Inflation, Panic or Passing?

"*If I had an hour to solve a problem and my life depended on the solution, I would spend the first 55 minutes determining the proper question to ask, for once I know the proper question, I could solve the problem in less than five minutes.*"
– Albert Einstein

Today, the question that most clients seem to be seeking a solution for is that of inflation. It is a concept that most people have basic familiarity with but do not understand in depth. Kind of like wine, a lot of people like to drink it but how many people understand what goes into making it? (When you consider that 85% of wines sold are less than $15, drinking for effect seems to be the goal.) How many people really know what goes into creating inflation? If you asked most people to explain inflation, I'd bet most people would say it's when prices go up! But this is hardly news. Since 1929 there have been only 6 years where prices declined, the last time being in 1954. Also, despite the stigma, inflation is not necessarily a bad thing. Going back to my wine analogy, inflation in moderation is actually healthy. However, in excess, it can get very messy.

The inflation comments making the biggest headlines are not even discussing mild to moderate inflation, they are the apocalyptic warnings of hyper-inflation. Take Jack Dorsey's comment from October as an example, when the former-CEO and Founder of Twitter stirred the pot by tweeting: "Hyperinflation is going to change everything. It's happening." One definition of hyperinflation describes it as a *50% per month* increase in prices. Another definition states a *1000% per year* increase in prices. I don't know what prices he could be referring to that are rising at this pace. Certainly, if he's expecting the prices of goods broadly in the U.S. to increase at these rates, he's claiming we have entered into the financial apocalypse. Clients shouldn't pay attention to this type of hysterical talk but instead focus on a more likely scenario which is moving from a mild inflationary world to a moderate inflationary world.

It may seem like a nuance as to whether we are facing mild inflation or moderate inflation. Over the last 20 years, inflation has run at a very mild pace, averaging 2.16% annually. If inflation were to accelerate to higher levels of say 4.25%, the impact would be material. I'll use a basic example to highlight my point. Let's assume that today you're 50 years old and you are fortunate enough to inherit $1,000,000 from your wealthy great Aunt who just passed away. You decide that you will set that cash aside in a bank to buy a vacation home, somewhere warm, when you turn 70 years old. At an inflation rate of 4.25%, 20 years from now that $1,000,000 will only allow you to purchase a home of $435,000 in todays dollars. You "lost" value because the price of the home you wanted today increased by 4.25% per year while the value of your cash remained frozen at $1,000,000. Said another way, to avoid this you must find investments that allow your money to keep growing along with the prices of goods you wish to buy.

At low inflation levels, finding investments that can keep up with low inflation is easy and doesn't require taking much risk at all. At higher inflation levels, you're forced to find higher returns to offset rising prices.

If we see a shift from mild to moderate inflation, cash is trash, as you saw in the example above. Many of our more conservative clients have a proclivity to sit on large cash balances. Historically, cash used correctly can be a source of dry powder to deploy in times of market volatility. The problem under a moderate inflation scenario is that sitting on cash is quite costly. Therefore, savvy investors will acknowledge this and look to combat it by seeking investments that can help them tread water as inflation rises. This a strange concept for many investors to digest because cash is typically viewed as a safe parking place for their assets. As inflation rises, it serves as an invisible and ongoing tax on cash-heavy investors.

I will go into further detail about the steps we have been taking on behalf of clients to prepare for the possibility that inflation is moving from mild to moderate for a prolonged period. Before I do that though, we have to ask a more basic question. Is inflation moving from mild to moderate? Below I present the typical cases being made by people on both sides of the debate.

Higher Inflation Argument:

Our country has printed (literally created out of thin air) an enormous quantity of money in response to the last two financial crisis' we've faced. First, it was done to help spur the recovery following the Great Recession and then more recently to help stabilize the economy from the shock of the global Covid Pandemic. We could debate the merits of these steps, but the end result is the government created lots of money and put that money in the hands of the people.

My kids recently ask me why, if the government can just create money, why it doesn't just print lots of money and hand it to everyone, so we are all "rich?" Unfortunately, some governments run by adults and not kids have tried this only to find disastrous consequences. There is a point at which you can create so much "free money" that money itself becomes worthless. The problem is no one knows exactly where that line exists.

