A Look at Inflation

By Michael Ouellette

May 12, 2022- The latest U.S. inflation number of 8.3% reported from April 2022 is slightly down from a 40-year high of 8.5% reported from March 2022. Here at Starboard, we believe that inflation will settle back down in the 4-5% range in the short to mid-term. We don't see inflation remaining at elevated levels for too long, but we are cautious as supply chain issues are still causing global disruptions. The invasion of Ukraine and the recent lockdowns in China will certainly delay the recovery of global supply chain.

Furthermore, there are other factors that are sensitive to the latest inflationary environment:

1. Consumers remained home during the pandemic and were able to increase their personal savings at historic levels, creating pent up demand once the economy reopened.
2. Corporations maintained strong balance sheets with high cash levels needed for components, inventory, and wages.
3. The U.S. government passed the largest stimulus package in history, releasing $1.9 Trillion into the economy to combat the Covid closures across the U.S.
4. Increases in energy costs driven largely by oil/natural gas prices prior to the invasion of Ukraine and have continued to rise steadily following the invasion.
5. An unprecedented increase in prices and demand for used cars as a lack of components persist for new cars (average price increases alone in March 2022 were +35%).
6. U.S. wage growth has increased significantly as there are over 11 Million job openings compared to the 5 Million Americans who remain unemployed and looking for work.
7. A "wealth effect" (although not a true component of inflation) is created in part by an increase in house prices which provides consumers with confidence to tap into their home equity and spend.

Higher prices in one sector alone doesn't lead to higher inflation across the U.S. economy, but consumers are now seeing price increases across many sectors and are now experiencing reduced purchasing power. For the past couple of decades, inflation has remained low in the U.S. as well as many other countries globally due in large part to technological advances which have increased overall economic output and productivity while keeping labor costs subdued.

What is Inflation?

A quick refresher may be in order for some of our investors who have not seen this level of inflation during their adulthood. Inflation is simply the decline of purchasing power of our currency, over time. A low inflation rate slows the decline of purchasing power while a higher inflation rate can rapidly decline purchasing power.

How to Measure Inflation?

While it is easy to see a price difference of a particular good or service that we buy frequently, economists along with the Federal Reserve Bank use a larger diversified set of goods and services that individuals buy and use regularly such as, but not limited to, food, fuel, utilities, transportation, healthcare, and labor.

The collection of this diversified "basket of goods and services" allows for a single representation of a "price level" of goods and services which can be measured over a period of time to gauge inflation. As prices rise, consumers lose value of their dollars and buy fewer goods and services.

The headline measurement of inflation is called the **Consumer Price Index** (CPI) which is released monthly by the Bureau of Labor Statistics. The CPI collects data from household surveys and only covers "out-of-pocket" goods and services purchased but it excludes other goods and services that are not paid for directly such as employer-paid healthcare, Medicare, and Medicaid.

CPI is considered the "headline" inflation rate but it includes more volatile prices from the food and energy sectors. To better understand underlying inflation trends, economists will exclude food and energy prices from CPI and this adjusted inflation rate is referred to as "Core CPI".

Alternatively, to smooth out these price swings of food and energy, the Bureau of Economic Analysis uses a broader "basket of goods and services" which is called the **Personal Consumption Expenditures** (PCE) price index. Our Federal Reserve Bank keeps a close eye on CPI, as it reflects the direct impact of a consumer. However, the PCE price index provides a wider lens to gauge overall inflation throughout the economy.

What Causes Inflation?

The consensus view among economists and policymakers is that inflation occurs when the growth of our country's "money supply" outpaces economic growth. Money supply is the amount of money that is circulating in the economy -- our country's money supply is roughly measured by the combination of cash and deposits that can be readily used as cash.

There are many factors that can impact inflation but generally they have been boxed in three categories: Demand, Cost, and Expectations.

1. "**Demand**" for goods and services can increase with a larger "money supply". When there are more dollars chasing fewer goods and services, prices will increase.
2. When the "**Cost**" of producing goods and services rises, businesses will increase prices.
3. Workers have the "**Expectation**" that the cost of goods and services that they consume or use over time will increase which leads to higher wage expectations, leading to higher costs for businesses to produce goods and services and eventually, higher prices. Alternatively, referred to as "wage-price spiral."

Hyperinflation vs. Stagflation

Hyperinflation is a severe instance of inflation whereby general price increases become excessive and rapidly erode the value of the dollar. Hyperinflation is defined as an inflation higher than 50% per month. Developed countries with central banks such as the Federal Reserve Bank seldom experience hyperinflation due to monetary controls to stabilize the currency's value.

Historically, hyperinflation occurs in developing countries (i.e., Venezuela 2019, Zimbabwe 2007, Hungary 1945) that experience a loss in confidence of the local currency and/or economy.

Stagflation is defined by an economy that is experiencing a period of decline in its Gross Domestic Product (GDP) combined with high inflation and high unemployment.

Federal Reserve Bank's Role

One of the main goals of the Fed is to foster economic growth in the U.S. by keeping general prices stable without experiencing large increases or decreases too quickly. The primary tool that the Fed uses to combat or control inflation is the **Federal Funds Rate** which is the interest rate that member depository banks charge each other overnight to borrow cash on an uncollateralized basis.

When the economy or inflation is running high, the Fed will generally raise the interest rate of the Federal Funds Rate whereby slowing down economic activity. Conversely if the economy or inflation is too low, then the Fed will generally lower the interest rate of the Federal Funds Rate to stimulate economic activity.

How To Navigate Inflation?

Some level of inflation is considered "good" because it means the economy is growing. However, if an economy experiences higher than expected inflation for a longer period of time than the market expects, then managing investment portfolios requires additional care to ensure that investors retain their purchasing power.

The investment team at Starboard & KFA believe that the best inflation buster is a focused, but balanced portfolio of large high-quality companies with a predictable stream of "growing" earnings year over year, no matter what the economic weather is. We continue to believe the best companies and best management teams are right here in America and are well suited to handle the challenges of inflation and repay shareholders with the long-term growth of share prices that should outpace the average annual rate of inflation.

Additionally, our clients understand that higher inflation leads to higher interest rates which leads to lower corporate profits. This raises the attractiveness to broader, alternative holdings in the S&P 500 to gain more exposure to commodity-producer equities such as energy, materials, and REITs. For our "sleep-at-night" bond allocations, we recommend keeping shorter duration bond maturities (five years or less) with the expectation that rates will continue to rise and will provide investors with frequent opportunities to roll maturing bonds into higher cash yields. While there is no silver bullet to combat elevated inflation, our ultimate goal is to protect the purchasing power of the investment portfolio over time with every tool at our disposal.

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