LEWIS WEALTH MANAGEMENT

Newsletter

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Executive Summary

Recent inflation reports are alarming. It's been a long time since inflation was a source of major concern (not since the Arab oil embargo in 1973). But inflation can be a stubborn problem to fix. The Federal Reserve had to raise interest rates to very high levels and trigger a painful recession to fix inflation the last time. We want to avoid that outcome again.

Much of the inflation we are experiencing today should be temporary. It is caused by the massive disruptions in the supply chains and pent-up demand. Inflation data is also noticeably distorted because of the base effect.

That said, massive amounts of monetary and fiscal stimulus have been poured into the economy to combat the pandemic, and this is a cause for concern about inflation.

Finally, accommodative monetary and fiscal policy is supporting asset prices in the stock, bond and real estate markets. While economic growth should be strong in the short term, we should be cautious about the current elevated asset prices.

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A Word on Inflation

Recent inflation reports are alarming. Core CPI was up 5.4% year-over-year in June, the largest 12-month increase since August 2008.[1] The price of gas is up 40% over this time last year.[2] Airfares are 24% higher.[3] Everything seems to cost more. Everyone is discussing inflation and why this is a problem, or not.

Since inflation has not been a significant problem for about 40 years, many of us have forgotten exactly what inflation is and why it is both a good and a bad thing.

What Is Inflation, and Why Is It Potentially Bad?

Inflation is the decline of purchasing power of a given currency over time. It is frequently measured by the increase in the average price level of a basket of selected goods and services over some period of time. The opposite of inflation is deflation, which occurs when the purchasing power of money increases and prices decline.[4]

Some Inflation Is Seen as a Good Thing by Most Economists

A certain amount of inflation is seen as economically healthy. If prices increase gradually over time, consumers and businesses have an incentive to spend money sooner rather than later because goods and services will cost more the longer they wait. The right amount of inflation also puts upward pressure on wages. In a deflationary situation, everyone would wait to purchase goods and services, knowing that the longer they wait those goods and services will cost less. Economic activity would suffer as a result.

Also, inflation and interest rates are correlated. If you save your money (instead of spending it now), you want to receive interest on

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[1] Guilford, Gwynn, "Inflations Accelerates Again in June as Economic Recovery Continues." *The Wall Street Journal*, July 13, 2021.
[2] Shapiro, Jake, "Denver Gas Prices Rise Again, Nearly 40% Higher than Last Year." *The Denver Post*, June 28, 2021.
[3] Usman, Khalid, and Spear, Bruce, "Why Airfares Will Likely Keep Getting More Expensive." CNN Business, June 24, 2021.
[4] www.investopedia.com/terms/i/inflation.asp.

your money to compensate you for the expected rise in prices between now and when you eventually spend your money.

The Federal Reserve's mandate is to keep inflation around 2%. The Fed needs some inflation in the economy. When inflation is positive, so are interest rates, and the Fed likes to lower interest rates to stimulate growth when the economy is struggling. Lower interest rates encourage economic growth because the cost of borrowing money is lower. Businesses borrow money to expand production capabilities and hire more workers. Consumers borrow money to buy houses and other items on credit.[5]

Importantly, since the Fed needs positive interest rates so it can lower them if it needs to, you also need some inflation. So the theory goes.

Too Much Inflation Can Be a Tough Problem to Fix

It's been a while since inflation was a serious problem. Back in 1973, the Arab oil embargo started in October that year and lasted about five months. During that time, the price of oil (and gasoline) quadrupled. Stations ran out of gas and the economy was sent into a tailspin as the cost of many items went up sharply. After that, OPEC carefully controlled the amount of oil it exported, keeping prices high. Our economy suffered from systemic inflation, and we descended into a recession in 1974-75.

Over the next several years, prices continued to rise. By 1980, inflation reached 14.5%. Mortgage interest rates were in the 16%-18% range (imagine that!). But at that time, the Fed was more concerned about unemployment than inflation. To keep unemployment low, the Fed kept increasing the money supply, but this only exacerbated the inflation problem, as too many dollars were chasing too few goods.[6] Presidents Nixon, Ford and Carter attempted several solutions to address the inflation problem, but none of them worked. That was when the term "stagflation" was born. It meant that the economy was stagnant while inflation raged on. The purchasing power of cash and savings eroded rapidly.

