PCM Insights: Is Inflation Coming Back?

PRIVATE CAPITAL MANAGEMENT

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"There is no such thing as a riskless hedge against inflation"
– Edgar Fiedler

EXECUTIVE OVERVIEW

We've all been hearing a lot about inflation in the news lately. In this month's PCM Insights we dig into the numbers for some perspective on current inflation trends, whether those trends are here to stay or short-term aberrations, and what this all means to investors.

WHERE ARE WE NOW?

Have you been to a lumber yard lately, or had a new deck, fence or anything else made of wood installed? If you have, you probably noticed that prices are up – way up. A common lumber benchmark is up almost 7 times from $251 (per 110,000 board feet) in April 2020 to a recent peak of $1,711 in May 2021[1]. So, this has led many to ask: Has inflation come back? And, is it here to stay? As reflected in Figure 1 below, many more people are expecting higher inflation than they were a year ago.

Figure 1. Source: Bloomberg. May 21, 2021.

The most recent inflation numbers show the Consumer Price Index (CPI)[2] reached 4.2% over the past 12 months, and the "core" CPI, which excludes volatile food and energy components, reached 3.0%. Both numbers were well above consensus expectations and have caused investors to wonder if inflation is coming back and, if so, are we seeing a transitory spike or something more long lasting?

1 Federated Hermes, "Whistling Past the Inflation Graveyard". May 21, 2021.
2 The Consumer Price Index (CPI) is a measure that tracks the weighted average of prices of a basket of goods and services purchased by urban households, including such items as housing, apparel, transportation, food, and medical care.

The Federal Reserve has set a goal of 2% per year for long-term inflation. As we have been below that number for a while, Fed Chairman Jerome Powell has expressed tolerance for inflation to run over 2% as he seeks to achieve an average of 2%. Figure 2 below shows the rate of inflation over the last 13 years.