In my office, as a reminder of this, sits a one hundred trillion-dollar bill from the Reserve Bank of Zimbabwe. In 2009, they issued these notes which translated, at the time in $.40 USD. Yes 40 cents! The currency has now been replaced by a new currency, but the bill serves as a symbol of financial mismanagement, highlighting that if you print enough money, it does all become worthless. Critics of our central bank and government fear we are dangerously approaching or have already crossed this point of no return, as we've tried to financially engineer our way out of the last two crisis'.

Today, it appears that the price of nearly everything is rising. In this upside-down world, the prices of used cars are actually increasing in value. Home prices too are rising at an unwavering pace. The cost to fill up at the tank is higher than in it's been in seven years. This year, the measure of inflation known as CPI (a basket of goods meant to resemble what an average American consumes) just registered a 6% year-over-year advance, almost 3x the average rate we've experienced over the past 20 years. Inflation cautioners have declared victory and insist that the consequences of so much free money are finally taking its toll in the form of higher prices, insisting this is the new norm. Further, fears are fueled by a massive $2 trillion social spending and climate bill that will only pour gasoline on the fire. They warn inflation is not some temporary phenomenon triggered by supply shortages from the Covid pandemic, but rather a permanent ailment brought on by years of financial sorcery.

Lower Inflation Argument:

Yes, it true, from 2009 to 2019 we printed massive amounts of money to get the economy back on its' feet after the worst economic shock since the great depression. But guess what? We had mild inflation despite the fact we printed so much money. Further, Japan has been printing money for 20 years, do they have inflation? No. In fact, they have been battling deflation for the better of two decades. A big reason to expect inflation to remain subdued is the increasing effect of technological innovation throughout our economy. Companies like Amazon are delivering goods at remarkably low prices to Americans everywhere with same day delivery for many of the items. In countless aspects of our economy, technological advances are helping us be more productive and lowering the costs to produce goods and services. Companies like AirBNB have sprung up creating lower priced substitutes in sectors previously dominated by established corporations. Automation will further lower production costs as companies substitute low-cost labor from China with even lower priced workers called robots that don’t get sick, ask for raises, or show up late to work.

Inflation defenders view the current spike in the price of goods as a simple imbalance created by a broken supply chain, a direct result of the pandemic. Many companies in the early days of Covid panicked and slashed investment, not knowing how long it would last or how severe it would become, leading to massive shortages. In the near future, these broad-based shortages will be replaced by surpluses as companies race to get goods produced and capitalize on the high prices they’re currently garnering. Much like we saw the invisible hand of supply and demand at work in the wildly volatile energy markets over the past decade, markets will eventually restore to a balance.

The net-net and investment implications:

The opening quote from Albert Einstein highlights his focus on getting the question right before seeking a solution. Right now, that’s exactly what we’re doing. The truth is, at this point nobody knows which inflation environment lies ahead. People have guesses and can gain followers or notoriety by taking a stand, but they are educated guesses at best. Trying to estimate the net effect of the deflationary forces from technology versus the inflationary policies being pursued by the Federal Reserve and Government spending is beyond calculation. Therefore, we want to form portfolios that can brave either outcome. Already, we have begun to insulate our client portfolios should inflation move from temporary to more permanent. This includes, shortening the duration of our bond holdings, buying securities that benefit from inflation and limiting the amounts of cash in portfolios.

At the same time, we believe that technological innovation is a very real force that brings with it a deflationary impact on the economy. We believe that we are far from the end of a period of innovation that will greatly outshine the industrial revolution. Our mission has been to find entrenched technology companies that are woven into the fabric of our everyday lives. Complimenting these companies with others that are pushing forward and unlocking new markets for growth. Telemedicine, artificial intelligence, cyber security, legalized gaming, are just a few areas where we expect tremendous growth.

We also believe that there will be a time to rotate a portion of portfolios into countries outside the US as their recovery from the pandemic continues to take hold. Many of these countries are at periods of historic discounts to the U.S. market.

Our philosophy in investing in rooted in the belief that we aren't playing a roulette wheel where a bet is made on red or black with a binary outcome. We think of investing as betting on a marathon race. While there will only be one winner of the race, there will be many finishers. Our goal is finding the runners with endurance and the stamina to cross the finish line. In investing, you don't have to predict the future, but you must survive long enough so that you can find answers to the questions it asks you.

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