by J.P. Mayer, MSBA, CFP ®
Sound Management for a Secure Future

PACIFIC WEALTH MANAGEMENT®

A historically unprecedented amount of monetary stimulus has been injected into the U.S. economic system in the wake of the 2020 global pandemic. As troubling signs of significant increases in the prices of various goods have materialized, fears of a reemergence of 1970s-level inflation abound.

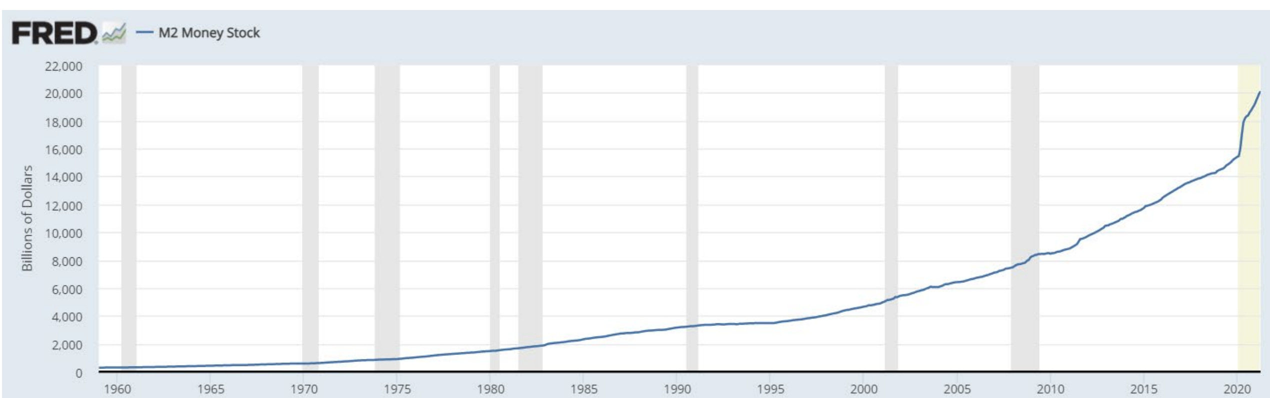
Is the U.S. economy headed towards an inflationary spiral?

Unprecedented Monetary Stimulus

The U.S. money supply has increased 250% from Great Recession levels. Market expectations of future inflation have been consistently revised upward over the past 12 months.

Amidst Unprecedented Money Supply, Market Inflation Expectations Rising

- More money than ever: The U.S. money supply has increased 250% from Great Recession levels.



- Real economic growth is projected to be at highest level in 37 years: Economists are projecting 2021 real GDP growth in the U.S. of between 6.4% and 8%. This would be the highest annual growth in real GDP since at least 1984 or if 8%, since 1951.

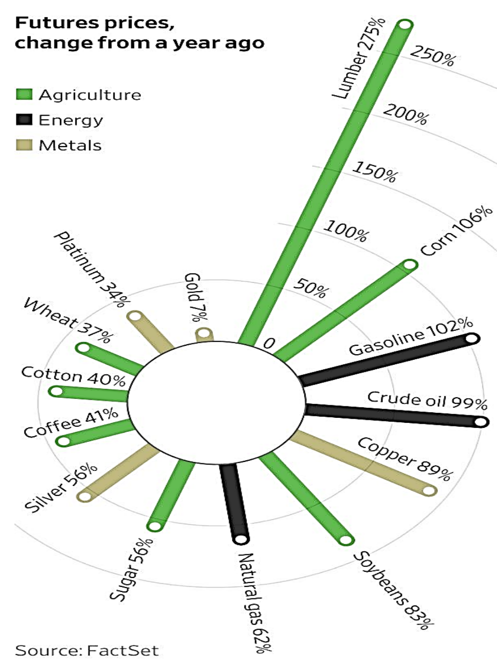
- Market inflation expectations are increasing: The 10-year breakeven inflation rate is now at its highest level since 2013.

- Robust growth + easy money: The backdrop of unprecedented liquidity in the context of an economy poised for robust growth creates fertile ground for accelerating inflationary conditions.

