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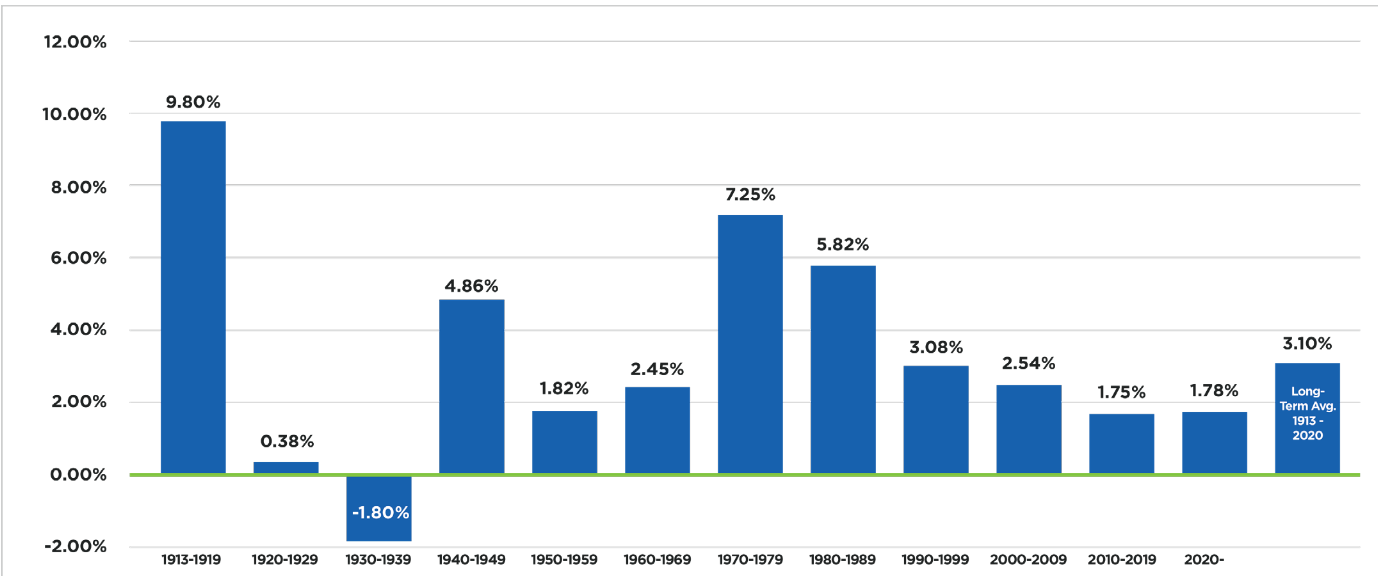
Trust & Investment Management Group

Average Annual Inflation by Decade



Source: InflationData.com. © 2020. Updated 12/15/2020.

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This is the season for Passover seders, Easter dinners and other celebrations that often invite intense family debates. When the topic turns to financial matters, my guess is your inappropriately outspoken Aunt Bee or too smart for his own good high school nephew Harry are more likely to bring up GameStop, bitcoin and SPACs versus boring old inflation.

While inflation may not be the most popular subject to discuss, its importance ought not to be ignored - given the recent heavy dose of government spending activities, and the growing comfort that we are nearing the end of our pandemic-induced lockdown days.

Inflation is near a decade low and well below the Federal Reserve target level of 2%. The conditions for high inflation often start with an increase in the money supply (from the government 'printing press') in conjunction with a hot economy and a tight labor force that leads to rising prices for goods and services in relatively limited supply. Too much money chases too little supply.

Milton Friedman, the late University of Chicago economist and Nobel Prize winner in 1976, described the roots of inflation as stated below.

> **"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."**

For most of the past 25 years, inflation has run close to or below 2%. This was true even during periods of strong GDP growth and the unemployment rate running below the Federal Reserve's estimate of its 'natural rate' (approximately 4.1% today).

There are a handful of key economic and societal differences that explain some of the divergence between high inflation times in the 1970s and 1980s and much lower inflation since the 1990s. Wage growth and aggregate consumer price increases have been suppressed due to increased globalization and automation. Aging populations are deflationary for economies as they tend to spend less on consumer goods and require more government funded resources like social security benefits and healthcare. Finally, it is widely believed there is more slack labor waiting on the sidelines today, and the natural rate of unemployment may be lower than the Fed's estimate. It is possible there are a lot of marginalized younger workers and willing baby boomers who would reenter the job market in a strong economy.

The major source of concern for inflation anxiety today stems from the past twelve months of significant government balance sheet expansion without offsetting tax increases or spending cuts. The US government has passed an aggregate of $5 trillion relief bills since the pandemic began, of which nearly half was approved since December 2020. The $5 trillion represents about 23% of annual US GDP.

President Biden has recently proposed a $2.3 trillion infrastructure bill that includes funding for repairing roads, bridges and tunnels, renewable energy projects and education and healthcare improvements. This bill proposes corporate tax increases to help offset the spending, but the net effect would be an estimated incremental $1.2 trillion bump to the deficit. This is an unprecedented level of government stimulus and the long-term impact on inflation is difficult to predict, but at the least, it brings the potential risks into the spotlight.

The story on consumer balance sheets is much different.

Aggregate excess consumer savings was estimated at $1.7 trillion as of January 2021 and is expected to grow to $2 trillion by the end of April. This is due to reduced pandemic spending for many and the increase in government transfer payments over the past year.

