EPIC INVESTMENT MANAGEMENT

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The Great Inflation Debate

The Federal Reserve, aka ‘the Fed’, was created in late 1913 to serve as America’s central banking system, with the explicit goals of maximum employment, stable prices, and moderate long-term interest rates. Oddly enough, this triple-edict is commonly referred to as the Fed’s ‘dual mandate’. Welcome to central banking.

For the most part the system has served our interests well, with the notable exceptions as follows:
in the 1930s, when the Fed tightened money supply against its own rules and mandates, turning an economic downturn into the Great Depression;
in the 1970s, when the Fed responded to an oil crisis by flooding the economy with money, creating the Great Inflation, eventually leading to the new and unpleasant condition of stagflation (stagnant growth and high inflation);
and the 2000s, when Fed Chairman Greenspan, ‘the Maestro’, believing his press clippings, allowed easy money to create a housing and mortgage bubble, leading to the Global Financial Crisis.

So all in all, the Fed’s record is a mixed bag. It includes three decades out of 11 highlighted by major policy failures, no matter how much power and how many PhD economists our central bank employs.

Through the years the Fed has gained increased attention in financial markets and the media, so much so that the once secretive central bank now holds regular press conferences, and invites interviews, not just for its Chairman but for many of its Governors and Regional Bank Presidents. Speaking with many voices, the message of late has been consistent: inflation, rearing its ugly head after decades of dormancy, is a temporary phenomenon. The word of the year is ‘transitory’, undefined in either magnitude or duration. Central bankers are no dopes.

And that brings us to the topic at hand. For a century the Fed went without defining the meaning of stable prices. Inflation might be zero, two percent or four percent, and if the Fed felt that meant stability, so be it. Then a curious discussion began... what is the optimal level of inflation in the US economy? While this may seem akin to philosophers debating how many angels can fit on the head of a pin, the repercussions are far more serious. And for whatever reason, the answer to this question came back as two percent. That means in a decade’s time, our central bank is happy to reduce the purchasing power of our dollars by 22 percent, including compounding. The ‘why’ of this issue will be left for another day. Suffice to say that after a century of leaving price stability as a vague concept, the modern-day Fed had pinned it down to the first decimal.

Should we just trust the Fed on this and other policy goals? A recent article by Stephen Roach, a faculty member at Yale University, former Federal Reserve economist, and former chairman of Morgan Stanley Asia, is informative on the broader issue of Fed omniscience.

Contributing his insights to Project Syndicate, Mr. Roach recalls his days at the Fed in the 1970s, under the leadership of Chairman Arthur Burns:

> "Yet Burns, who ruled the Fed with an iron fist, lacked an analytical framework to assess the interplay between the real economy and inflation, and how that relationship was connected to monetary policy. As a data junkie, he was prone to segment the problems he faced as a policymaker, especially the emergence of what would soon become the Great Inflation. Like business cycles, he believed price trends were heavily influenced by idiosyncratic, or exogenous, factors -- "noise" that had nothing to do with monetary policy. This was a blunder of epic proportions. When US oil prices quadrupled following the OPEC oil embargo in the aftermath of the 1973 Yom Kippur War, Burns argued that, since this had nothing to do with monetary policy, the Fed should exclude oil and energy-related products (such as home heating oil and electricity) from the consumer price index.
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> The staff protested, arguing that it made no sense to ignore such important items, especially because they had a weight of over 11% in the CPI. Burns was adamant: If we on the staff wouldn't perform the calculation, he would have it done by "someone in New York" -- an allusion to his prior affiliations at Columbia University and the National Bureau of Economic Research. Then came surging food prices, which Burns surmised in 1973 were traceable to unusual weather -- specifically, an El Niño event that had decimated Peruvian anchovies in 1972. He insisted that this was the source of rising fertilizer and feedstock prices, in turn driving up beef, poultry, and pork prices. Like good soldiers, we gulped and followed his order to take food -- which had a weight of 25% -- out of the CPI.
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> We didn't know it at the time, but we had just created the first version of what is now fondly known as the core inflation rate -- that purified portion of the CPI that purportedly is free of the volatile "special factors" of food and energy, where gyrations were traceable to distant wars and weather. Burns was pleased. Monetary policy needed to focus on more stable underlying inflation trends, he argued, and we had provided him with the perfect tool to sharpen his focus.
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> It was a fair point -- to a point; unfortunately, Burns didn't stop there. Over the next few years, he periodically uncovered similar idiosyncratic developments affecting the prices of mobile homes, used cars, children's toys, even women's jewelry (gold mania, he dubbed it); he also raised questions about homeownership costs, which accounted for another 16% of the CPI. Take them all out, he insisted!
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> By the time Burns was done, only about 35% of the CPI was left -- and it was rising at a double-digit rate! Only at that point, in 1975, did Burns concede -- far too late -- that the United States had an inflation problem.

