First Forward Investment Insights™

June Commentary

Chess or Checkers Anyone?

Did you know that during the pandemic last year, home-bound Americans boosted the sales of board games by over 300%? People gathered around kitchen tables, coffee tables, patio tables, bar tops, and game tables across the country and played good old-fashioned board games. Some of the same skills and strategies that one needs to utilize for success at a game of Monopoly®, Parcheesi®, or Clue® can also be used by investors as they hunt for clues and strategies to either affirm or alter their investing views. Do these extraordinary times, the post-pandemic era, demand a fresh investment toolkit to solve the complexities of the market? Or should we return to using the same tactics and strategies we use to pass "Go" and collect $200?

The U.S. economy passed "Go" and has a collective $2 trillion in excess spending capacity as a result of Congress' generous, stimulus-driven treasure chest. That chest continues to grow with the Child Tax Credit commencing in July and likely additional government infrastructure packages. While taxes are expected to move higher for corporations and the wealthy, the income tax bite will be less onerous than originally proposed. Lastly, the U.S. debt ceiling will likely be raised by the end of July, meaning there is little chance of government default or bankruptcy.

Now that consumers can socialize over dinner with friends, go to sporting events and concerts, and travel more freely on planes, the U.S. has regained all its economic activity lost during the recession. The hot real estate market confirms people are buying properties and higher home prices are a key driver of the "wealth effect" for consumers. Once more, economic growth should surge as a result of increased consumer spending, rebuilding inventory levels, recovering foreign economies, and rising U.S. employment (most economists expect an average of 500,000 new jobs a month over the next six months).

As the economy recovers, Federal Reserve (Fed) officials will attempt to carefully remove some of the ultra-accommodative monetary policy that nursed the economy back to full speed. The trick: remove pieces from that strategy without triggering a surge in inflation or short-circuiting the economy. The Fed has its hands full, but if inflation proves to be short-lived and peaks during the third quarter as we expect, it should be able to taper its bond purchases by late this year or early next year and not raise interest rates until 2023.

"Inflation is when you pay $15 for the $10 haircut you used to get for $5 when you had hair." - Sam Ewing, former professional baseball player

Regarding the buzz surrounding the topic of inflation, I reached out to First American Bank's Director of Equity and Economic Research, Kurt C. Funderburg. The following is the Q&A I held with Kurt and should provide an understanding of inflation, how the Fed responds, and where the economy stands right now on the inflation front:

Q: It is widely held that the Fed has changed the way it measures the economy as it relates to inflation and how they are going to react. Why did they change, and will it work?

A: Measurement of the economy should remain the same, but the Fed has altered the way it thinks about managing its two statutory mandates – inflation and employment. Ideally, the Fed is supposed to guide the economy to the minimum level of inflation necessary to achieve maximum employment. A challenge the Fed faces is that the definition of "maximum employment" has evolved significantly over time.

There will always be some level of unemployment regardless of how strong the economy is. This is due to "friction" in the economy. There will always be some people out of a job because of business closures, geographic living preferences, mismatches between available jobs and available worker skills and a variety of other factors. A few decades ago, it was thought that an unemployment rate of 5%-6% would reflect full employment. Currently the conventional wisdom is that an unemployment rate of 3% to 3.5%, or maybe even lower, would reflect full employment.

Additionally, in the last few years opinion has shifted somewhat on the point at which the Fed should react to its perception of full employment. The Fed is often accused of "taking away the punch bowl just when the party is getting started." In other words, some observers believe the Fed focuses too much on inflation fighting and thus raises interest rates just before true maximum employment is achieved and the rewards of an expanding economy have just begun to be felt at the bottom of the income scale.

The Fed, under Jerome Powell, appears to have accepted this way of thinking. Powell announced last year the Fed was changing the way it reacts to inflation. Instead of the former philosophy of moving to raise rates and drain liquidity from the economy at the first sign inflation is near 2% annually (the Fed's inflation target) as measured by the Personal Consumption Expenditure Price Index (PCE), the Fed will now allow inflation to rise above that level. The theory behind this change is because inflation has failed to consistently achieve the Fed's 2% target since the Global Financial Crisis over a decade ago. Allowing inflation to "run hot," as the saying goes, will help achieve an average level of 2% over an extended period. The Fed also believes this will better allow full employment to be achieved and the benefits of economic growth to be more broadly distributed.

