Higher Inflation Coming?

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Trying to predict the future is always tricky. Even when you are right, if you are too early or too late, you still miss any benefit for predicting what might happen. Take this commentary as thoughts on what may be coming, not as absolute guidance in what will happen.

Inflation is "the overall general upward price movement of goods and services in an economy" (Bureau of Labor Statistics of the United States Department of Labor). For example, in our recent webinar, we noted that an entrance ticket to Disneyland in 1955 cost $1.50 per day. Over the years, the price of a ticket has increased so that as of the time this is written, a 1-day Park Hopper ticket goes for $159. While we agree that Disneyland today is a lot different from Disneyland of 1955, the price increases show the effect of inflation.

The world is definitely changing. After the high inflation and poor economy of the 1970's and early 80's – often referred to as "Stagflation" – we have seen falling inflation, falling interest rates, accompanied by upward stock and bond markets for almost 40 years. We believe we are now at another turning point in long-term economic trends. We are seeing a lot of signs for additional inflation in our future. Let's look at a few:

- Short term, the measures of inflation are being compared to last year when the world was deep into the COVID-19 pandemic, which automatically means that figures are going to be higher as things recover. It is this reason that the Federal Reserve believes that the push up in inflation figures will be "temporary."

While we can understand this position, we believe there are longer term trends that will make inflation run higher and longer than they expect.

- The Federal Government in response to COVID-19 has pushed more money into the hands of consumers. We are seeing some of this reflected in the run up of stock and real estate prices and expect to see increased demand for other goods and services.
- Supply disruptions from COVID-19 have resulted in several key industries being slow to recover. In traditional supply-demand curves, reduced supply typically results in higher prices.
- There have been significant disruptions in employment. Everywhere we look, we see Help Wanted signs. This is a result not only of businesses reopening, but is also a reflection that many workers have simply exited the workforce. Fewer workers, more jobs that need workers, and your typical result is higher wages being paid. Add in the supply disruptions raising prices for materials and the final prices to consumers are going to be going up, i.e. higher inflation.
- We are concerned about the level of debt being run up by governments and companies. If you want to see some terrifyingly high figures, look at the increase in government debt – not only in the USA but around the world as well. Trillions of dollars in debt are being added. We believe this gives the government an incentive to create greater inflation. One way for governments to lessen the burden of too much debt is to inflate their way out of the problem. When "money doesn't buy what it used to" it is easier to pay off the principal on your debts.

In a dissenting opinion to our outlook for inflation, Dr. Lacy Hunt of Hoisington Management calls for deflation. Dr. Hunt views today's core problem as "excess debt suppresses economic growth, without which demand can't rise enough to generate inflation or push up interest rates over the medium term." He calls for deflation. In Dr. Hunt's words, "We simply do not have the resources to fund ourselves and to obtain a higher standard of living, which means that the economy will falter as we go forward, inflation will move lower."

- There are two major worldwide demographic shifts that appear to add to the inflationary spiral long term. These and similar trends are highlighted by Charles Goodhart and Manoj Pradhan in their book, <u>The Great Demographic Reversal</u> (2020), well worth reading. The first demographic shift is the aging of the workforce. In the U.S., as Baby Boomers (born 1946 to 1964) move into their retirement years, they are followed by smaller numbers in future working generations. Fewer workers and greater numbers of dependents is likely to mean that workers are more prized and able to demand higher wages. As retirees spend more of their accumulated wealth, they are likely to drive prices higher. Much of the developed world is facing similar demographic changes. Japan has faced this for several decades. Developed Europe also faces these trends. China faces its own aging workforce, even more so than the United States of America. The “One Child” policy mandated by the Chinese government for decades coupled with improved health and longer life of the aged means that China is facing an even more dramatic demographic change. (As a side note, after seeing the effects on the One Child policy, China has now implemented a Three Child policy to try to make up the lapse.)