The painful lesson: ignore so-called transitory factors at great peril."

According to the late Nobel-laureate economist Milton Friedman, inflation is always a monetary-explosion phenomenon. We can't have one without the other. Create too much money for a given level of economic activity, and prices are sure to rise. Reverse the mistake and deflation is sure to follow, as occurred in the Great Depression of the 1930s. This theory explains the hyper-inflationary scourges ranging from 1920s Weimar Germany, to 21st century Zimbabwe and Venezuela.

For decades this was the accepted model of inflationary forces in an economy, and the Fed and its critics kept a close eye on money supply growth. No more. For whatever reason, and those reasons are not well stated, the idea of money driving inflationary pressures has become passe. One replacement theory is that of inflation expectations. According to this concept, if the populace expects higher prices, it will get higher prices. If not, then society will neither demand higher wages nor accept price increases. It's a neat construct, though largely untested and perhaps a bit too clever.

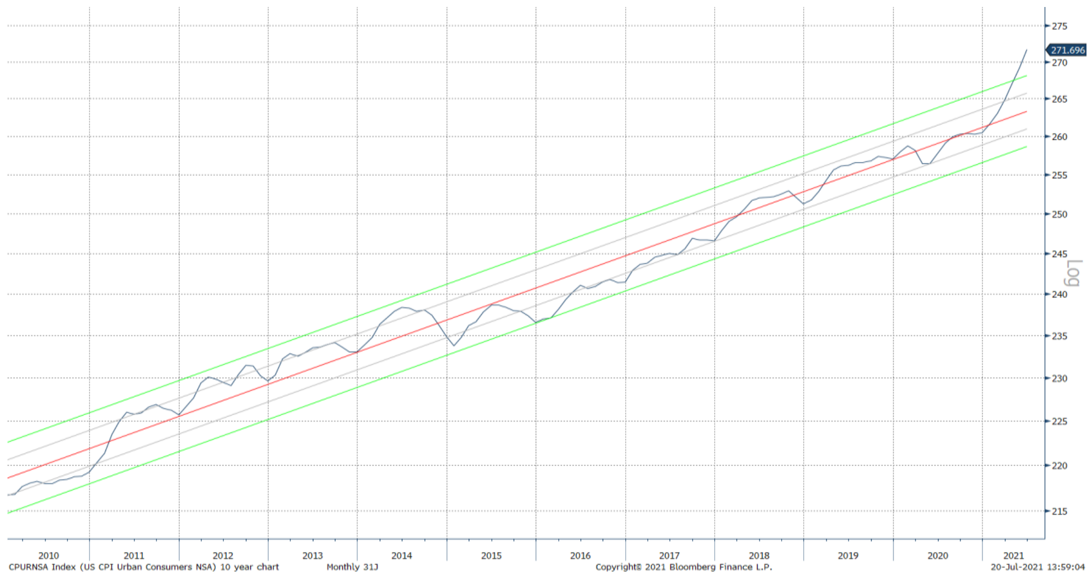
This is more than an academic discussion. Inflation has pervasive consequences, both in the real economy and financial markets. In the real economy, it means a higher cost of living for most Americans. People living on a fixed income find their purchasing power diminished, as does the low-to-middle income wage earner. Indeed, most studies reveal higher inflation to be a form of regressive taxation. For financial markets, inflation should mean higher interest rates and shrinking valuation multiples, leading to lower prices for stocks and bonds. That this has not yet occurred may be explained by several factors, first among them the belief that this inflation scare shall pass.

