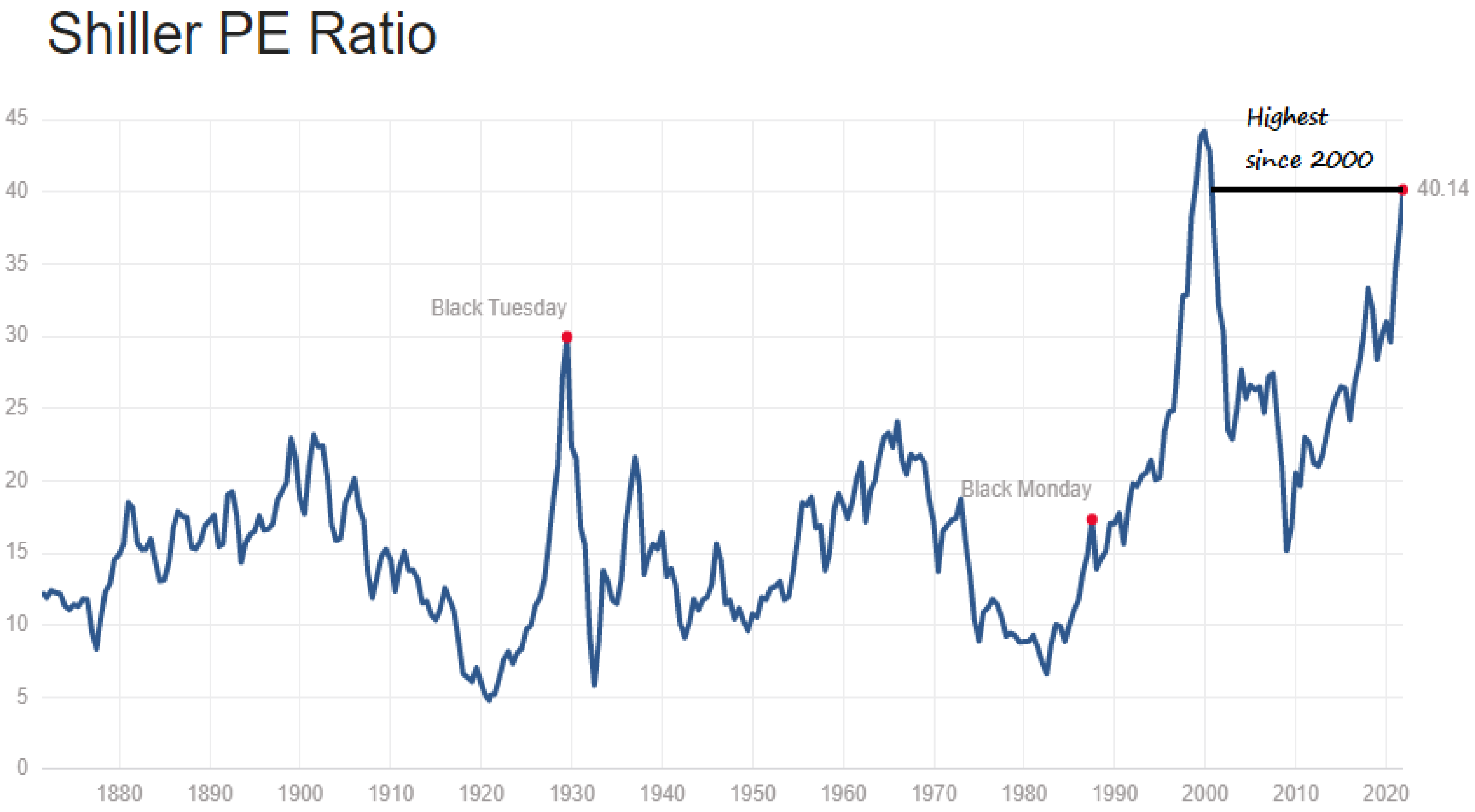
- White House statement from Biden: “Inflation hurts Americans’ pocketbooks, and reversing this trend is a top priority for me.”
- President Joe Biden’s nearly $2 trillion social spending bill, which is still being debated in Congress, “is actually going to address the core costs that American families are facing,” National Economic Council Director Brian Deese said, especially in child-care, housing and health care.
- The bill would lower prescription drug prices and reduce child-care costs.
- Deese said getting the job done on fighting Covid-19, which would allow people to return to work and “return to a sense of normalcy,” was important as was tackling the supply chain issues crippling economies around the globe.

Sector correlation during inflation regimes



Monthly data. Source: FMRCo.

