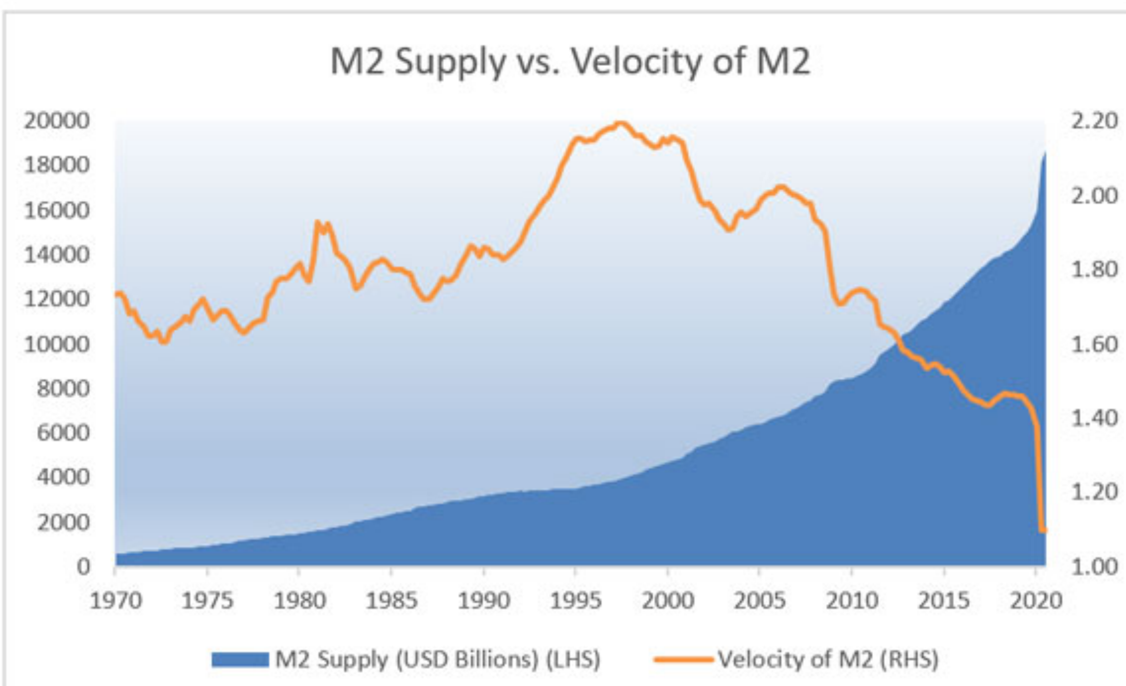
Second Quarter 2021

Inflation on Our Minds

In 2020, the amount of money in the U.S. economy increased by more than $4 trillion, a one-year increase of more than 26% in M2 - a measure of the money supply that includes cash, checking deposits, and easily convertible near money. Another $2.3 trillion (12%) increase is already built into Federal Reserve planning for 2021. That’s a lot of money.

According to the Fed, the purpose of the money is to spur the economy and drive employment up, moving money into the consuming public. The problem with this plan is that “created” money all too often ends up producing inflation. In 2009 and 2010, the Wall Street Journal reports that China’s money supply grew by 23%. By July of 2011, inflation had increased from 1.8% to 6.5%.

Many economists point to the lack of inflation in the U.S. to date as proof that the increase in M2 does not affect inflation. The U.S. at an average annual inflation rate of 1.8%, is still below the Fed’s 2.0% average inflation target. But there’s also not a lot of evidence that the new money has made it into circulation and had an opportunity to impact prices. Thanks to the Covid lockdowns and economic uncertainty, Americans have been spending less on non-essentials and saving more than ever. Banks tightened standards in 2020 for commercial and industrial (C&I) loans, along with many other lending products, because of the uncertain economic outlook, worsening of industry-specific problems, and reduced tolerance for risk. As a result, new loan originations faltered.