As with most issues economic, this one has no definitive conclusion. What follows are a few ideas and datasets to ponder as we discover the true nature of what the Fed calls "transitory inflation".

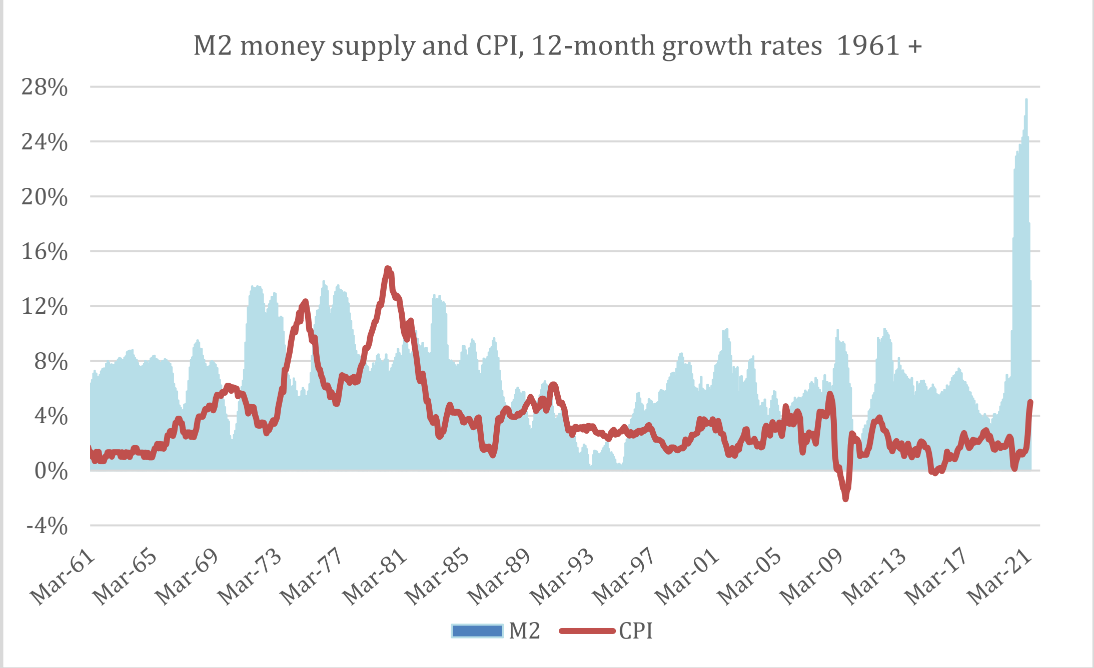
<u>What Inflation?</u>

United Nations world food price index... up 23 percent since December 2019.

US Consumer Price Index (CPI) -- log scale with regression line in red, two-standard deviation lines in either direction -- is now three standard-deviations above trendline. If the Federal Reserve wanted higher inflation, it has succeeded beyond its expectations.