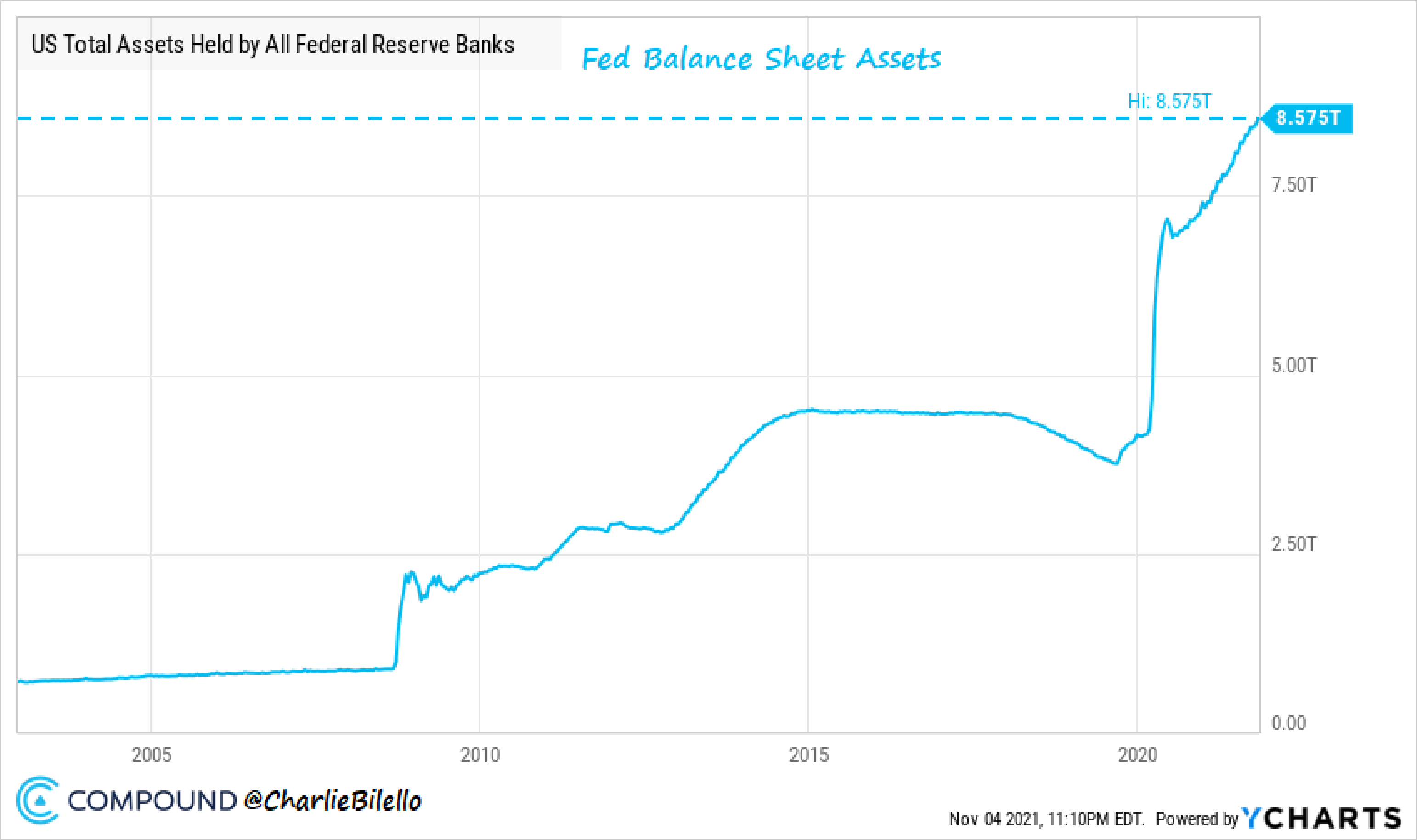
The result of the unrelenting upward stock market advance: higher valuations. On that front, the S&P 500 Shiller P/E Ratio ("CAPE Ratio") moved above 40 this week for the first time since 2000.