Q: Why is the Fed saying there is little to no inflation when the prices of everything we are buying are going up?

A: The debate about official government measurements of inflation and how consumers experience changing prices on things they buy is age-old. The most popular official measure of inflation is the Consumer Price Index (CPI), which is maintained by the Bureau of Labor Statistics. The CPI is a statistical average designed to reflect the experience and spending patterns of a sample of urban consumers. Few consumers have spending patterns that match up well with the CPI statistical average. One major disconnect is the CPI average considers prices on 80,000 goods and services while no individual consumer purchases more than a tiny fraction of those items in a month or even a year. Individual consumers have a heightened perception of the prices of frequently purchased items, especially necessities. If prices for food or gasoline are rising rapidly, we feel that impact every week. The prices of home appliances or cars may change only gradually, and since those things are relatively infrequent purchases, that lack of inflation does not register – yet those items are significant inputs to the CPI. Different experiences among individuals also play a big role in inflation perceptions. If you have the misfortune of interacting with the healthcare system frequently, increases in the cost of medical care (physicians, hospitals, pharmaceuticals) are going to matter much more to you than to someone in good health.

Another factor at play here is the use of something called "hedonic adjustments" to the price of some goods. A hedonic adjustment attempts to adjust price changes for changes in the utility or usefulness of a good. Perhaps the best example of this is new cars. The average price of a new car today is somewhere in the vicinity of $40,000. If you are like me and have been interested in cars since the 1970s you know that back then, $40,000 would have purchased a top-of-the-line sports car or luxury car while today that price will get your average Honda or Toyota SUV. Yet the official statistics will tell you that automobile prices have risen only modestly over that time period. This is partially due to hedonic adjustments. While the price paid has clearly risen dramatically, an economist will tell you the utility you get from an average new car purchased today is much higher than for an average new car purchased 40 years ago. Today's cars are more dependable, more fuel efficient, last longer and have many more amenities than cars back then. Using the theory that all the benefits of today's cars make their utility to the owner higher, economists adjust the price paid for a car today to reflect that utility – effectively lowering the rate of automobile price inflation. Another useful example is cell phones. Cell phones did not exist as a communication option 40 years ago. Yet today they are ubiquitous and carry the benefit of also being a TV, camera, mobile map and library, let alone possessing much more computing power than NASA used to send men to the moon in 1969.

Q: What does it mean when the Fed says that any inflation we could see will be "transitory"?

A: Whether the increased level of inflation recently seen in the U.S. is enduring or transitory is a very hot topic of debate. If inflation is transitory, it would be expected that upward pressure on prices would be limited in duration and the overall level of inflation would return to more normal levels of 2% or less regularly experienced over the last 10 or 12 years. The definition of transitory is opened to debate. If you believe transitory means the current surge in consumer prices will be over within a few months, you may be sorely disappointed. If you believe transitory means inflation is likely to have returned to something close to 2% over the next 12 to 18 months, you have a better chance of being satisfied. The two key areas we are watching that could make high inflation a more enduring concern are the persistence and strength of wage growth and the degree of ongoing fiscal support for the economy.

Q: Why does the Fed exclude food and energy from inflation statistics? We all need food and gas.

A: This ties in closely to question #2. The Fed leans on inflation statistics excluding items like food and energy specifically because such items can be very volatile and for reasons that have little to do with the overall condition of the economy. Food prices can be impacted over the short term by weather phenomenon that are unlikely to have a long-term impact on supply and demand. Say an unexpected cold front damages the citrus crop in Florida. Citrus prices will rise, perhaps precipitously, because demand, which is relatively stable, will far outstrip the supply available from the damaged citrus groves. That situation is likely to be temporary. We have a good idea from history that such cold fronts during the peak citrus growing season are relatively rare and so the supply of citrus is very likely to rebound next year, bringing supply and demand back into balance and citrus prices back to normal levels. Similarly, imagine a hurricane in the Gulf of Mexico knocks out both oil production in the region but also shuts down the region's many oil refineries. Prices for gasoline, aviation fuel and heating oil will probably rise substantially, but once the storms are over and any damage has been repaired, supply and demand will rebalance, and prices will normalize. Were the Fed to react to such price changes resulting from such short-term, temporary disruptions in supply that have little if any enduring impact on economic activity or prices levels, they would be apt to make policy mistakes that could have a significant negative impact on the economy. Enduring inflation generally arises when there is more demand for goods and services than the economy can produce. Short-term supply shortages within food and energy and resulting price spikes have little impact on the economy's ability to produce or the long-term level of consumer demand.

