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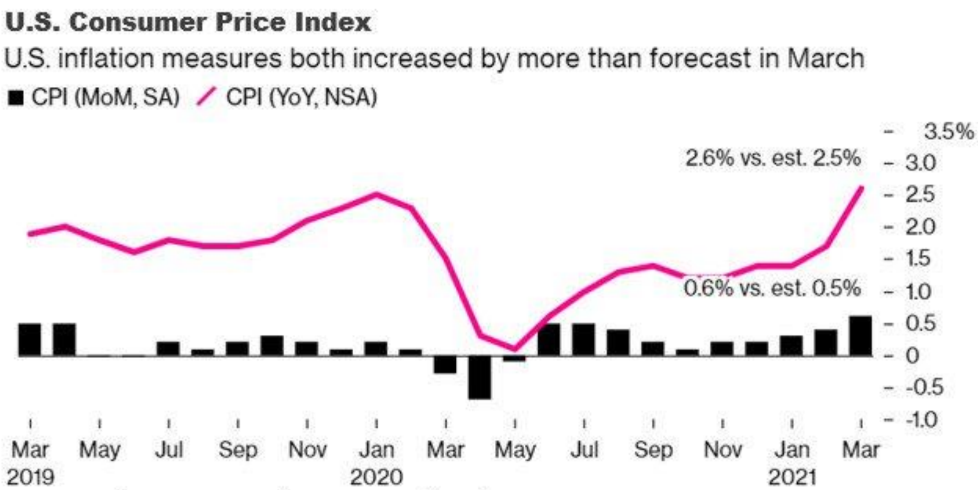
Inflation Ahead?

The Consumer Price Index (CPI) is the most frequently used statistic for measuring inflation. The index measures the change over time of the prices paid by urban consumers for a basket of goods and services that are arranged into eight groups - food and beverages, housing, apparel, transportation, medical care, recreation, education and communication, and other goods and services. The monthly CPI is calculated by averaging the monthly price change of each item in the basket of goods and comparing this number to the 1984 CPI which was set to 100. So, the April 2021 CPI reading of 267 indicates that prices have gone up 167% since 1984, or about 2.7% on an annualized basis. Monthly inflation is the percentage change in the CPI over two consecutive months and year-over-year inflation is the percentage change in the CPI over a 12-month period. Inflation has averaged less than 2.0% for the past 20 years and it was just 1.4% in 2020.



Source: US Labor Department; chart courtesy of Bloomberg

This chart shows the CPI's monthly change (the black columns) and its year-over-year change (the magenta line) from March 2019 through March 2021. The Labor Department reported in April that the CPI rose 0.6% in March, the highest monthly reading in almost nine years. For the 12 months ending in March, the CPI jumped 2.6%, the highest year-over-year increase in the CPI in several years. Massive government spending over the last year, the reopening of the economy and pent-up spending demand has led to warnings of 1970s type inflation. Similar warnings followed the financial crisis, but higher inflation did not materialize.

Are these inflation fears justified? Perhaps, but the March 2021 CPI data is misleading. Last March, the CPI fell 0.2% from February, so the CPI rose just 2.4% from February 2020 through March 2021. The CPI fell another 0.7% last April, so last week's Labor Department report that the April year-over-year CPI rose 4.2% is misleading. Year-over-year comparisons to months in which the CPI fell tend to overstate current inflation. Nevertheless, it produced large font, clickbait headlines proclaiming: ***The Highest Annual Inflation Rate In 13 Years!*** and gave inflation doomsayers, who will not mention the deflationary period of March through May last year, the opportunity to assert that higher inflation is upon us. They will also fail to mention that even after the high CPI numbers of the past two months, the CPI has increased at just a 2.2% annualized rate over the past 24 months.