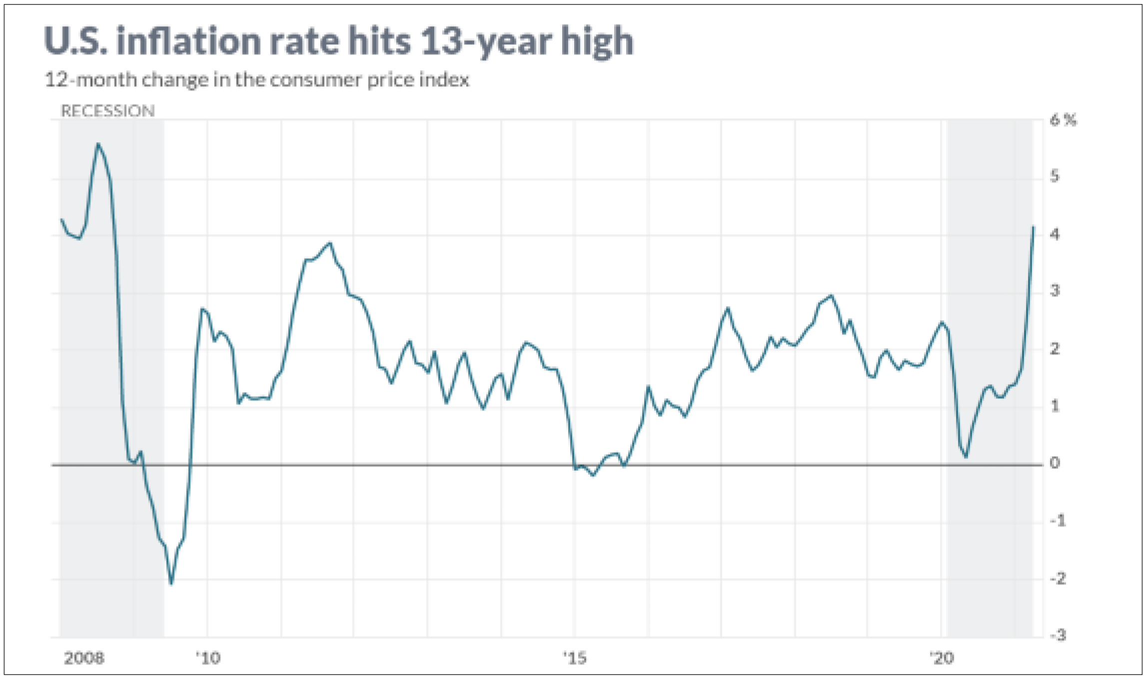

Figure 2. Source: Labor Department, Haver Analytics

A year ago, we were in the early stages of the Covid lockdowns, which caused many commodities and consumer goods prices (gasoline for example) to drop. As the country comes out of Covid lockdowns, it seems reasonable to see a temporary spike in inflation as businesses readjust to a more open economy, inventories turnover, and prices return to pre-pandemic levels.

THE CASE FOR SUSTAINED INFLATION

The famous economist Milton Friedman said "inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." Over the last 12 months the broad money supply (M2)[3] has risen 18%, and is up 30%[4] going back to February 2020 - more than twice the rate it grew in 1978 before inflation spiked to 13.4% in 1979.

In addition, the Federal government under both Presidents Trump and Biden has enacted trillions of dollars of stimulus and the Federal Reserve has shown no signs of slowing down its purchases of $120 billion/month of Treasury Bonds and mortgage securities.

Figure 3 below shows that Federal Reserve's balance sheet has grown from under $1 trillion in 2008 to almost $8 trillion dollars today. As Milton Friedman might observe, the quantity of money has certainly increased.

[3] M2 is a measure of money supply that includes cash, checking deposits and other funds easily convertible into cash.
[4] Federal Reserve (St. Louis) economic data. www.fred.stlouisfed.org/series/M2SL.