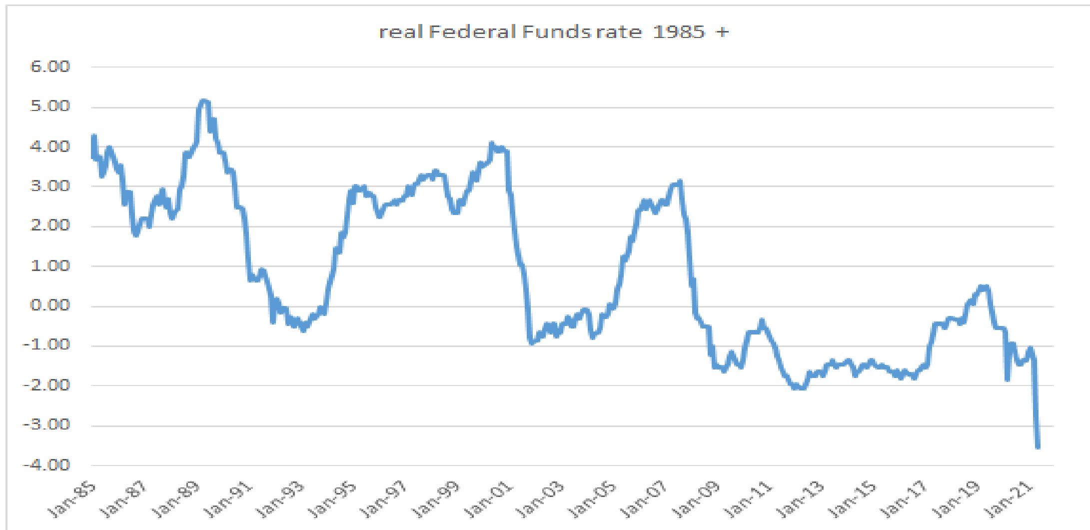


In the 1970s there was a considerable time lag between money growth and subsequent inflation. Reassurances of a broken link between money and pricing pressure seem premature.

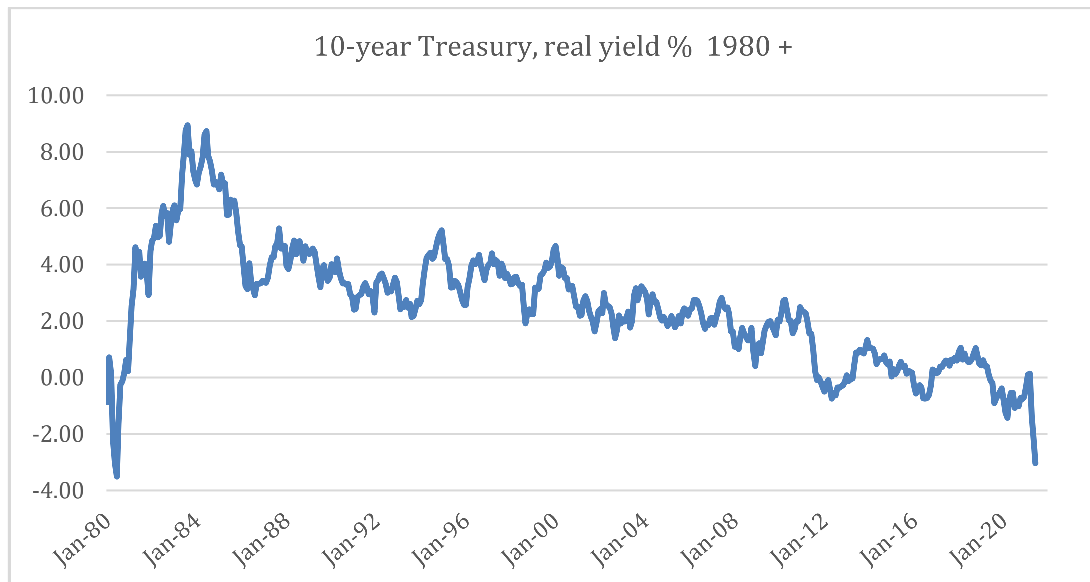


Inflation-adjusted yields

The relationship between inflation and the federal funds rate -- a benchmark for short-term interest rates -- has completely broken down.