Fed Chairman Jerome Powell has stated that inflation is being pushed higher for three reasons: the low CPI levels of a year ago, supply chain bottlenecks, and pent-up demand. Businesses slashed prices at the onset of the pandemic, leading to the three months of deflation seen in the chart above. The trend has since turned, and inflation will likely be volatile in the near term given the unusual discontinuity between supply and pent-up demand. The Fed believes that this summer's inflation spikes will start lowering as the output of goods and services gets back towards normal, which will allow it to describe the inflation spike as "transitory." Let's hope so. Inflation spikes often accompany economic recovery and are not necessarily precursors to higher, runaway inflation. Most forecasters expect inflation will remain in the 2% to 3% range.

Investors have two types of assets at their disposal to combat higher inflation - inflation hedges that preserve purchasing power and inflation beaters that grow in value above the rate of inflation over time.

Two excellent inflation hedges are short-term bonds and Treasury Inflation Protected Securities (TIPS). When the Fed raises interest rates to combat inflation, short-term bond funds, which have higher portfolio turnover than long-term bond funds, use the proceeds from maturing bonds to make ongoing purchases of newly issued bonds yielding the higher rates.

TIPS are bonds issued by the US Treasury whose principal value rises and falls with changes in the CPI. If inflation goes up, the TIPS owner receives an increase in the bond's principal value. If the CPI declines, the principal value goes down. Upon maturity, TIPS owners receive their original principal or the inflation-adjusted principal, whichever is greater. Additionally, the interest paid by TIPS is calculated on the current principal value of the bond.

Every TIP bond has an implied inflation rate called the "breakeven rate." In the first week of May, the 10-year nominal (non-inflation adjusted)Treasury note was yielding 1.6% and the 10-year TIP was yielding -0.8% . The difference, 2.4%, is the "breakeven rate" – what bond market participants expect inflation to be over the next decade. If inflation averages more than 2.4% over the next decade, the TIP is the preferred investment. On the other hand, if inflation averages less than 2.4%, you will be better off owning the higher yielding nominal 10-year Treasury. Since nobody knows what inflation will be over the next decade, wise investors will own both nominal and inflation-protected Treasury securities.

Stocks have been excellent inflation beaters. Over the past 90 years, large company domestic stocks have yielded an annualized rate of return about 7% greater than inflation. During times of elevated inflation, companies pass on their higher costs to consumers to maintain their profitability and it is these price increases that lead to increases in the CPI.

Contrary to what many people believe, gold has not been an effective inflation hedge. Annual inflation averaged 7.4% in the 1970s and peaked at 12.4% in 1980. Gold rose from about $100/oz. in 1976 to more than $700/oz. in 1980, making it appear to be a good inflation hedge. But at its May 1st price of $1,770/oz. it has not kept up with inflation since 1980. It is hard to see how gold can act as an inflation hedge. It has no intrinsic value; does not grow over time, it generates no income or dividends, and its price suffers from random volatility.

Some people call bitcoin digital gold and see it as a hedge against inflation. But an asset with no intrinsic value cannot be an inflation hedge. Bitcoin is the most popular cryptocurrency, and the most hyped asset in the world. Greed, speculation, and naïve investors have had a big impact on the price of bitcoin and its price volatility makes it unsuitable as a replacement for government backed fiat money. Its price rose to near $65,000 on April 14th. Less than 10 days later, its price collapsed to below $50,000 - a 23% decline – calling into question claims that it is a good store of value. Bitcoin cannot be considered to be a valid currency as long as there are ongoing concerns about safe custody, fraud and price manipulation. It is not legal tender for paying debts and taxes and the IRS considers it to be an asset, not a currency. Thus, each bitcoin transaction is a taxable event. One claim of bitcoin acolytes is that it will maintain its price because there are a limited number of bitcoins that can be "mined". But there are an unlimited number of other cryptocurrencies that can be "mined", including those that might be issued by central banks as legal tender. When there is an unlimited supply of an asset, it's hard to see how any price above zero can be justified.

