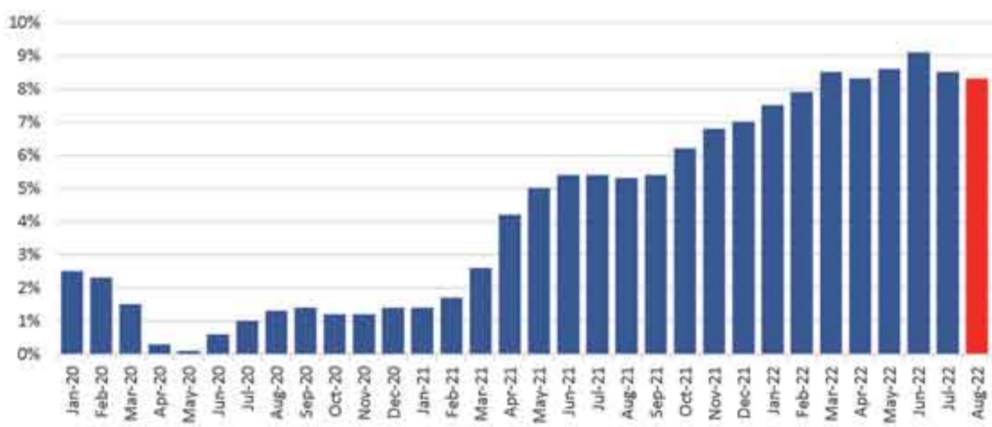
Fourth Quarter 2022

The Good News, Bad News of Inflation

July and August brought good news on the inflation front with a drop from a 9.1% annual increase in the Consumer Price Index (CPI) recorded in June to 8.5% in July and 8.3% in August. But the end of inflation still has a rocky road ahead. Behind the recent decline are two major factors, lower energy costs and lower sales prices for used cars, both of which had seen increases in excess of 40% over the past 12 months.

Gasoline prices were 49% higher in June than the year prior, but declined in July and August, in part due to fewer miles driven and a strong U.S. dollar. Used car and truck prices had seen an unprecedented increase of more than 40% in 2021 and began falling in early 2022. Those declines helped offset inflation in many other categories of the CPI that continued to take a bite out of Americans' income. T he food component of the index rose 11.4% over the prior year in August, the highest increase since May of 1979. With fall and higher heating costs looming, the respite from inflation could be brief.

Monthly 12-Month Inflation Rate in the U.S.
January 2020 to January 2022



Source: U.S. Bureau of Labor Statistics – Division of Consumer Prices and Price Indexes

Following the Federal Reserve Board's August 2022 meeting at Jackson Hole, Fed Chairman Jerome Powell warned, *"Reducing inflation is likely to require a sustained period of below-trend growth…. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain."*

The problem with inflation is that it rarely ever ends without a fight. Rising prices spur demands for rising wages, higher interest rates, and higher prices to protect from inflation. Those higher costs tend to be sticky and often never drop back to earlier levels. The stickiest cost is labor. Union contracts and minimum wage laws lock wages in at inflation highs. Which is where inflation gets ugly with "pain to households and businesses."

To break an inflationary cycle, you have two options – reduce demand or increase supply. Reducing demand comes down to making products and services more expensive. Since businesses typically depend on lines of credit and borrowing for inventory, facilities and equipment, increasing interest rates increases costs, forcing prices higher. Higher prices tend to limit demand.

Increasing supply is trickier. In an inflationary environment, consumer spending focuses on essentials. Prices of non-essential goods fall as businesses lower prices to reduce inventory and pay their operating costs. But if they can't produce future goods at the lower price due to inflation, there's little incentive to do so. For prices to fall after the fire sales, the cost of production needs to fall and that requires increased productivity from a more efficient labor force, new technologies and/or new sources of supply that lower the costs of production and providing services. Prices retreat as it becomes less expensive to supply the desired good or service. Computer technology is a prime example.

Percent changes in CPI Items for All Urban Consumers
U.S. city average - Unadjusted 12-months ended Aug. 2022

Food	11.4%
Food at home	13.5%
Cereals and bakery products	16.4%
Meats, poultry, fish, and eggs	10.6%
Dairy and related products	16.2%
Fruits and vegetables	9.4%
Other food at home	16.7%
Nonalcoholic beverages and beverage materials	13.4%
Food away from home	8.0%
Energy	23.8%
Energy commodities	27.1%
Fuel oil	68.8%
Gasoline (all types)	25.6%
Energy services	19.8%
Electricity	15.8%
Natural gas (piped)	33.0%
Apparel	5.1%
New vehicles	10.1%
Used cars and trucks	7.8%
Alcoholic beverages	4.3%
Tobacco and smoking products	8.8%
Rent of primary residence	6.7%
Owners' equivalent rent of residences	6.3%
Medical care services	5.6%
Physicians' services	1.1%
Hospital services	4.0%
Transportation services	11.3%
Motor vehicle maintenance and repair	9.1%
Motor vehicle insurance	8.7%
Airline fare	33.4%

Source: U.S. Bureau of Labor Statistics

Inflation has existed since the invention of money and the discovery of governments that they can print money. The Roman empire was beset with inflation in the 3rd century but managed to hold on for nearly 200 years before disintegrating in the 5th century. Gold pouring into Europe from the New World triggered 400% inflation in the 16th century. The U.S. Constitution owes its existence to inflation. Prices in the colonies doubled in 1776, doubled again in 1777 and 1778. By 1781, prices had increased 80-fold as the Continental Congress printed money to finance the Revolution. The new "Union" was falling apart under financial pressures. Alexander Hamilton's monetary and tax systems combined with the discipline of the Constitution kept inflation away until the Civil War.

Wars historically are almost always linked to inflation. Soaring inflation crippled the south during the Civil War as the Confederacy printed money, while the North was able to finance much of its war effort with debt. World War I caused prices in the U.S. to increase almost 100% in two years. Wage and price controls were used during World War II to keep inflation around 25%. But after the war, inflation took off with farm prices up 30% in a year. The U.S. was saved from an inflationary spiral by an incredible surge in productivity, much of which resulted from lessons learned supplying the war effort.

In the 1980s, inflation in the U.S. hit 13.5%, the highest ever peacetime rate. It only fell after the Federal Reserve sharply increased interest rates, triggering 10.8% unemployment and a deep recession.

Is there a way to reduce prices and reverse inflation without the pain of higher interest rates? You need to increase productivity -- to find ways to make products, grow food supplies and provide services more efficiently and at a lower cost. That doesn't happen in a month. Unless we are very fortunate, it's not going to happen in a year.

Inflation is as old as the creation of money; somehow people always survive in the end. What inflation does require is looking carefully at your finances (particularly if you are nearing retirement), finding ways to optimize your investments, and minimizing your outflows. You also need to consider how to adapt your lifestyle if there is not a soft landing. If you are concerned about inflation's impact on your life, call and let's set a time to talk.

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