Harbingers of Inflation Abound

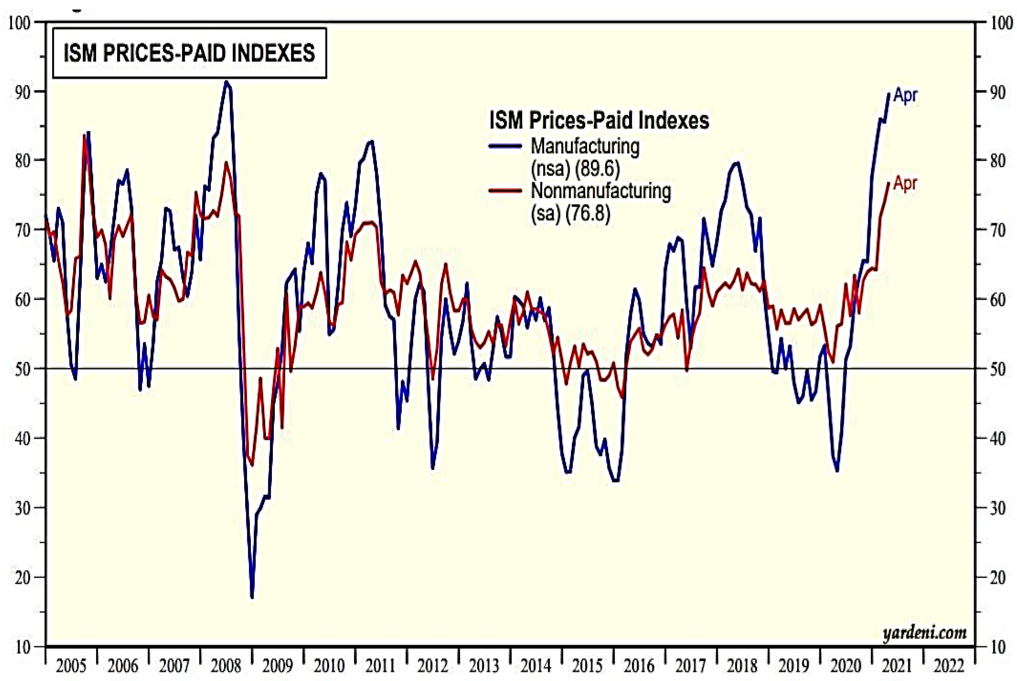
Input Prices Surge

- Supply & Demand: Fundamentally, inflation occurs when the supply of goods and services is inadequate to meet the demand, causing a rise in prices. This rise in prices can be transitory. If sustained, it may result in a pernicious entrenched inflationary spiral where the expectations of continued price increases exacerbate the conditions created by the supply-demand disequilibrium.
- Commodity Prices Soaring: Led by lumber, core commodities have experienced double and triple-digit price increases.



Source: FactSet

- **ISM Prices Paid Indexes:** The ISM survey's measure of prices paid by manufacturers in April hovered near its highest level since July 2008.