Velocity is a measure of the number of times that the average unit of currency is used to purchase goods and services within a given time period. For example, when you purchase a pair of shoes, your money may be used by the store owner to purchase more inventory, providing the manufacturer with funds to purchase more raw materials. Comparing the growth of M2 (money supply) with the velocity of M2, shows money creation has outstripped the willingness to spend. With velocity at an all time low, money isn't making the world go round.

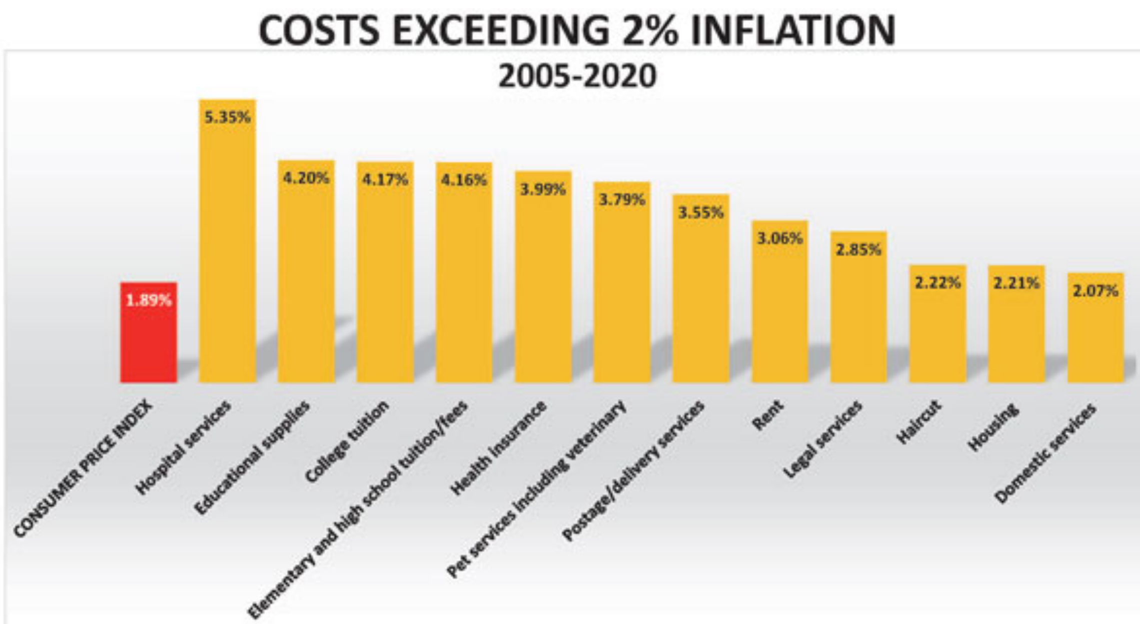
There is the belief at the federal level that increasing money supply is not inflationary. Fed Chairman Jerome Powell made clear on February 23, 2021, that he did not think increased stimulus spending would trigger higher inflation:

"Inflation dynamics do change over time but they don't change on a dime, and so we don't really see how a burst of fiscal support or spending that doesn't last for many years would actually change those inflation dynamics." …

But that doesn't mean inflation is just a bogeyman of the past. It needs to be a very real consideration for investors.

In 2008, Warren Buffett called "exploding" inflation the biggest risk to the economy. Inflation, he explained, acts as a gigantic corporate tapeworm eating investment capital. Ronald Reagan put it a little differently, explaining, *"Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man."*

Recent increases in stock market volatility and short-term bond yields has a number of analysts concerned that the Fed will keep its "foot on the accelerator for too long." Even with low velocity of M2, many spending categories of the CPI are already exceeding the Fed's 2% inflation target.