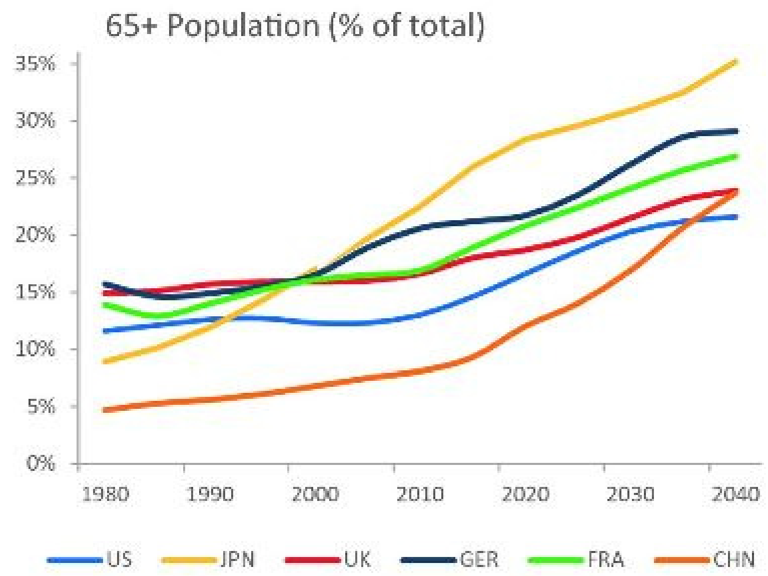

Diagram 5.2 Proportion of population aged over 65

(*Source* UN Population Statistics)

In the past several decades, there has been another demographic factor driving inflation low, the ability to move much of the work “offshore” to lower cost populations – especially to China. While this off-shoring may have helped Japan keep inflation low despite that country’s aging trend, this is changing. Again, drawing from The Great Demographic Reversal, trends in China are such that the deflationary industrial boom that made China the world’s manufacturer have topped out and are unlikely to bring that benefit in the future. In fact, China may be adding to the worldwide trend with higher inflation and lower output. India and Africa do not appear to be places that will be able to pick up the slack.

So what is the timing on this? As John Mauldin summarized in his recent “Thoughts from the Frontline” (May 29, 2021):

> *. . . William White, former Chief Economist at the Bank for International Settlements and holder of many other global economic honors . . . explained all these forecasts could actually be right. The key is to consider the sequence in which they will happen.*
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> - *In the near term, we could well see significant inflationary pressure for the reasons outlined by Peter Boockvar, Jim Bianco, Louis Gave, and others…*
> - *But in the medium term that follows, the math Lacy Hunt describes will catch up, squelching inflation and maybe forcing deflation…*
> - *While in the long run, monetary excess and the need to liquidate debt could send inflation sharply higher, possibly to the point of hyperinflation.*

We would add to the last paragraph, the demographic trends that appear poised to boost inflation worldwide. We find that demographic trends may not happen quickly, but they inevitably grind their way through the population.

So what is a prudent investor to do? As we noted in our commentary last year, So “What’s Next? (Part 2)” available on our website, hard assets seem to be the best protection, investments such as commodities, gold, or real estate. While stock markets have not done well historically during inflationary environments, having income producing investments, such as Growth and Income stocks and mutual funds, seem to be a good place to go. Of these, our “go-to” investments are the growth and income stocks of high quality companies. Not only do the prices of the stocks tend to rise with inflation, but the income that is produced also increases. Automatically reinvesting that income as stocks rise and fall can add value.

The biggest thing **NOT** to do during inflationary times is to flee to the short-term “safety” of cash, bank accounts, or short-term bonds, no matter how tempting it may be during wild market fluctuations. After taxes and inflation, these investments lose spending power – what we not so fondly refer to as “Going broke safely.” The greater the inflation rate, the faster these investments “go broke.”

The Advisory Group and your advisors are here for you and will help guide you through whatever happens and will help you meet your financial goals. Reach out to us whenever you need our guidance. Stay safe and healthy!

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