We are all suckers for a good, compelling story and it's dangerous to act on a story instead of an investment strategy. Articles touting inflation fears are sure to fill the financial media and Wall Street will offer new products designed to take advantage of investors' anxieties. The future is unpredictable, and we must decide how to manage our portfolios in an unpredictable world. Most of the time, coping with rising inflation does not require complex solutions. For most investors, having an appropriate allocation to stocks, short-duration bonds and TIPs will do the job.

In the News

Bernie Madoff died in prison in April. Like Charles Ponzi, whose 1920 con earned him a place in the annals of crime, Madoff seemed to deliver stunning returns for his clients, when in fact he was paying existing investors with money from new ones. Thousands of clients entrusted him with more than $19 billion and were led to believe, through phony statements and trade confirmations, that they had almost $65 billion in their accounts. Unlike Ponzi, who soared and fell in just one year, Madoff achieved a level of respect and acclaim among finance professionals and kept his scam going for 15 years. The fraud collapsed during the financial crisis when clients requested more withdrawals than he could accommodate. When Madoff pleaded guilty in March 2009 to fraud, money laundering, perjury and theft, he insisted that he had run a genuine investment business for many years before finding himself unable to maintain the generous returns his clients had come to expect. Madoff asserted that banks and hedge funds were complicit in his Ponzi scheme. In his words, "*They had to know. But the attitude was, 'If you're doing something wrong, we don't want to know.'*"

The trustee appointed to unwind the accounts, has recovered more than $14.4 billion to partially reimburse Madoff's victims. Madoff's Ponzi scheme provides us these lessons –

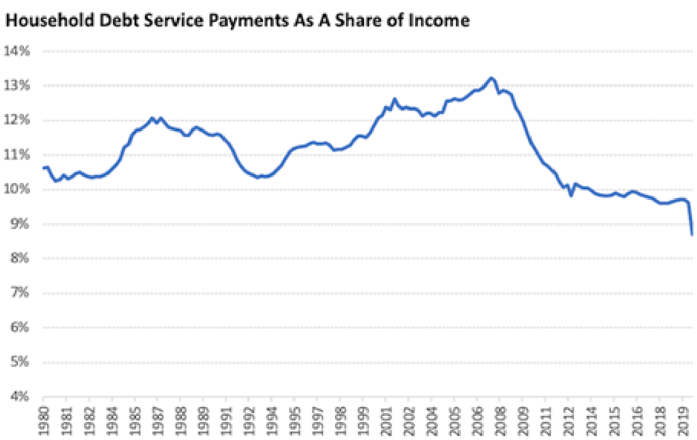
- Beware of any investment that promises stock-like returns and low volatility.
- Beware of any financial advisor who maintains custody of client funds. Your funds should be held by a third-party trustee that allows unhindered access to your investments and daily account valuations.
- Beware of promises of "safe" returns greater than the yield on a 10-year Treasury note. Get this settled in your mind once and for all - nobody can get 6 pounds of sugar out of a 5-pound bag and nobody can get a "safe" 5% return in a 2% world.
- Beware of any investment that appears to yield positive returns every year.

Too many people invest their hard-earned retirement dollars in investments they do not understand on the advice of people they barely know, all the while hoping that they will not be cheated. No money manager or investment strategy can consistently provide market beating returns. Wealth accumulation is a long-term activity, a byproduct of deferred gratification, proper asset allocation and attention to costs. Slow-but-steady wins this race.