Stocks still benefit from low interest rates

- A lot of people refer to the US stock market being overvalued. And indeed, it is trading at historically high valuations by most metrics. With bank accounts and Treasuries yielding below the prevailing inflation rate for a while, investors have basically monetized stocks and used them as a store of value wherever possible.
- Stock valuations in the United States have benefited from a four-decade long bond bull market (i.e. lower and lower Treasury yields). As bonds offered lower and lower yields, it presented a lower and lower discount rate for valuing companies, meaning that an investor could justify paying up for higher stock valuations, since her risk-free opportunity cost primarily consisted of low-yielding bonds.
- Growth stock valuations have been the primary beneficiary from lower yields.
- Historically, the P/E ratio for stocks is inversely correlated to inflation, generally speaking. But that doesn't necessarily translate to negative or below-average returns. It all depends on the starting point and what happens on the "E" side of the P/E ratio.
- When interest rates rise growth stocks (esp. technology) get hurt, whose distant earnings are worth less today, when discounted at a higher interest rate.

the Fed finally announced a tapering of asset purchases a The plan: reduce purchases of Treasuries by $10 billion per month and purchases of mortgage-backed securities by $5 billion (from current totals of $80 billion in Treasuries and $40 billion in MBS).
But a slowdown in the purchases is still an increase, and the Fed's balance sheet hit another new high at $8.575 trillion.



Inflation and Rate Hike expectations

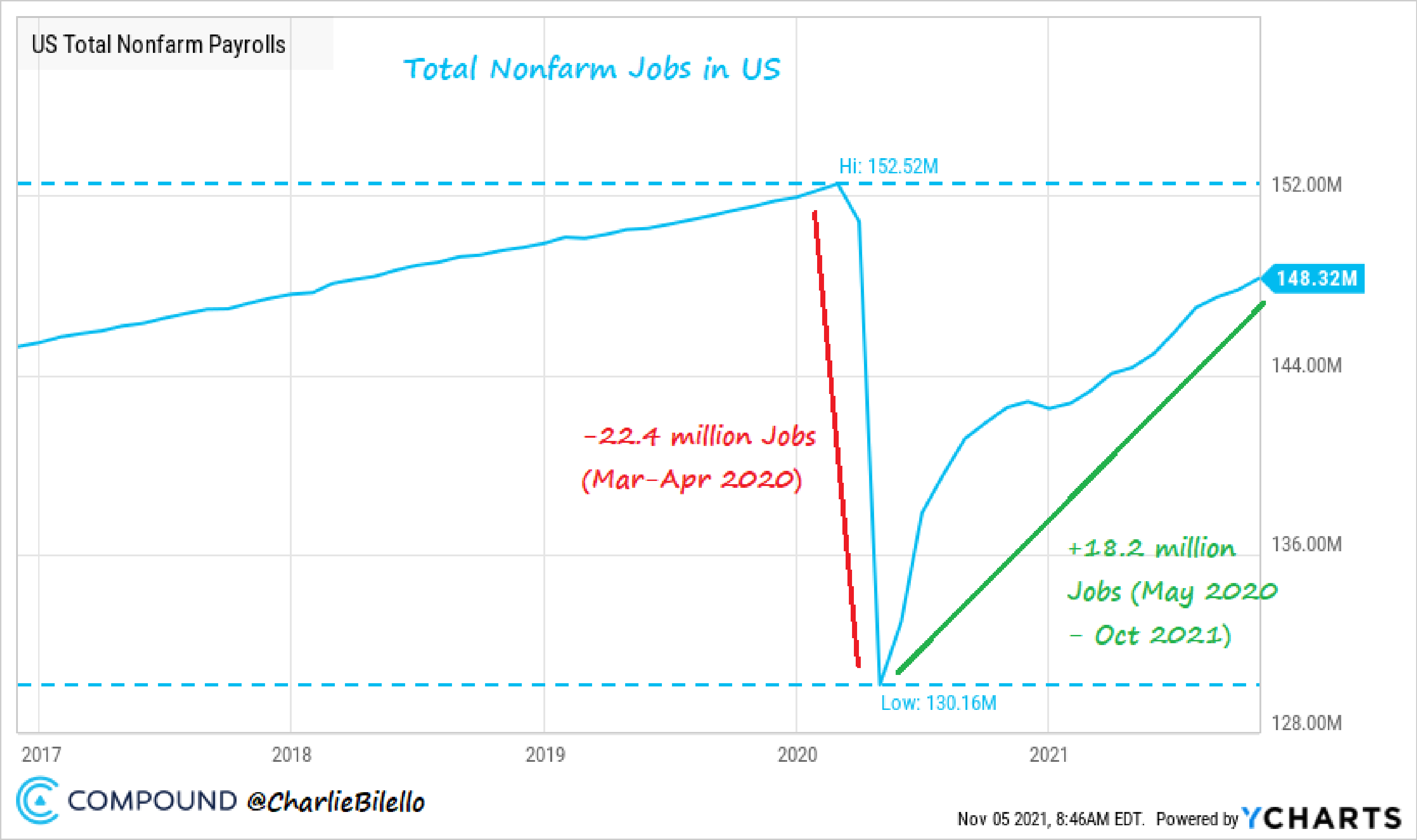
- Traders in federal fund futures have been assigning a more than 70% probability to a rate rise by June 2022.
- Consumer expectations of future inflation can become self-fulfilling, as households are more likely to demand higher wages and accept higher prices in anticipation of further price increases.
- Larry Summers is a former US Treasury Secretary in the Clinton administration. Back in March, Summers called the $1.9 trillion coronavirus stimulus package the “least responsible” economic policy in 40 years. He warned that “the primary risk to the U.S. economy is overheating — and inflation.”