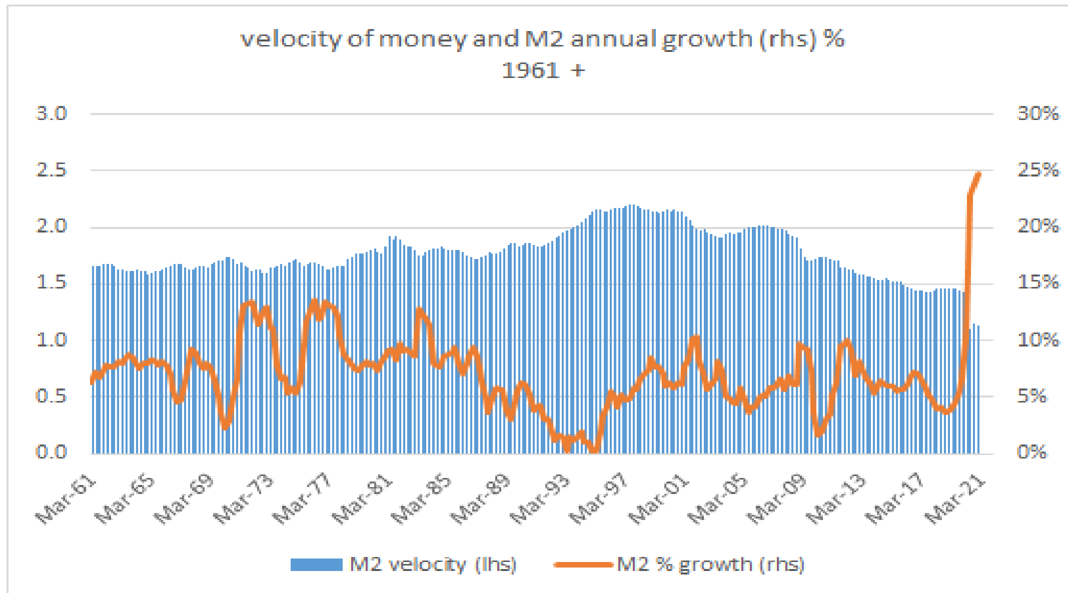


So too for inflation and Treasury yields. Bond investors are being asked to lock in an almost certain loss of purchasing power, a condition that has existed off and on for the past decade.



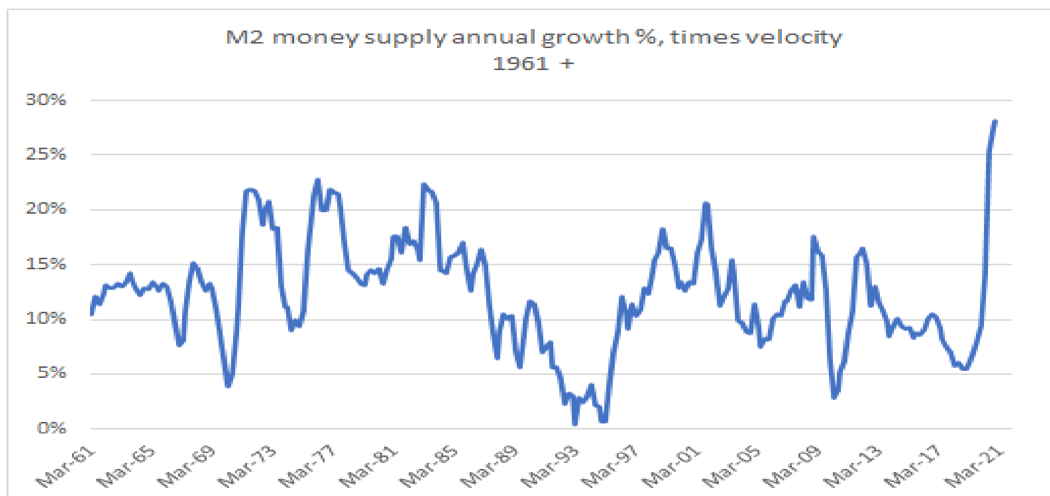
Velocity of Money

One possible explanation for low inflation despite rapid money growth is the slowing velocity of money -- the rate at which money moves through the economy -- as shown in the blue columns.



Since velocity is inferred by comparing Gross Domestic Product (GDP) to money supply, another way of looking at this is that it takes more and more money to drive each one percent growth in GDP. Much more. As an aside, it also takes far more debt. This combination cannot be laudable.

Here is the result when combining velocity and money supply growth. It looks troubling and no doubt Milton Friedman would disapprove. Does it matter? We will find out soon enough.



Undergraduate Economics, Four Years in Three Minutes

Freshman Year

econ 101: Economics is the study and policy of production(supply) and consumption(demand) of all goods and services. It can be applied to locales, states, regions, nations, larger regions, or the world.

econ 102: If you buy a pack of gum for 25 cents, you are participating in the economy. If you steal the gum, you are still participating(shrinkage); but really you are a two-bit kleptomaniac.

econ 103: Governments pay for their spending either via taxes on current income earners, or by borrowing. The latter is a tax on future earners, who will pay for the borrowing eventually. In the US, this debt bill totals 28 trillion dollars and rising. Keep on working.

econ 104: If a government defaults on its debt, it shifts the burden on who pays for its past spending, away from income earners, to bond investors.

econ 105: Governments can also pay for their spending by printing currency, pretending there is such a thing as free money.