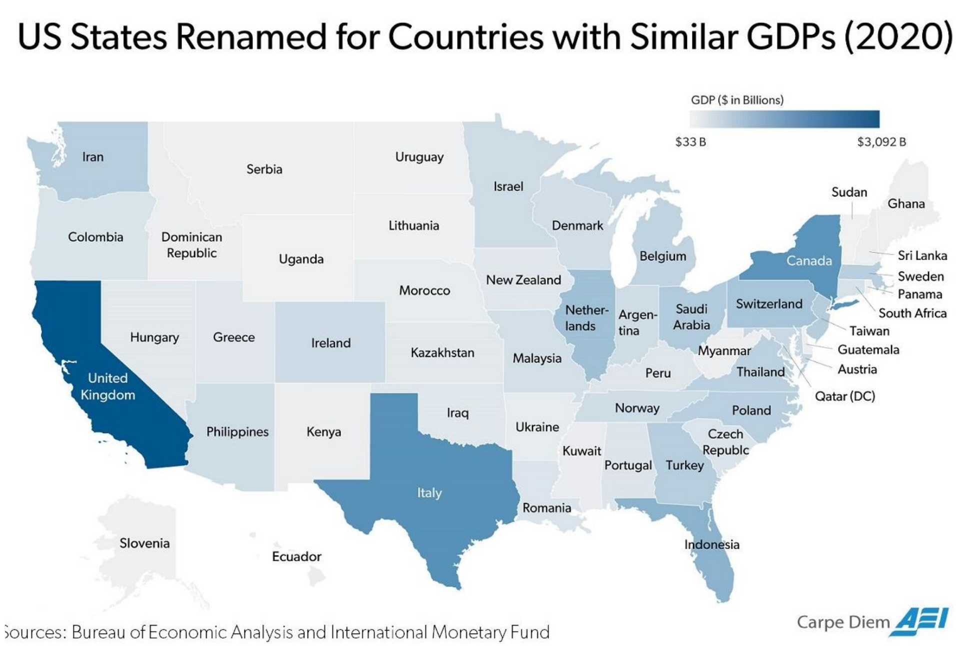
The average age of a mortality claim from Covid-19 on a life insurance policy has been 81 years old according to the CEO of Northwestern Mutual. This is consistent with known mortality data, which shows that 80% of Covid-19 fatalities have been people over the age of 65.

According to the *Wall Street Journal*, drug overdose deaths exceeded Covid-19 deaths in San Francisco in 2020.

By the first week of May, 146 million people in the U.S. (nearly 60% of the adult population) have received at least one dose of a Covid-19 vaccine. The CDC tracks data on "breakthrough" Covid-19 cases, which are defined as infections, hospitalizations, and deaths occurring at least 14 days after receiving the final vaccine dose. Close to 100 million Americans are fully vaccinated and breakthrough cases are very rare. There have been 7,157 "breakthrough" Covid-19 cases resulting in 498 hospitalizations and 88 deaths as of April 20, 2021. Using these figures, the breakthrough infection rate is approximately 0.01% (1 in 10,000), the hospitalization rate is 0.0005% (1 in 200,000) and the death rate is approximately 0.0001% (1 in 1,000,000). On May13th the CDC said that those who are fully vaccinated against Covid-19 no longer need to wear masks or physically distance indoors or outdoors, whether in small or large gatherings.



What happens when you cannot go to concerts, sporting events, the shopping mall, restaurants or take a cruise because everything is locked down? Well, it seems that millions of Americans spent the last year paying off debt and refinancing their mortgages. Credit card balances declined by more than $100 billion over the last year to a level not seen since 2007, despite an economy that is 48% larger and a population that has increased by 30 million. Mortgage payments as a percent of household income have declined from 7% of income in 2007 to less than 4% today. Today, there is $1.8 trillion in checking accounts compared to $800 billion a year ago. Thus, we hear many predictions of a pent-up demand spending spree as the year unfolds.



This chart from the American Enterprise Institute (AEI) compares states with the nations of the world whose economic output closely matches that of each state. In 2020, the US produced nearly 25% of the world's $84 trillion economic output with only 4.3% of the world's population. California, Texas, New York, and Florida produced more than $1 trillion in output and each would have ranked in the world's top 15 national economies last year. As AEI noted – *"The map and the statistics…help remind us of the enormity of the economic powerhouse we live and work in. So let's not lose sight of how ridiculously large and powerful the US economy is, and how much wealth, output and prosperity is being created every day in the largest economic engine there has ever been in human history…with individual US states producing the equivalent economic output of entire countries."*