Inflation devaluates fiat currencies

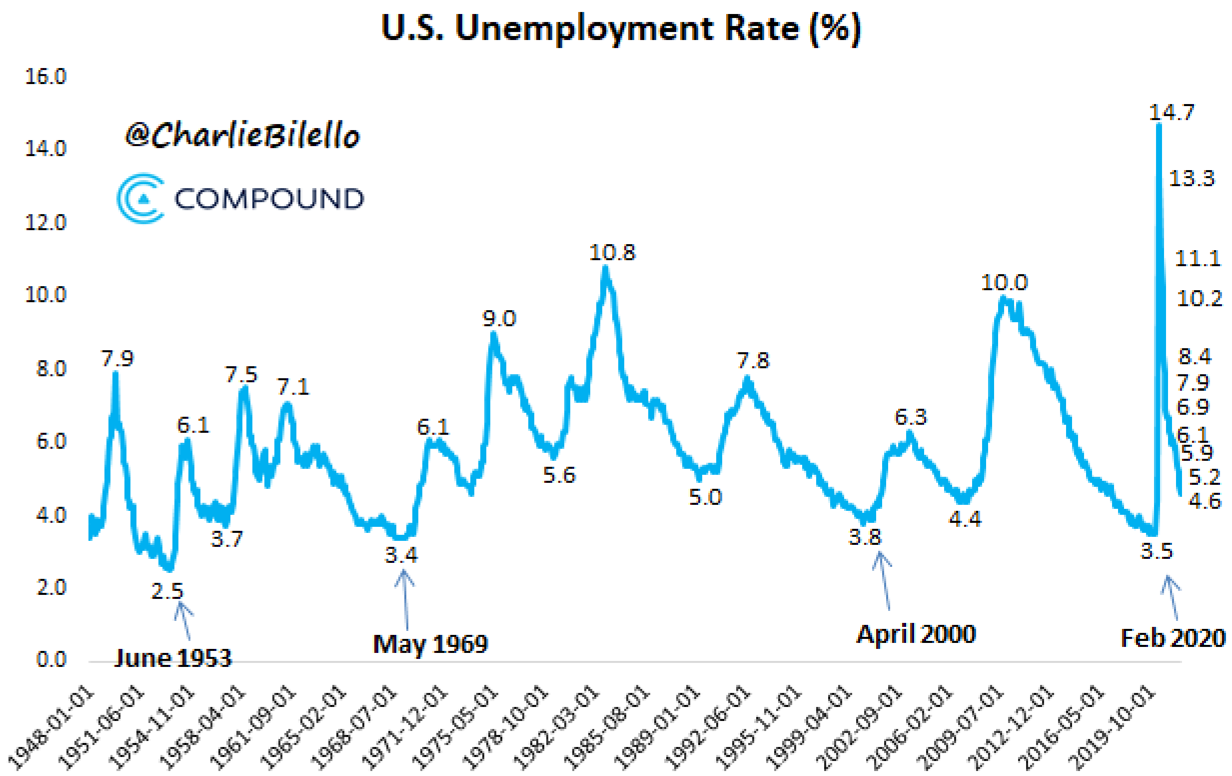
- Excessive money-printing not only in the U.S., but Britain and the European Union is continuing to devalue currencies at an alarming rate.
- This by definition is inflation, because it takes more units of currency to buy the same amount of goods as before.
- Inflation erodes the purchasing power of fiat currencies and eventually they become worthless. The dollar has lost 90% of its purchasing power since 1950.
- At unsustainable high, and going much higher, debt levels, the interest payments will eventually cripple the federal government, corporations and the consumer.
- The U.S. government is addicted to spending and Wall Street is addicted to easy-money policies.