If you add in the wealth effect of a significantly higher stock market and a red-hot real estate market, then you can imagine there is a large amount of dollars on the sidelines waiting to be spent once we reach herd immunity levels by September, if not earlier. There is talk about a modern-day version of the roaring 1920s as lockdowns ease and people are more comfortable congregating. A lot of money could flow into restaurants, hotel rooms, flight tickets, concerts, ball games and anything else that was off limits during the pandemic. Companies will need to add employees to serve this increased demand and potentially plan for even stronger growth levels than the pre-pandemic times due to the high consumer savings rates. This cycle would drive down unemployment and could eventually lead to higher inflation.

Since the Federal Reserve began its quantitative easing program in 2009, there has been a visible correlation between the expanded money supply and an increase in asset market valuations. This is visible in global equities, high yield bonds, residential and commercial real estate, cryptocurrency and gold. Furthermore, since the Democrats won the Georgia race in early January, the types of stocks that have outperformed the market have been companies that tend to benefit from inflation. This includes industrials, energy, banks and semiconductor companies.

Bond yields have also risen sharply since January as the 10-year treasury yield is 1.7% and well off the pandemic lows of 0.3%. Rising bond yields are often a signal of increased market expectations for economic growth and inflation. Treasury Inflation Protected Securities (or TIPS) breakeven spreads of 2.5% are a proxy for current market expectations of future inflation. This suggests the market is expecting a rise in inflation over the next couple of years towards 2%-3%, but not much more at this point.

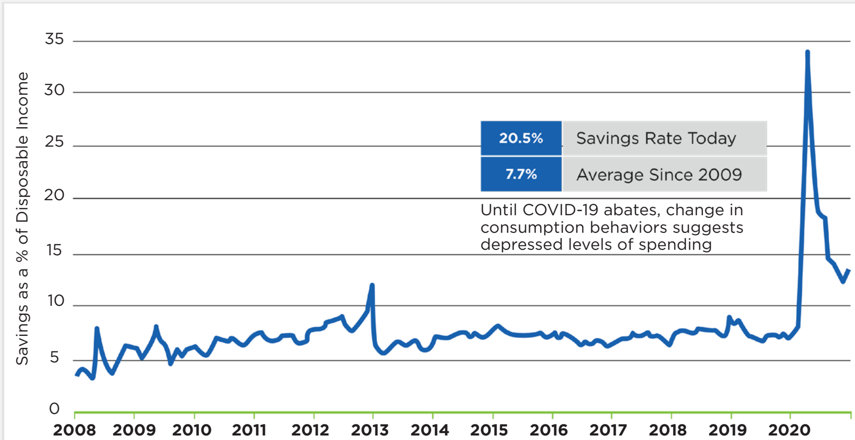
The bottom line is that the potential for inflation north of 4% or so is no sure thing, but it is an important metric to watch over the next year. This is a good time to review your financial plan to make sure you have natural inflation hedges in your portfolio like real estate (home ownership is one of the best ways to keep up with inflation) and the types of equities that keep pace during rising inflation. There is clearly an appetite for deficit spending in Washington and a more accepting view of above 2% inflation from the Federal Reserve for an unknown period of time. The best you can do is to pay attention, enjoy your time reconnecting with family and friends and encourage Harry to include an economics course or two during his senior year because this may be a much more topical dinner discussion item over the next few years.

Sources:

1. Bureau of Labor Statistics. https://www.bls.gov
2. *JP Morgan*

Today's High Saving Rate Could Reflect Pent-Up Demand

US personal savings rate (as a percentage of disposable income)

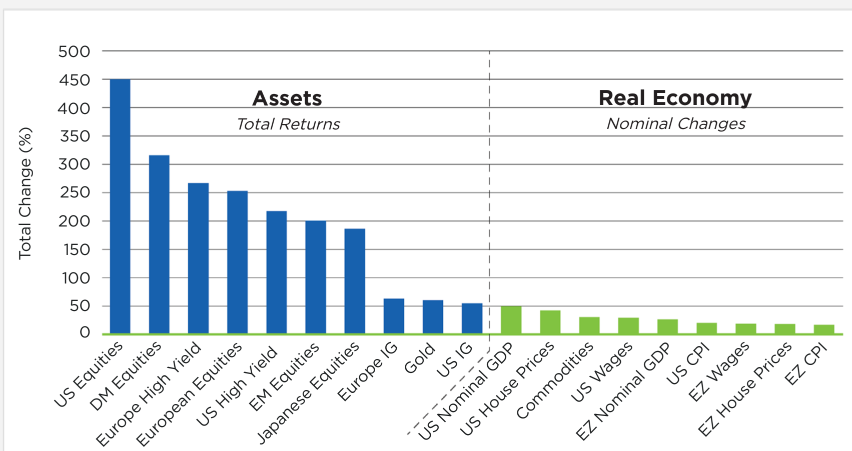


US households' savings rates have spiked during the COVID-19 outbreak, as Americans have altered their consumption behaviors during the pandemic. A return to "normal" activity could provide a near-term boost to prices, particularly in the service sector.

Source: U.S. Bureau of Economic Analysis, as of 31 January 2021. Lastest data available.

So, where does all that money go? Financial assets absorbed much of post-Global Financial Crisis money supply expansion

Comparing nominal changes (percent change from March 2009 to December 2019)



If we look to recent history, it becomes evident the expansion of central bank balance sheets and the consequent rise in money supply flowed to asset markets, not the real economy. From March 2009 to end-December 2019, M2 money supply rose 83% in the US, 39% in Japan, 53% in the Eurozone (EZ), and 32% in the UK. During this same period, inflation was little changed. In the US, inflation grew just 21% over this period and wages just 29%, versus the 451% rise in the US equities.

Sources: Bloomberg, US Bureau of Economic Analysis, US Bureau of Labor Statistics, Standard & Poor's/Case-Shiller, Eurostat, and Invesco, as of December 31, 2019. An investment cannot be make into an index. Past performance does not guarantee future results.

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