Sophomore Year

econ 201: In almost all cases, economics entails trade-offs. There is no ceteris paribus. There is no free lunch. Unlike 3+3 = 6, two thoughtful economists may view an issue as polar opposites. Thus, economics is referred to as the dismal science. Also it is said, if you line up all the world's economists from end to end, you will never reach a conclusion. Economists get that joke.

econ 202: At a higher level, economics is about the allocation of scarce resources, and investment of capital. Every resource in the world is or may become scarce, including labor, clean air and water. Capital is fluid, moving to wherever it is treated best, considering opportunity, liquidity, stability, taxation, value, rule of law and investor rights. The US still ranks atop this heap.

econ 203: The greatest collective wisdom in the world is the bond market. The greatest arbiter is price.

Junior Year in Washington

econ 301: Some people are called greedy for hoping to keep more of their own money. Consider the government and tax hikers, wanting to take what is not naturally theirs. What could be more greedy?

econ 302: There are differences between a two-bit gum thief and the tax confiscation of citizens' income or wealth. The differences are scale and opportunity. Plus, the tax man carries a gun.

econ 303: Republican politicians understand economics but pretend they can cut taxes forever, that the optimum tax rate is zero. Democratic politicians forget all they learned about economics and believe the optimum tax rate is 100 percent. In just over a century, the top marginal tax rate on US citizens' income has ranged from seven percent to 94 percent.

There is no economic concept of "fairness" or "fair share". These are cliches used by politicians when they run out of intelligent thoughts.

Senior Year, Book of Wisdom

"A government which robs Peter to pay Paul can always depend on the support of Paul."
-- George Bernard Shaw

"Democracy must be something more than two wolves and a sheep voting on what to have for dinner." -- James Bovard

"If you think health care is expensive now, wait until you see what it costs when it's free."
-- P.J. O'Rourke

"The inherent vice of capitalism is the unequal sharing of the blessings. The inherent blessing of socialism is the equal sharing of misery." -- Winston Churchill

"Everyone wants to live at the expense of the state. They forget that the state wants to live at the expense of everyone." -- Frederic Bastiat

"A cynic is a man who knows the price of everything and the value of nothing." -- Oscar Wilde

Keystone XL Pipeline 2008-2021, RIP

In June, Canada's TC Energy and the Alberta provincial government decided to abandon the Keystone XL pipeline project. The pipeline, intended to transport Canadian crude oil to US refineries, faced environmental opposition and legal challenges almost from day one. Its opponents, including the Obama and Biden Administrations, can finally claim victory.

There has been a nagging issue all through this 13-year saga, and the issue remains. As originally proposed, the pipeline would have traveled 1700 miles, some of this in Canada. The US already has operational pipelines measuring over two million miles. Do the math. The Keystone XL project represented less than one-tenth of one percent of our existing pipeline network. If Keystone XL was such a bad idea, why are so few officials ranting about the 99.9 percent?

15 Percent or Bust

In a push for global tax harmony, Treasury Secretary Janet Yellen is leading the Biden Administration's efforts to negotiate a global minimum corporate tax rate. The stated target rate, at 15 percent, is lower than most statutory rates around the world, and has received initial support from over 130 nations. According to Ms Yellen, the goal is to halt a "global race to the bottom" on corporate taxes, while making sure all companies pay their "fair share".

While this may not be the worst idea to come out of Washington, it still has enough problems. Conceptually, it is a form of anti-competitive collusion. While nations often reach agreements on trade tariffs, the goal is usually to promote competition and trade flows, not to step on smaller nations.

Secondly, it hinders one form of competition which undoubtedly will harm certain nations more than others. The US, Netherlands and France all boast major seaports providing trade advantages. How does Hungary compete? The US and Germany maintain large manufacturing capabilities linked to land-based infrastructure, serving huge national and foreign markets. How does Ireland compete? The US, UK, and Japan enjoy well-established free market economies supported by long-standing legal systems, accompanied by highly developed capital markets. How does Estonia compete?

Care to guess three nations voicing opposition to this idea? Hungary, Ireland, and Estonia, all of whom use low corporate taxes as a competitive advantage. Take that away, and what can they offer?

As long as there are corporate taxes there will be arguments about what is fair, competitive and how to avoid a race to the bottom. Alas, there is a simple solution: Set the rate at zero.

