Weekly Market Insights

May 17, 2021

A volatile market and the question of inflation

Equity Markets

This past week, equity markets had a dramatic ride. The week started strong, then deteriorated dramatically, falling on a government report showing much higher inflation than expected, and perhaps a wave of selling in anticipation of an increase in the capital gains tax rate. Equities then rebounded the last two days of the week.

Investors and some analysts interpreted the latest report on inflation as the beginning of an inflationary spiral, forcing central banks around the globe to tighten heretofore very loose monetary policy, and slow their respective economies. The Dow ended the week down 1.14%, the S&P 500 decreased 1.39%, while the NASDAQ closed down 2.34%.

The Economy

Many wise and respected economists, Larry Summers and William Dudley to name two, have argued that Central Banks have kept monetary policy too stimulative for too long, and now there is a price to be paid—inflation.

Our argument against imminent and long lasting inflation is not that monetary policy has been perfect, but, for inflation to become rampant, demand must be robust enough to put pressure on supply, allowing prices to rise. Inflation is not a one-dimensional phenomenon. We argue that any shortages in supply are temporary. Remember, just two weeks ago investors and analysts were quite disappointed that the economy was producing so few jobs, implying a future weakening of demand.

A tightening of labor markets is a sign of future wage increases, which is inflationary, and there are plenty of reports about the difficulty employers are having filling jobs. This is correct, but it is also still the case that the official unemployment rate is 6.1%, and some private estimates are as high as 10%. These reports seem to defy logic. How can it be difficult to fill jobs when so many appear to be out of work? The logical arguments are the supplemental unemployment pay, childcare constraints due to mixed school reopenings, and lingering COVID concerns. To relieve some of the pain of unemployment and stimulate the economy, the government has temporarily added to unemployment pay. At the time, it was necessary, but now it may be a strong disincentive for some to go back to work. This program will be ending, schools will reopen, and vaccinations will increase. These together should ease any labor shortage.

But it is not only labor shortages that can cause inflationary pressure. There must be enough capacity in the industrial world to fill demand. We believe there is plenty of slack in the economy. The world has not nearly recovered from the recession created by the pandemic. The United States, the European Union, and parts of Asia have excess capacity, but it takes time to bring it back on line.

These are the reasons inflationary pressures appear to us to be transitory. It most likely will take months before demand exceeds supply to a degree that produces a threat of long-term inflation. This does not mean we are not concerned about inflation, but just not now. Our best guess is, if all goes well, the world will be at full capacity in late 2022 or early 2023. Then, if central banks don't react, inflation will be a real problem.

Weekly Market Insights (cont'd)

Conclusion

Severe long-term inflation is unlikely at this time, although there will be constant bouts of inflationary fears. This in no way argues that inflation is not a problem. As always, investors must pay close attention to the Fed, but remember it takes more than money to create an inflationary problem. Capacity in the real economy is also an important factor.

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