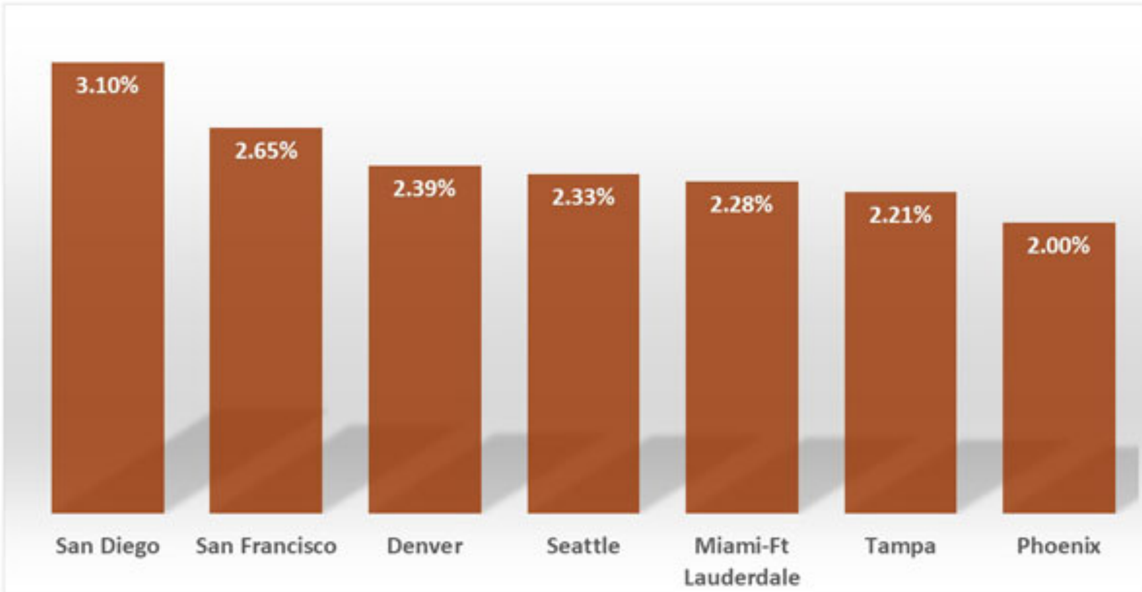


Source: U.S. Bureau of Labor Statistics

The impact of inflation varies based on where you are in your economic cycle. Individuals over 50 who own their own home and cars and have minimal healthcare expenses may be least impacted. Inflation typically hits hardest on the poor, with the least ability to afford increased costs for basic consumables. At present, Inflation is highest in what one might call aspirations – the desire for a college education, to own a home, to have affordable healthcare, to send one's children to a good school, and even to have a pet.

Inflation also varies by geographic region and municipality. Even now, areas of the U.S. are experiencing costs increasing at a faster pace than the national average.

CITIES EXCEEDING 2% INFLATION



Source: U.S. Bureau of Labor Statistics

Will or won't inflation take off? Which monetary theorists will be right? Is there a limit to how much money supply and government debt can increase without rebounding on consumers? We will know the answers in hindsight. A better question may be - how can individuals best prepare if inflation is in our future?

Begin to think how you might best protect your investments. Research past inflationary periods to see which investments historically perform best in inflationary environments. Just remember that while past trends may recur, there are always variations on the theme.

Debt planning is one strategy. If you are planning on buying a home, auto, or other major purchase that will require financing, putting that financing in place now, while rates are low, may have value.

The fascinating aspect of financial markets is that there is typically a way to make a profit if you study and understand market trends and are flexible in your investment approach. Commodities and real estate have been effective inflation hedges in the past. Stocks of companies that are able to raise their prices faster that production costs increase can do well. Government inflation-protected bonds such as Treasury Inflation-Protected Securities (TIPS) are indexed to an inflationary gauge to protect investors from the decline in the purchasing power of their money.

Just remember, past performance is NOT indicative of future performance. Work with a qualified financial advisor. Ask questions before you make any major moves. And always have a plan to change directions if the scenario you are anticipating doesn't materialize. Remember every investment has the potential for loss as well as gain, and not every investment strategy will be successful. A sure thing, or an investment too good to be true, most likely isn't.

TOP

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