The Greatest Jobs Comeback in History

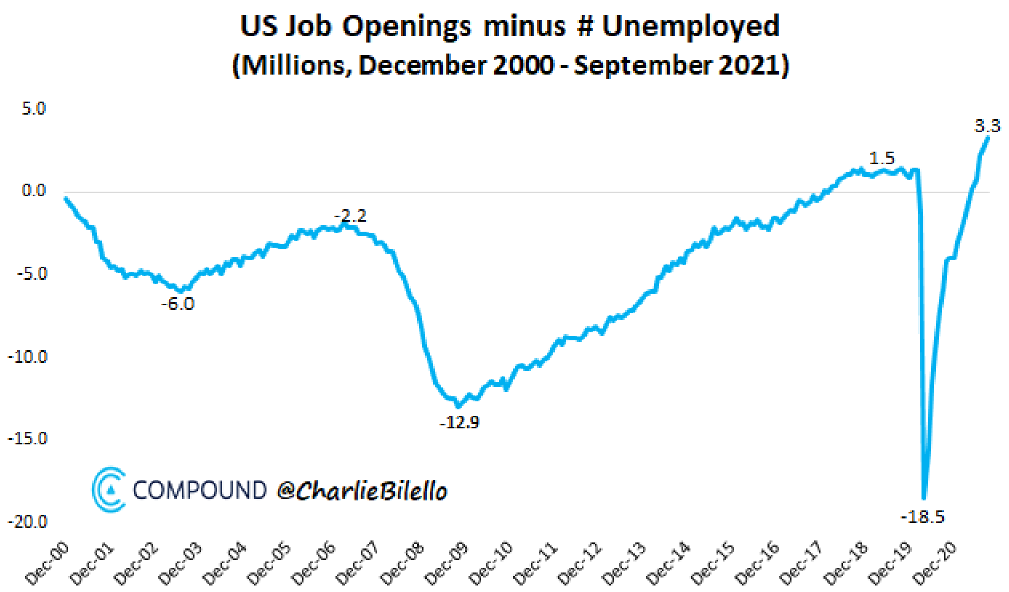
22.4 million jobs were lost in March-April 2020 during the nationwide covid shutdowns. Since then, 18.2 million jobs have been added back, including 531,000 in October. That still leaves 4.2 million to get back to pre-covid levels.



The US Unemployment Rate continues to move down, hitting 4.6% in October, its lowest level since the start of the pandemic. This is now well below the historical average since 1948 (5.8%).



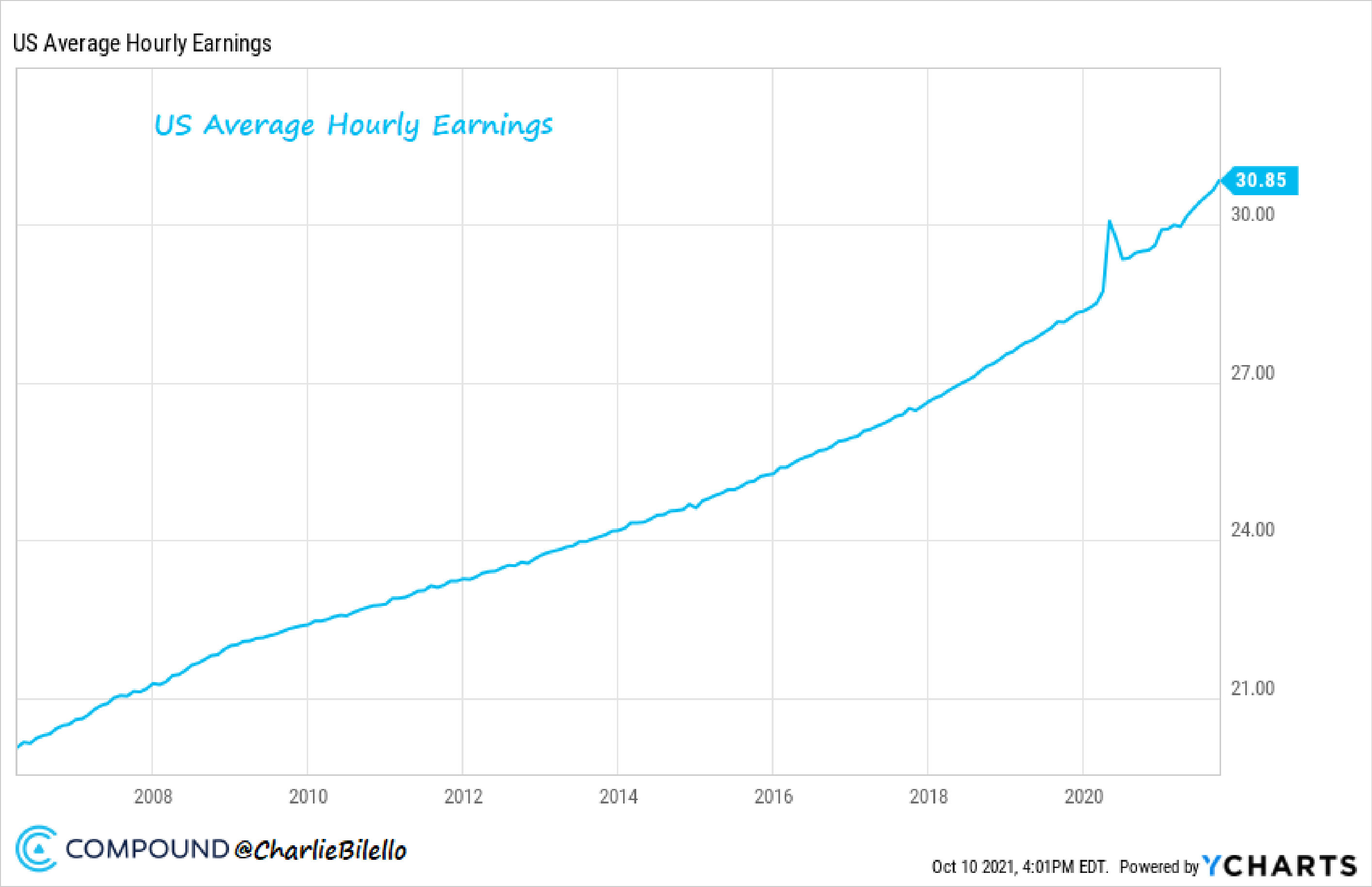
There are 3.3 million more jobs openings in the US than unemployed persons. That’s another record high.



