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Inflation -- The Dog Caught the Car!

Inflation is best described as a general increase in prices and a fall in the purchasing value of money. From 1965 to 1980, inflation increased from 1% to 14% per annum, driven by a combination of expansive fiscal policy and an accommodative Federal Reserve Bank. The Fed talked tough about taming inflation, but in reality, they didn't want to inflict pain on the economy. As a result, interest rates lagged inflation for the entire period. In 1979, Paul Volcker became Chairman of the Federal Reserve, and by 1981 he had raised the fed funds rates from 11% to a peak of 20%. His actions were reviled at the time. After not one but two recessions (1980 & 1981-1982), inflation finally began to subside.

For nearly 30 years, this playbook was used to fight price increases. Every time the economy appeared to overheat, the fed would begin raising interest rates to slow down the economy and moderate inflation. The resulting recessions were generally mild. After the economy cooled, rate cuts began, and soon after, demand would return, and the economy would begin to power forward. The Fed was the master of the universe. Long powerful expansions followed short, shallow recessions, and inflation was "easily" defeated by raising interest rates anytime inflation perked up.

The hubris embedded in that last sentence ultimately caught up with the Fed in 2008. They were 'late to the party' in their efforts to step in and stem the tide of the housing bubble. The subsequent bust triggered much more than a little downturn. The great recession was severe enough to take our financial system to the brink. The predominant concern was avoiding a depression, which could cause a deflationary spiral. Suddenly, the Fed found themselves fighting deflation, a battle they were simply not equipped to fight. Interest rates were cut to zero, but that wasn't enough.

It was then that the new tool of quantitative easing was created. Simplistically speaking, quantitative easing is the Fed's idea to purchase government bonds using newly created cash. This cash would then make its way into the economy and, as a result, lift aggregate demand - such that a depression and the ensuing deflation could be avoided. **The previous foe, inflation, suddenly became our objective!** Since 2009, central bankers have been combining various levels of quantitative easing with very low, mostly zero, interest rates in an attempt to create inflation.

Milton Friedman famously said that "Inflation is ever and always a monetary phenomenon in the sense that it can be produced only by a more rapid increase in the quantity of money than in output." That was the premise for the Fed's actions. Unfortunately for the Fed, post the great recession, consumers and businesses - having looked into the abyss - were not enamored with the idea of taking on more debt. In fact, both spent the first couple of years paying down debt. Combined with regulations requiring banks to hold more capital, the result was a reduction in the velocity of money. The net effect was money supply nearly doubled, but the velocity was halved. The Fed was stymied as they appeared to be pushing on a string. Enter Covid-19.

To combat the virus, governments around the globe ordered their citizens to shelter in place. Our government also took extraordinary financial measures. These moves ranged from direct relief for individuals and small businesses to support capital markets via more open market purchases of government securities. Direct fiscal relief totaled nearly $6 trillion, approximately 27% of annual

GDP. Unlike the last crises, most of this support was provided directly to individuals. Importantly, this massive expansionary fiscal policy was accompanied by a continued accommodative monetary policy. By restricting demand via lockdowns while at the same time directly increasing the money supply, inflation, once consumers were allowed to spend, was seemingly guaranteed.

Inflation can be described in one of two ways; demand-pull inflation or cost-push inflation. Demand pull inflation is essentially what Friedman described, put more money into the economy, lifting demand while supply remains constant, and voila, you have inflation. This is what the Fed had been seeking for a decade. This inflation creates higher nominal rates of growth, inflating away deficits and debts and penalizing savers over time. The silent thief. Cost-push inflation occurs when prices are rising not because demand is increasing but because costs are increasing. This was the inflation that Volcker inherited, and the Fed feared for nearly three decades. Driven by increases in input costs such as wages that tend to be stickier than the price of plywood, this inflation, once it takes hold, can have significantly more permanence.

When the economy began to reopen, consumers flush with cash and filled with pent-up demand spent with abandon. As we wrote last year, it was gonna be a good year to be a grandkid, and it was. Excess demand was met in many cases with reduced supply, and prices began to rise. Often, this rise was meteoric in nature as the desire to spend was so strong that consumers were undeterred by higher prices. Many of these price spikes seemed unsustainable, and as a result, the Fed believed that the inflation we began seeing in early 2021 was "transitory."

As spring turned to summer and summer into fall, the Fed erred on the side of assuming the inflation we were seeing was transitory. What was initially supposed to subside after a couple of months remained stubbornly high. Complicating matters were continued supply chain constraints. Wages and raw materials were rising, which looked like cost-push inflation, but at the same time supply was so constrained for goods and services that demand-pull had a significant impact as well. Uncertain of the predominant force, the Fed remained accommodative and continued purchasing securities while leaving interest rates at zero.

In November, after six months of inflation readings over 4%, current Federal Reserve chairman Jay Powell announced with some fanfare that, "Most consider 'transitory,' in the context of inflation, to mean that higher prices will be short-lived, but the Fed believes that 'transitory' means that inflation will not lead to permanent economic damage. It is a good time to retire the term." It was an acknowledgment that after seeking out higher inflation for most of the past decade, the dog had finally caught the car. **We have inflation, and it is not transitory. Now what?!**

The Fed continues to have the tools necessary to fight demand-pull inflation, and the question will eventually shift to whether they possess the courage to use them. We believe that much like the Fed before the great recession saw inflation around every corner and persistently fought it, this Fed will see deflation around every corner and seek to avoid it at all costs. We believe this will allow cost-push inflation to take hold and strengthen in duration though it will likely soften in magnitude as supply chain disruptions dissipate. **The previous regime of easy money in search of inflation has ended.** While the response is likely to be measured in the short term, over time, interest rates will move higher in an attempt to keep up with inflation. The Fed will also be forced to deal with all of the money they created over the past decade. We've previously noted that people will speculate when the cost of speculation is zero. Those "free credit" speculative chickens are coming home to roost.

Most importantly, the economy is still growing, and private sector balance sheets remain strong. We do not forsee a recession on the horizon and, as a result, will continue to focus on investing in businesses that benefit from economic growth, possess pricing power, and generate significant cash flows that they can return to us as investors. Many of these companies have not participated in recent market performance, and as a result, we continue to find ways to deploy your capital prudently.