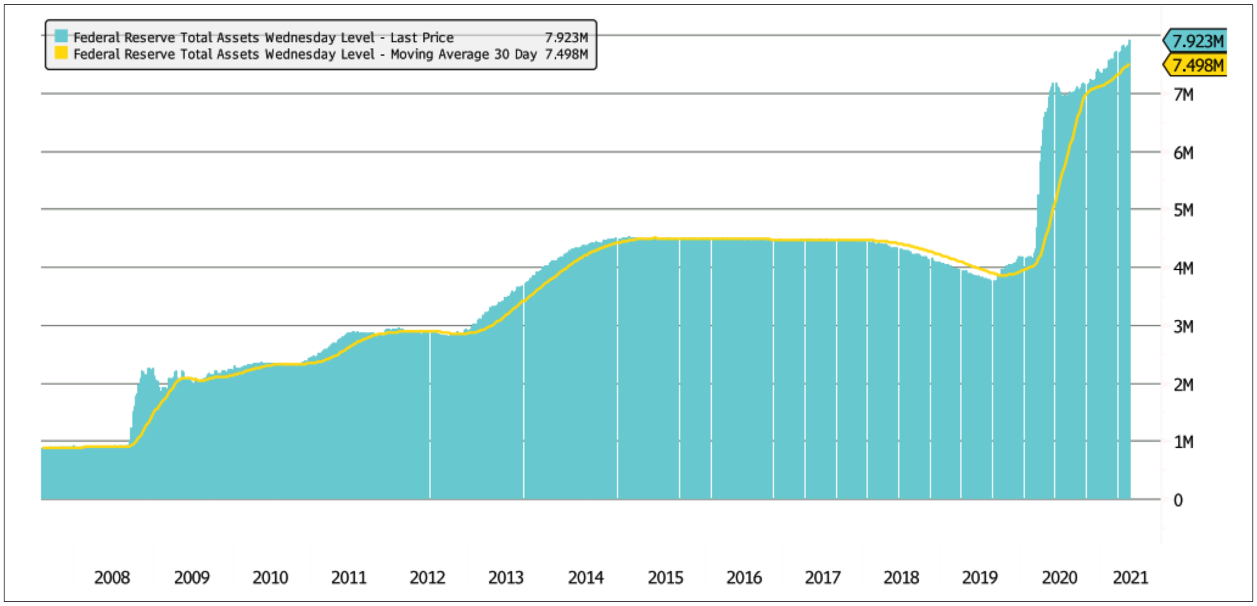

Figure 3. Source: Bloomberg

Looking forward, the Federal Reserve has communicated that it intends to maintain its monthly asset purchases at $120 billion/month. And on the fiscal side, the Federal government is in talks on a major infrastructure bill. The only difference between the Republicans and Democrats seems to be whether the bill will be large, or very large. That being said, it is still unclear whether a final compromise on an infrastructure plan will be reached.

THE CASE FOR A RETURN TO LOW INFLATION

While more money in circulation can lead to inflation, it doesn't have to. One example is Japan. Statista reports Japan's national debt to GDP ratio at 256% (2020). In contrast, the Federal Reserve estimates the United States' debt to GDP ratio at a comparatively modest 129%. And inflation in Japan? It is practically non-existent and recently turned negative. Over the last year (as of April), Japan's inflation rate was -0.2%.[5]

Both the United States and Japan are mature economies with aging populations. The large investment firm PIMCO even coined the term "the new normal" several years ago to describe their low expectations for long-term economic growth.

INVESTMENT ALTERNATIVES

Is inflation coming back? The short answer is that, for now, it is already here. The Federal Reserve has committed to their current level of monthly asset purchases, and will certainly be watching the inflation data closely. If inflation persists, they may begin to taper their asset purchases and perhaps even raise interest rates. Which begs the question: How can investors protect themselves?

Historically, many people have viewed gold as a safe haven and a source of inflation protection. It can be, but the timing can be very difficult. In 1981 gold rose to over $800/oz. Forty years later, it trades near

[5] Goldman Sachs Market Monitor. May 21, 2021.

$1,900/oz – an increase of 140%[6] (6). Over the same time period the Dow Jones Industrial Average has risen from 1,000 to over 34,000 – up over 3,300%.

Treasury inflation-protected securities (TIPS) are another option. These are government bonds that pay interest and the face value of the bond adjusts over time to account for inflation (as measured by the CPI). However, because of the inflation protection, TIPS typically pay less than a normal Treasury bond. The Wall Street Journal[7] notes that 10 year TIPS were recently trading at a negative interest rate of -0.826%/year compared to a +1.629%/year for a nominal Treasury note. This means the CPI would need to average at least 2.45% over the next 10 years for the Treasury inflation-protected security to pay as much or more than the nominal Treasury.

Finally, some people may view Bitcoin, or other cryptocurrencies, as an inflation hedge. The debate is still open about whether these are a store of value, a currency, or a passing fad. Over two weeks in May, Bitcoin's value plunged 43% - the volatility alone should make most investors cautious. And whereas gold has few competitors, the supply of cryptocurrencies seems endless – Ethereum, Ripple, Litecoin, Tether and, yes, even Dogecoin. Perhaps more will be created in the future?

FINAL THOUGHTS

Inflation is something investors have had to deal with for many years. While we may not return to the high rates experienced during the 1970's, even a modest inflation rate can erode one's purchasing power over a lifetime.

The good news is that many companies impacted by inflation can make adjustments (such as changing prices) to cope, while others will not be as impacted. In either case, for the long-term, inflation wary investor, we believe a well-diversified investment portfolio remains the best way to prepare for almost any eventuality. Thus, in the end, our perspective is that for the long-term, inflation wary investor, we believe a well-diversified investment portfolio remains the best way to prepare for almost any eventuality.

Sincerely,
The Private Capital Management Team

6 In contrast to gold's 140% rise, US inflation measured +194% over the same time period (1981-2021) according to www.usinflationcalculator.com.

7 Wall Street Journal, "Signs of Inflation Threaten Investors' Portfolios". May 24, 2021.