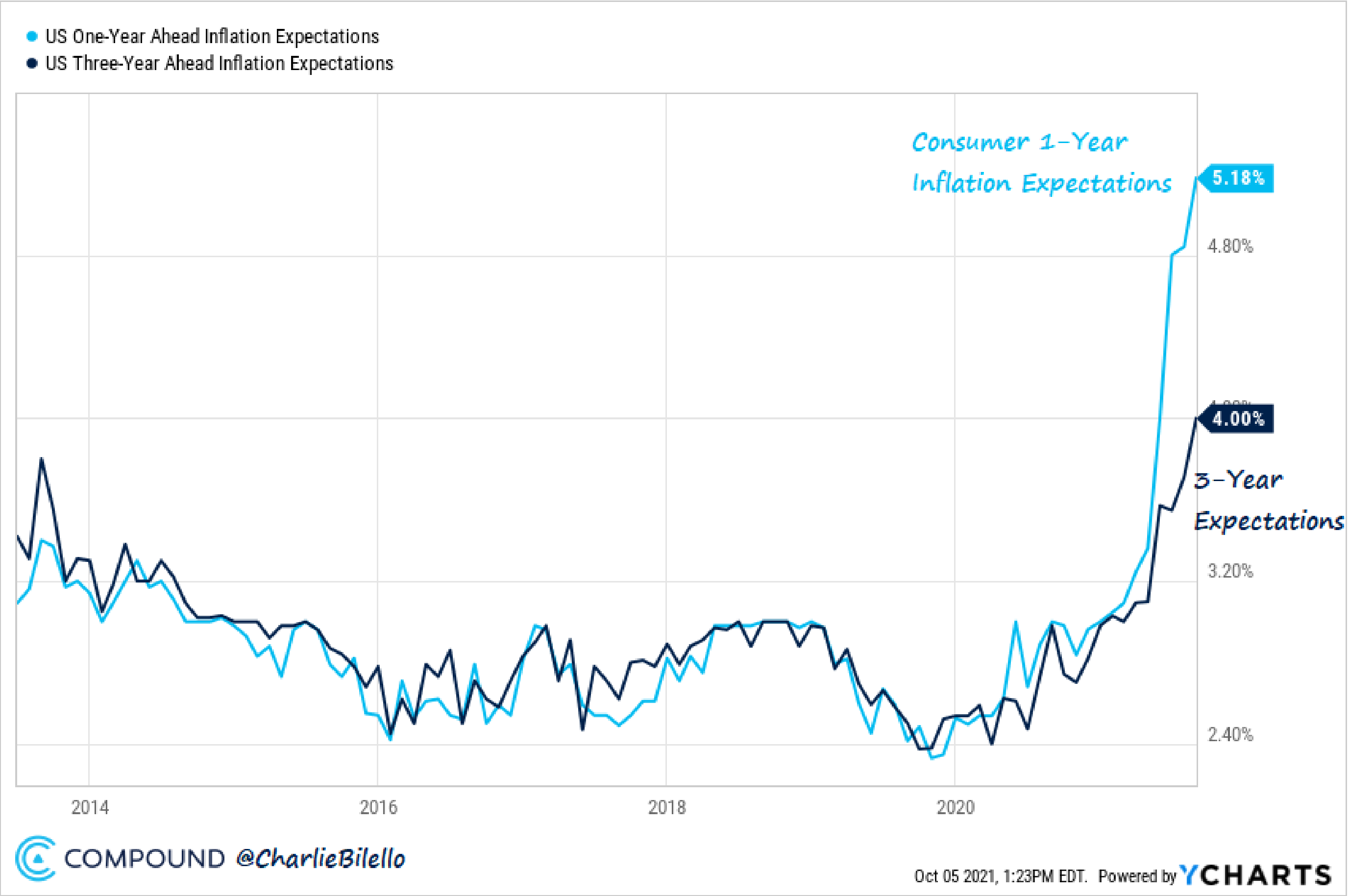
Labor shortages

- Labor force participation has declined to 61.6% in October, which compared with 63.3% before the Covid crisis struck and it is expected to remain below trend.
- About 5 million people have left the labor force since the pandemic started.
- At the end of September, there were 10.44 million job openings and a 3% quit rate. 3 million more job openings than unemployed, forcing small businesses to boost compensation to highest level since 1984.
- Until September, people got paid not to work.
- The latest ISM manufacturing reports have a consistent theme: labor shortages, supply chain