1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

July 13, 2020

The Enigma of Inflation

Equity markets were up modestly this past week. This is interesting since we have argued long and hard that the driving force behind investor behavior is the pandemic. Certainly, it is difficult to interpret last week's news concerning the pandemic as positive. The Dow rose 0.96%, the S&P 500 increased 1.76% and the NASDAQ gained 4.01%. All in all a good week considering the unpleasant reports concerning the spread of the coronavirus.

The Economy

Reports concerning the spread of the pandemic were discouraging this past week. Countering those reports, domestic economic news remains either encouraging or mildly bearish at worst. The Federal Reserve continues to give investors and business leaders assurances about continued liquidity and a market of last resort for most debt instruments.

It seems reasonable for investors to think there will be another fiscal policy bill being passed either at the end of July or very soon after. The reason is clear—self-preservation. As the November elections approach, no politician wants to face her constituency and explain why she has either voted against or voted to delay passage of a spending bill, which their opponent will argue would have saved jobs. We understand politics is not always rational, but to not pass a spending bill under these circumstances tests rationality a bit too far. There do remain dangers to the economic recovery from outside the United States. The E.U. continues to struggle, and China has real internal problems and remains at odds with the U.S. administration about trade.

Inflation

We have received an increasing number of inquiries about the dangers of inflation. This week we will explain why concerns about inflation are legitimate and why we believe hyperinflation is unlikely. We will do this in three steps. First, we will explain why intelligent investors are rightly concerned. Then, we will provide a quick primer on the three major views on the causes of inflation. Last, we will explain why the current situation doesn't meet all the requirements for hyperinflation.

Why the fear of hyperinflation? In order to combat the economic effects of the pandemic, most countries are running very high budget deficits and their central banks are adding enormous amounts of liquidity into the system. Both have potential to explode money supply and add to inflation. Furthermore, trade tensions are creating a growing fear of disruptions in the free flow of international trade. Investors rightly look at these developments and think hyperinflation.

Time to look at theory. We are going to take an abbreviated look at the classical, the Keynesian view, followed by the monetary view most eloquently argued by Milton Friedman. A quick reminder, these are much abbreviated explanations.

Classical economists believed that all markets were self-correcting and a number of arguments existed to explain the cause of inflation. Thomas Malthus pointed to crop failures and rapid population growth, while Adam Smith contended that government action to restrict international trade was the cause. Regardless, both economists believed markets will always self-correct. Two basic beliefs that make this work are flexible interest rates and Say's law.[1]

The modern theory, as originated by John Maynard Keynes and his followers, lists three major causes. First, increases in aggregate demand, known as demand-pull inflation. Examples are government spending, money supply, and shortages of material or labor. Second, cost-push, where prices increase due to an increase in any of the factors in the production process. This includes built-in inflationary agreements such as increases in wages, commodity prices, tax levels and exchange rates. Later, the supply and demand for labor markets were explicitly added. Economists used the Phillips curve, which is a mathematical representation of the relationship between levels of employment and wages, to help explain inflation.

Last, Monetary Theory. Milton Friedman famously argued, "Inflation is always and everywhere a monetary phenomenon." By this, he meant that inflation could not exist without an excess of money in the system. He argued that the only cure for inflation is to cut excess spending. In other words, take money, spending power, out of the system. He said that the result would be temporary unemployment and a reduction of total spending.

Modern economists generally accept the latter two economic theories.

At first blush, one could argue that the world is likely in for a powerful bout of inflation. But, embedded in each of these theories is a critically important factor, which is totally missing from the current equation. That is demand. Demand is the vital trigger that sets inflation in motion. It is the delicate balance between supply and demand. Neither supply nor demand act independently, but in concert. Yes, almost all the factors leading to inflation are present. We base our argument against inflation on that point. Demand in the labor market or real goods market does not exist. Does this mean we won't have serious inflation in the future? No. It is very possible that if governments don't begin to rein in spending and excess liquidity, we most likely will see serious inflation, but that is not in the next year or so. What we have left out of our simple equation is that there are two sides of an economy, real goods and financial. It is possible to have inflation in the financial side and not the real goods side. In fact, this may very well be the case. Inflation in the financial side will manifest itself by very low interest rates and high equity prices. Sounds familiar. A good way for investors to follow demand is to keep an eye on the growth of labor markets.

We are confident about inflation being under control for 12 months or so. We will be carefully monitoring both the real goods markets and the financial markets for signs of building pressures.

As in all forecasts, knowing the time frame is vital.

[1]Say's Law. When an economy produces a certain level of GDP, it also generates the income needed to purchase that level of real GDP. In other words, the economy is always capable of demanding all the output that its workers and firms can produce. The economy is always capable of achieving its non-inflationary natural level of real GDP.

Michael Olin Clark moclark@1919ic.com | Ryan Schutte rschutte@1919ic.com

Please click here for the updated Economic Release Calendar - July 2020.