The Fed was in a serious dilemma. To control inflation, it needed to reduce the size of the money supply by increasing interest rates, but this would send the economy into another recession and increase unemployment. After a change in leadership, the Fed finally decided that correcting inflation was more important than low unemployment. In 1980, it increased interest rates and contracted the money supply, sending the economy into another recession in 1981-82. While unemployment increased, inflation was finally brought under control. The economy then worked its way out of the recession and the unemployment problem abated. Inflation in the U.S. has been under control since that time.

The point here is that when inflation is too high, it can be a very painful problem to fix. The Fed would like to avoid triggering another painful recession to bring inflation under control.

The Goldilocks Zone

In planetary science, the Goldilocks Zone is when a planet is just the right distance from the sun so that water is present to support life. If the planet is too close to the sun, all the water evaporates. If it is too far away, the water freezes.

The same is true for inflation. If we have no inflation (or deflation), economic activity stagnates and eventually contracts (like in Japan in the 1990s). If we have too much inflation, purchasing power erodes

[5] www.federalreserve.gov/faqs/economy_14400.htm.
[6] The collapse of Bretton Woods and the gold standard in the 1960s was also a major factor, but that is beyond the scope of our discussion here.

rapidly and economic activity again contracts (like in the U.S. in the 1970s). But if we have the right amount of inflation (about 2%-4%), the economy and asset prices grow and the Fed has room to lower interest rates if necessary to stimulate economic growth. We have been in the Goldilocks Zone for many years, fortunately.

The Pandemic Is a Massive Global Economic Event

When the global pandemic hit, major portions of the global economy were essentially shut down. This had never been done before. Almost immediately, we entered a sharp and deep global recession to combat the spread of the pandemic. We all stayed at home. There were strict travel restrictions. Restaurants, gyms, highways and airports were empty. I don't think I really drove my car for a couple of months. The stock market and the economy were sent into a tailspin. Unemployment surged to levels not seen since the Great Depression. People went hungry.

In the U.S., the Fed responded with a massive quantitative easing program that pushed trillions of dollars into the economy. In March 2020, Congress and President Trump passed the $2.2 trillion CARES Act that pumped massive amounts of fiscal stimulus and relief into the economy. Additional fiscal relief of $2.3 trillion was passed in December 2020 and then $1.9 trillion more in March 2021. Additional relief bills totaling $3.5 trillion are currently being debated in Congress.

A year after the economy was shut down, there was a massive effort to develop and distribute vaccines, and the economy was suddenly open again. People are back on the road, at the gym, at the airport and eating out, while many less fortunate people are simply trying to get back to work and dig out of financial trouble. This all happened very suddenly. It is unprecedented.

The impact of the pandemic cannot be overestimated. It was and is a seminal event in world history. We are only now beginning to understand the real impact of this event on all our lives. We are still in the middle of this massive crisis. While the outcome is unknown, the aftermath will be with us for many years to come.

The pandemic has triggered inflation in several important ways.

Supply Chain Disruptions and Surging Demand Have Caused Temporary Inflation

The pandemic has impacted the global supply chain in every way possible. When the global economy was effectively shut down, the demand for many goods completely collapsed overnight (like airline tickets, hotel rooms and rental cars). Suppliers of those goods had to make radical and immediate changes to their businesses just to survive. The demand for other goods and services (like toilet paper and food delivery) went through the roof. And now that the economy has reopened, the reverse is occurring at a rapid rate. This is causing a significant surge in inflation.

Let us look at cars, for example.

In the new- car market, there is a chip shortage that is preventing manufacturers from making enough cars. Now that the pandemic has eased, people want to buy new cars, but there is extremely limited inventory. Demand has surged while supplies are limited. Not surprisingly, prices have noticeably increased, which is inflationary.

