NORTH WOODS
ASSET MANAGEMENT

First Hints of Inflation

The equity bull market continued its torrid pace in the second quarter as all major asset classes posted positive returns. We are now on month 15 since the S&P 500 hit a low in March 2020 and the market appears to be Teflon – nothing seems able to hurt it. However, one issue is increasingly talked about as a cause for concern: inflation. From politicians to economists to business leaders, more and more people are sounding the alarm on inflation and the damage it would do. We have not had to deal with any serious inflation in decades, which begs the question – why now?

First, a few historical notes. After the 1970's & 1980s when America experienced inflation rates above 12%, the Federal Reserve was laser-focused on limiting inflation. They were successful – inflation has hovered in the low single digits for a couple decades and moved way down the list of things most Americans worry about. Thirteen years ago, this policy shifted in response to the Great Recession and the Fed began aggressive monetary stimulus programs & policies which, according to core economic theories, should lead to higher inflation. After a decade of not seeing the resulting inflation show up in the data, the Fed doubled down (or tripled down) on these policies in response to Covid-19, which has amplified the expectation/concern of impending inflation.

Let us explore the various possible explanations of what is happening, and why we are not seeing the inflation that our core economic theories say we should.

Hypothesis 1: We are using the wrong measurement tool. The primary measurement of inflation is the Consumer Price Index (CPI). CPI attempts to cover the average expenditures per individual and measure how much the prices of those goods are increasing over time. However, many critics suggest that the "basket of goods" used by the CPI is not reflective of actual costs incurred by Americans. Therefore, inflation may be present in our economy, but potentially not in the way we measure it.

Hypothesis 2: Sticky prices. This thesis states that inflation will eventually result from monetary stimulus, but it may take a long time (even decades) for prices to adjust accordingly. This would imply that there is an inflation "bomb" waiting for us at some point. It is this hypothesis that has been gathering attention in the media lately – we are seeing the first signs of higher inflation, although many contend that these higher readings are simply transitory due to the pandemic. In fact, the Fed is on record claiming that current higher CPI readings are a temporary result of the pandemic.

Hypothesis 3: The money has flowed into asset prices, not the consumption economy. This theory claims that the money shot into the economy has found its way into capital prices (stocks, bonds, real estate) and not into consumption patterns which would explain low inflation. Basic economics would argue that this money should "trickle down" into the consumption economy over time, but it may be that this process is taking significantly longer than estimated.

Like many things in life, there is probably some truth in each explanation, but probably more truth in some than in others. What is certain is that the more monetary stimulus there is, the more important the answer to which hypothesis is true becomes to investors & policymakers – and until the data makes the answer clear we will continue hearing more and more about inflation concerns as Congress & the Fed continue pumping out more and more stimulus.

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