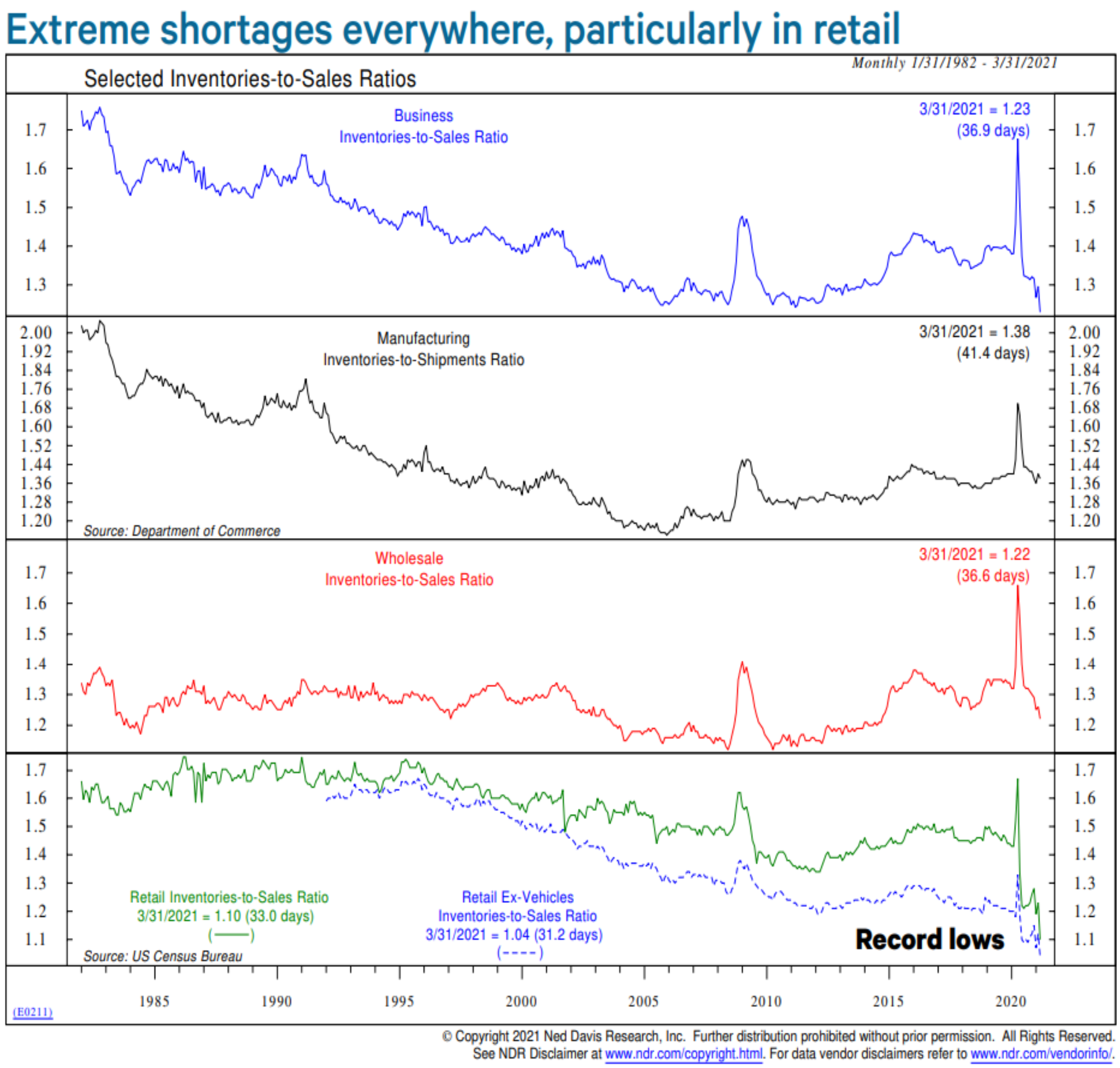
Source: Institute for Supply Management.

- **April '21 Consumer Price Index readings unnerve**: Headline CPI +0.8% month/month (largest jump since June 2009). Headline CPI +4.2% year/year (largest jump since September 2008). Core (ex-food/energy) CPI +0.9% month/month (largest jump since September 1981). Core CPI +3.0% year/year (largest jump since January 1996). CPI (Gain/Annum: 4.2%) Core CPI (Gain/Annum: 3.9%).

'Transitory' Inflation or Something Worse?

The Case for 'Transitory' Inflation

- **Pandemic dislocations and supply/demand disequilibrium:** The U.S. economy shifted in a few months, from a complete shutdown in March 2020 to a demand surge buoyed by unprecedented fiscal and monetary support. Production capacity, which was slashed in anticipation of a cataclysmic recession has not reflated sufficiently to meet current demand levels. Lingering uncertainty regarding future economic growth has limited producer willingness to invest capital to expand capacity to meet demand levels that may well be temporary.



- Federal Reserve believes current inflationary trend is 'transitory': Jay Powell, Chairman of the U.S. Federal Reserve attributes the accelerated rise in prices over the last year to the dislocations caused by the pandemic and believes inflationary pressures are 'transitory'. "An episode of one-time price increases as the economy reopens is not likely to lead to persistent year-over-year inflation into the future," he said at the Fed's April meeting. Clogged supply chains won't affect Fed policy, Powell said, because "they're temporary and expected to resolve themselves."