Q: Why are some economists more concerned about inflation than others?

A: The level of concern a given economist has about rising inflation probably has a very significant correlation with the economist's age. Anyone born in the U.S. beyond the 1970s probably has little direct experience with persistent, high inflation – unless you have spent some time living in an emerging market. The U.S. has had spells of very strong economic growth and tight labor markets over the past 40 years, yet none of the periods have led to enduring bouts of high inflation. There are many reasons for this. The rising importance of technology in broad swaths of the economy is one — i.e., technology generally aids productivity and puts downward pressure on prices. The end of the Cold War also opened many economies and ushered billions of workers into capitalism and the global marketplace. In many industries, this large supply of new workers overwhelmed demand for goods and services and drove down prices or at least limited their rise.

Q: What if the Fed is wrong and inflation does rise sharply?

A: The are a couple of likely negative outcomes if the Fed misjudges the level of price pressure in the economy and higher inflation becomes persistent. The first of these would be a policy move by the Fed that could overcorrect. So, if the Fed felt inflation was out of control, its reaction would be to raise the general level of interest rates in the economy using the target discount rate, which governs relatively low-risk borrowing between financial intermediaries, like banks. The Fed likes to make changes to this rate in ¼ percentage point increments. When such increases are implemented gradually over an extended time period, a growing economy can adapt to the rising cost of credit. The problem would come about if the Fed felt inflation was so out of control that it did not have the luxury of being gradual. For instance, the Fed, fearing that rapid economic growth could spur higher inflation, raised the discount rate from 2.00% to 6.25% between June 2004 and June 2006. That cycle featured nine rate hikes including six hikes of ½ percentage point and one of ¾ of a percentage point. While raising rates can be effective at reducing the rate of inflation, it often comes with the side effect of reducing economic growth, sometimes even to the point of causing a recession.

Perhaps an even worse outcome would be a return to the "stagflation" that gripped the U.S. for a significant portion of the 1970s. Stagflation occurs when inflation remains high while the economy grows at a very modest rate — such that growth is unsatisfying for consumers as inflation reduces their quality of life.

Q: Will the increased savings and cash reserves Americans have accumulated lead to higher inflation?

A: It is possible that the huge amount of excess savings among U.S. households could make inflation worse. As these savings are spent down, in an economy that is already growing rapidly, supply and demand could take longer than expected to come into balance. Normally, savings get depleted during a recession as households are forced to raid their nest eggs in order to fund normal consumption. When economic prosperity returns, a portion of excess household cash flow goes into rebuilding the depleted savings. That will be largely unnecessary this time as the high level of fiscal support provided by the federal government during the pandemic allowed many households to maintain or even grow their level of consumption while also adding to their existing savings. Even so, the supply of savings is not infinite and any inflationary impact of the depletion of these savings would not likely be enduring.

Q: Should investors change their portfolio and asset allocation if inflation picks up?

A: At First American Bank, we focus on investing in high-quality assets and maintaining flexible and balanced asset allocations. We believe our equity portfolios are constructed of good companies that have ample growth prospects and the ability to offset higher input costs by charging higher prices. On the fixed income side, we have shortened the duration of our portfolios to make them less susceptible to rising interest rates, which often accompany higher inflation. This lower level of duration in our bond portfolios should also provide us with opportunities to reinvest proceeds from maturing bonds once the level of interest rates rises enough to provide more attractive real or after-inflation yields.

Thanks, Kurt. Hopefully, we are better equipped to reach our investing goals and objectives despite the potential challenges of COVID variants, geopolitical tensions, politics and, of course, inflation.

Just like classic board games, the rules for investing remain timeless — adhere to your asset allocation strategy, periodically review your goals and objectives, and do not let emotion dictate your investment decisions.

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