In the used-car market, there is a crippling shortage. A steady stream of used cars usually comes from rental car companies when they turn over their fleets to buy new cars. When the pandemic hit and people stopped traveling, car reservations effectively dropped to zero. To financially survive, rental car

companies sold off large parts of their fleets last summer to raise cash. Now, demand for travel has suddenly surged, but the rental car companies do not have enough cars to meet demand and there are no new cars available to buy (because of the chip shortage). And now used-car prices have noticeably increased, causing more inflation.

Most economists believe this is a temporary situation. The chip shortage will abate and new-car inventories will go back to normal levels. Rental car companies will be able to purchase new cars to replenish their inventories. Prices of used cars are already going down.

Of course, this is just one example – there are many, many more. The point is that much of the inflation we are experiencing right now is probably temporary and we should not overreact to this trend. These disruptions should work themselves out over the next 12-24 months.[7]

The Base Effect Is Distorting Current Inflation Data

The base effect is distorting much of the current inflation data. The "base effect" refers to how you are comparing numbers, especially the choice of reference points, which can be misleading. Using a different reference or base numbers for comparison can lead to significant differences in the data.

Here is an example: What if I told you that the price of gas is up 55% over last year? Now, that is certainly inflationary and quite alarming, right? Here is some data:

U.S. Regular Retail Gasoline Prices per Gallon[8]

April 2019	$2.798
April 2020	$1.841
April 2021	$2.858

Looking at this data, you can see the problem. The price of a gallon of gas dipped to as low at $1.841 in April 2020, when the pandemic was at its absolute peak and the demand for gas was exceptionally low. The price about a year later was $2.858. Mathematically, that is an increase of 55.24%. But it is certainly misleading. Over a two-year period, the price of a gallon of gas has increased by only 2.14%.

Here are two points to consider: First, we should be careful about misleading inflation statistics. Second, when you look at a lot of recent data over a two-year period (where economic activity was more comparable), the data does not look nearly as inflationary. One-year comparison numbers are quite distorted right now.

Monetary and Fiscal Policy May Have Long-Term Inflationary Consequences

From a monetary standpoint, the Fed expanded its balance sheet once again to provide liquidity and support for markets that were in crisis last spring, and it continues to buy bonds each month. When the Fed buys bonds, it creates cash to pay the seller, and that is how it increases the money supply.

This is not what the Fed wanted. The Fed's balance sheet was dramatically increased to about $4.5 trillion to combat the Great Recession (2007-09), and the Fed was starting to slowly unwind its balance sheet

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[7] Timiraos, Nick, "Powell Says Inflation to Remain Elevated Before Moderating." *The Wall Street Journal*, July 14, 2021.
[8] U.S. Energy Information Administration – Independent Statistics and Analysis, www.eia.gov.

holdings. But then the pandemic suddenly arrived, surprising everyone. The Fed increased the size of its balance sheet (and the money supply) again. The Fed's balance sheet is now at $8 trillion.[9]

From a fiscal standpoint, the government has injected a lot of money into the economy to combat the pandemic:

The CARES Act (March 2020) = $2 trillion

The Consolidated Appropriations Act (December 2020) = $2.3 trillion

The American Rescue Plan (March 2021) = $1.9 trillion

And the current administration is proposing additional spending on infrastructure and social programs of about $3.5 trillion.

To put this into context, the two major pieces of legislation to combat the Great Recession totaled about $1.5 trillion (the Emergency Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009).

Politics aside, there has been a massive amount of monetary and fiscal stimulus pumped into the economy over the past year. These measures have increased the money supply, and many economists are expressing concern that too many dollars may be chasing too few goods very soon. This has the potential to cause long-term inflation (like in the 1970s), but it's really too soon to tell.

Finally, it is worth noting that all this stimulus is supporting high asset values here in the U.S. All three of the major asset classes – stocks, bonds and real estate – are near all-time highs. While economic activity should continue to be strong this year and maybe next, we should all be cautious when asset values are this elevated.

I hope this newsletter finds you safe and well. Please reach out with your investment questions and concerns.

Thank you.

D. Austin Lewis

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[9] www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm.