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Musings on Inflation

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There is no hotter topic in the financial markets today than the prospects for inflation. In a normal, functioning economy, inflation is the key driver of interest rates. Interest rates are, at their core, the price of money and therefore are the most important price for an economy. If you can, with reasonable clarity, forecast inflation you should have insight into the direction of interest rates. This should inform any coherent view of the economic outlook and asset prices.

Forecasting is inherently difficult, and it has become vastly more difficult in the past thirteen years as central bankers and governments have unleashed truly historic experiments in monetary and fiscal policy. These experiments have had enormous economic impact, but not everyone agrees about what that impact has been. Hence, the current debate about inflation.

To observers concerned about inflation, the incredible surge of pandemic related stimulus is the straw that is breaking the camel's back. Every popular measure of inflation is rising. The question at hand is how high inflation may go, and how long the price increases will persist. The Fed says the higher inflation is transitory, but critics have many objections to this assessment.

The first objection is that the popular measures of inflation are flawed. Many people report that their own experience suggests more than 2% inflation that the Fed has targeted. Much of this criticism has to do with how we measure inflation. Take housing as an example. Home prices are in a frantic melt up that feels great if you own a home but is incredibly discouraging to the aspiring home buyer. This melt-up in housing prices, however, doesn't make it into the calculation of inflation. Instead, the Bureau of Labor Statistics uses owner's equivalent rent. This theoretical figure is derived by surveying homeowners and asking how much they think they would have to pay to rent their home. It is an interesting question for an economics dissertation, but it doesn't seem to capture real life.

Inflation measures also make critical assumptions about changes in quality and the willingness of consumers to substitute goods. Take buying tires for your car as an example. Forty years ago, 4 tires might have cost $100 and been expected to last 30,000 miles. Today, tires are better and might last twice as long but cost $400. How much as the price of tires increased? According the BLS, not by a factor of 4 as they "adjust" the data to reflect the longer expected life. In the case of the substation effect, if a basket of food included beef, and the cost of beef rises, the BLS assumes that there will be a substitute of a cheaper protein (i.e., chicken) for beef. That may be what happens in the grocery

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store, but what does that adjustment tell us about actual inflation?

A second objection to the Fed's position is that the measures of inflation ignore asset (stocks, bonds, real estate) price changes. If inflation is too much money chasing too few goods, why should the goods only include basics. Clearly, too much money has been flooding asset markets including real estate (homes being sold far in excess of asking prices) and historically high stock prices. Isn't this a measure of inflation that should be considered?

The Fed and those economists that aren't concerned about inflation believe that they move higher in measured inflation is a temporary phenomenon driven by the year over year comparison to the spring of 2020 when the economy was locked down and prices plunged. Naturally, they assert, as the economy opens up, we will see transitory higher prices.

Their argument is bolstered by the ongoing weakness in the velocity of money. Velocity is a derived measure of the frequency with which money circulates in the economy. Since the 2008 financial crisis, this rate of turnover has plunged as businesses and consumers have retrenched and hunkered down to weather the financial and economic storm. We are sympathetic to this argument, and it does seem to explain some of the behavior we have seen. The question, however, is whether velocity will remain muted as the economy reopens and consumers seek to satisfy pent up demand for services. Their apprehension may be lessened by the seemingly limitless largesse of the Federal government.

The answers to the inflation question aren't clear and there is ample room for reasonable people to disagree about the prospects for sustained higher prices. Because of the enormous impact that higher inflation has on the cost of living in retirement and on asset prices, we view it as one of the most important variables to monitor and attend to as we help you navigate these new economic realities.