constraints, and rising prices. Said one respondent: “we will not see and end to this in 2021.” All evidence is pointing to above-average inflation continuing in the near term.

The wage push inflation - The labor shortage continues to drive wages higher, with average hourly earnings in the US increasing 4.6% over the last year.



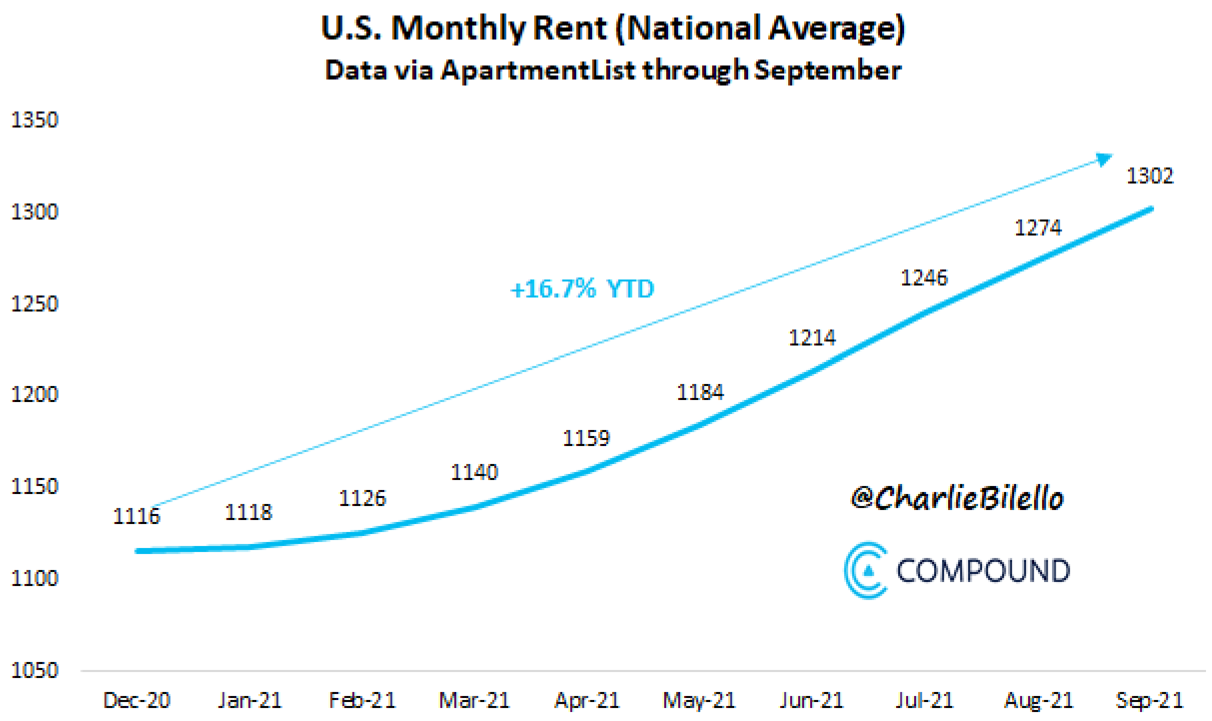
This is pushing many companies to increase the prices they charge for goods and services, so that they can maintain profitability. Consumers are anticipating this trend to continue, with expected inflation of over 5% in the coming year and 4% per year over the next 3 years.



