FolioBeyond

The Whimsical Nature of Inflation and Interest Rates

The well-known neo-Keynesian economist Arthur M. Okun, who served as the chairman of the Council of Economic Advisers between 1968 and 1969, wrote a piece for the Brookings Institute precisely 50 years ago called "The Mirage of Inflation." There he wrote:

"A predictably steady inflation rate of 5 percent is not significantly inferior to a rate of 2 percent; and if it permits the unemployment rate to be lower by as much as 1 1/2 points, the 5 percent inflation rate seems a small price to pay…. the current rate of 5 percent would save the nation from the needless agony of the prolonged transition period of high unemployment required to wind down the inflation rate." To say that today would be considered highly controversial. Indeed, in the last four decades, we've seen a mild form of deflation in many segments of the economy. Thus, even relatively mild inflation looks quite concerning. Wasn't a 4% inflation rate desirable at one point?

Our focus on inflation is a national pastime. Recently, there have been a few signs that the Federal Reserve may incrementally raise interest rates sooner than expected. The public statements by the Fed indicate inflation is temporary—a result of the economy quickly re-opening, coupled with pandemic induced supply/demand imbalances. These proclamations give the markets needed comfort, which is precisely the Fed's intent. Recently, a NYT article proclaimed: "The closing price (July 8, 2021) of inflation-protected bonds implied expectations of consumer price inflation at 2.25% a year over the coming decade, down from 2.54% in early May…the price swings do show an economy in flux and undermine arguments that the United States is settling into a new, high-inflation reality for the indefinite future." Decade long or indefinite future forecasts are meaningless. At the same time, many economists see more permanent inflation given massively expanded money supply and what seems to be exceedingly strong wage pressures. Still, the prevailing thinking is that year over year inflation numbers will increase into the fall season and then decelerate. One additional concern is emerging-market borrowings approaching $90 trillion - up more than $11 trillion during the pandemic. Any defaults (and we've seen plenty over the decades) could shake up both emerging market borrowers and the U.S. economy. The Fed hypnotizing the investment community into believing they will always be there - forever- will not end well.

Though Fed policymakers raised their inflation forecast in June and said they could hike rates in 2023, that is a long way into the future, and we know events unfold much faster than an advertised timetable. Waiting until 2023 to see if rising prices cool down is not viable.

The metrics the government uses to define inflation have been a game of three-card monte over the years, switching from a cost of goods index (COGI) to a cost-of-living index (COLI), allowing the U.S. government to report a lower CPI. Whatever metrics or definitions we use, the facts are that gas prices are up more than 25% since last December, lumber prices are up more than 180% in the past year, and copper and other industrial metals have soared and are now at the highest level in a decade. Coffee is the latest commodity to hit multi-year highs as the Brazil drought sent prices soaring 70% in the last year. In addition, the BLS puts the year-over-year change of unadjusted consumer price index of medical care at around 5%. A lesser-discussed price rise is the cost of insulin moving from $2864 in 2012 per diabetes patient to $5,705 in 2016. Today, one vial of insulin can cost $250, and some people need six vials per month. No doubt this is drug companies gone

wild, but it still has inflationary consequences. Given that 35 million Americans have diabetes and another 90 million are pre-diabetic, that should be disconcerting.

Finally, overall global food prices are another concern as they have soared to a six-year high and are not likely to come down anytime soon. These are not inconsequential numbers as inflation first hits commodities and later works its way into the CPI number.

Of course, there are enough pundits who believe we're in for more longer-term disinflation, and the recent 1.75% 10-year yield marked a peak, given future tax increases and massive deficits slowing overall growth. This, they say, will result in a 1% bond yield by 2023. Though history shows that the minority is often right, this is a counterintuitive argument that ignores almost every sign of consumer misery already in play. It also downplays the most massive monetary and fiscal stimulus this country has ever experienced.

The critical issue for investors must be not forecasting rate moves but preventing a black swan event from interest rate shocks sinking their portfolios. Protection from the Fed's changing views and overly nuanced statements (which could significantly increase volatility) will be an absolute necessity to endure possible havoc. While we are basking in a goldilocks environment, implementing those safeguards earlier would keep investors from panicking when this bubble finally bursts. And, by definition, bubbles always do.

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