Corporate taxes support only about 10 percent of our federal receipts, a figure that could be easily recovered by raising other taxes. Moreover, economists already debate whether corporations truly pay taxes or merely pass them along in an inefficient and, yes, unfair, manner. With a zero percent rate, clever ploys such as domicile shifting and inversions will be relegated to the scrapheap of corporate history. And if none of this works, well, deficit spending is all the rage anyway; there isn't the slightest pretense of fiscal discipline anywhere near our nation's capital.

Fast, Not Stable

We have written on several occasions that our equity market seems increasingly vulnerable to volatility shocks. In these events, such as the bear markets of 2018 and 2020, as well as the 'flash crash' of a decade ago, prices drop further and faster than we and other investors might expect, based on decades of experience.

The commentary below, from the Financial Times, supports this observation. Sadly, investors may have little choice in the matter. If we want to play the game, we must accept the rules. While the explanation is a bit technical, its message should be clear -- markets are now built for speed, not stability.

> "Broad market liquidity -- the ease with which investors can buy or sell a security without affecting its price -- has been in a downward spiral for more than 10 years. Look, for example, at what has happened to trading in futures contracts on the S&P 500 index -- typically the world's most liquid equity index futures. Over the past decade their liquidity, as measured by market depth, has collapsed by around 90 percent. This pattern is repeated across asset classes and regions. Depth is broadly a measure of the market's ability to absorb flows without meaningful price impact in the underlying security.
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> More specifically, it denotes the number of shares or contracts available on the bid or offer on a security at any point in time. The decline in liquidity coincides with a huge increase in the number and magnitude of "volatility shocks" -- defined as daily moves of more than five percentage points in the Vix Index which measures markets' expectations of volatility.
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> Between 1994 and 2007, there were nine. In the years since the 2008-09 financial crisis, there were 62. More significantly, market liquidity has started to behave like sand -- the tighter you try to grip it, the faster it slips through your fingers. Just when demand for liquidity is greatest, especially during periods of stress, it has tended to drain away. So not only is liquidity low, it has also become fragile and unreliable."

The message? Volatility shocks are a part of the current investment landscape. With equity prices rich and ripe for profit-taking, something will pop up to set investors back on their heels. When it happens, market liquidity will be too scarce to provide a stability buffer. Just like the last time, and the time before.

Tidbits...

Efforts to unionize Amazon workforce at Alabama warehouse are resoundingly defeated.
Union membership in US private industry sits at six percent, down from 24 percent in 1973.

Internal Revenue Service estimates one trillion dollars per year of tax under-payment in US.
Good luck finding that money.

Bernie Madoff, world's largest Ponzi-scheme fraudster, dies in prison.

US median sales price on existing homes reaches 350,000 dollars, up 24 percent in past year.
US households raise equity investments to 41 percent of financial assets, record level.

Telecom giant Verizon sells its Yahoo and AOL businesses to private equity firm Apollo Global for a measly five billion dollars.

Total births in US drop to lowest level since 1979.
Insert reproduction joke here.

China bans financial institutions from offering crypto-currency services.
Note to speculators: central banks hate crypto-currencies.

Ford Motor introduces all-electric version of its best-selling F-150 pickup; expects 30 billion dollars in electric vehicle spending; targets 40 percent of its fleet electric by 2030.

Streaming wars heat up:
AT&T, forever confused, reverses course on its 2018 push into media, jettisons its Warner Media assets into Discovery.
Amazon agrees to acquire MGM studio and its 4,000 films for 8.45 billion dollars.

Bank of America to boost its minimum wage to 25 dollars per hour by year 2025.
No wage inflation here.

Italian artist Salvatore Garau sells invisible sculpture for 18 thousand dollars.

Medical supply company Medline to be taken private for over 30 billion dollars in biggest leveraged-buyout in more than a decade.

Study estimates half of pandemic unemployment payments went to fraudulent recipients.

OPEC + reaches oil production agreement, to return to pre-pandemic output by end of 2022.

US and Europe reach tentative agreements on ending childish trade disputes, tariffs.
Adults back in charge.

Source:
Bloomberg
Financial Times
Project-Syndicate.org
Tax Foundation
The Wall Street Journal
Wikipedia