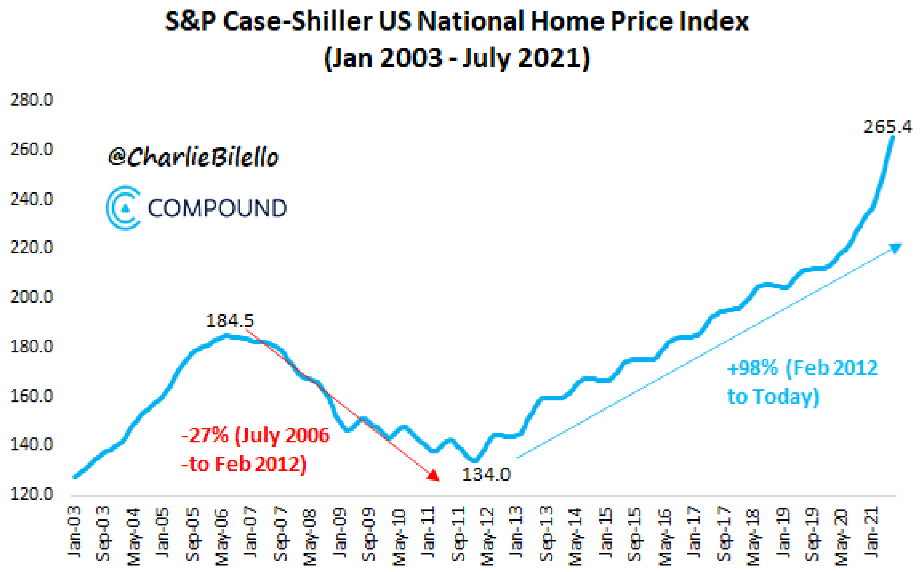
Waning productivity growth bodes poorly for taming inflation

- Gains in productivity can offset wage inflation and boost earnings.
- Productivity is output per unit of labor or capital input.
- Companies are incorporating new technologies and efficiencies.
- Productivity took off after the pandemic hit. From Q2-’20 to Q1-’21 nonfarm business productivity grew an average of 3.2% per quarter YOY.
- Recent gains are fading. Q2 was 1.8%, while wages are continuing to climb as labor force participation remains low and number of jobs openings are at a historic high.
- In the third quarter the employment cost index rose 3.7%, the fastest pace in 14 years and is outpacing slowing productivity.

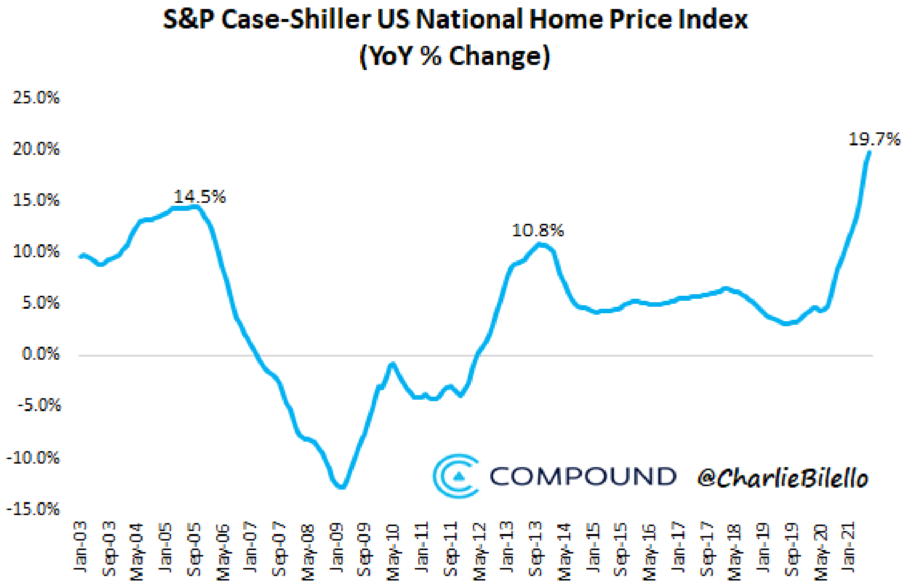
The largest expense for most households in the US is housing, at over 40% of CPI. And with rents rising over 16% already this year, more and more people are going to be feeling the effects of higher prices



Home prices doubled since 2012 and trend is accelerating.



The nearly 20% increase in national home prices over the last year is the largest in history by a wide margin. And yet, rates are expected to remain at 0% for at least another year.



Gas prices are typically falling at this time of year (blue line), but in 2021, they're soaring to YTD highs (red line).
The estimated increase in energy bills this winter for U.S. households that rely on natural gas: 30%