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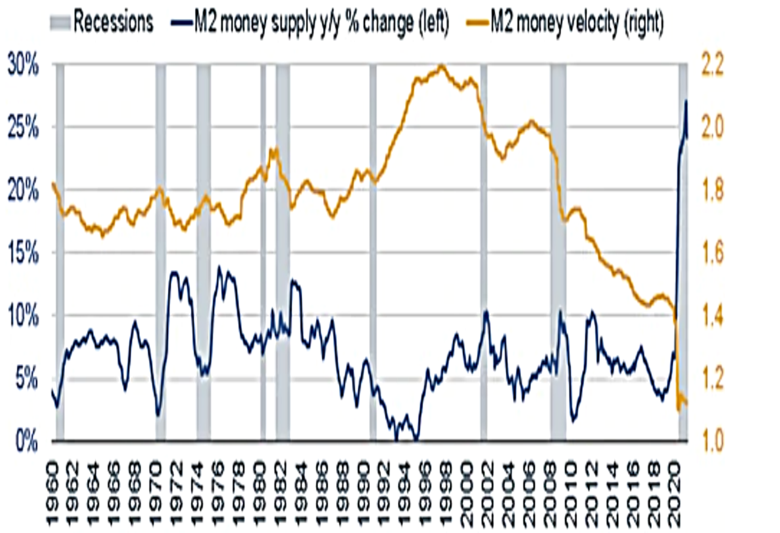
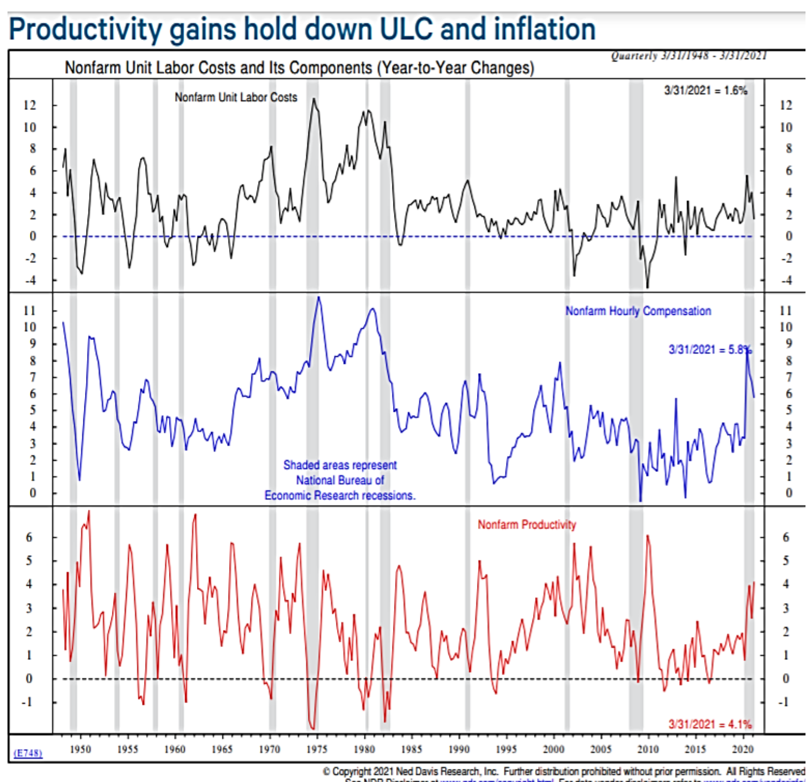
Structural Impediments to Inflation

- **Velocity of Money:** Velocity measures how many times money turns over in the economy. Money supply growth times its velocity equals nominal GDP growth. In principle, elevated levels of both should manifest inflation. However, as the money supply has risen over the last few decades, velocity has steadily declined.



Source: Charles Schwab, Bloomberg, Federal Reserve Bank of St. Louis, as of 3/31/2021.

- **Productivity and Unit Labor Costs:** Labor costs represent roughly two-thirds of the total costs to private U.S. businesses. Unit labor cost, which is how much a business pays its workers to produce one unit of output, have been contained since the mid-1980s.
- **Technological advancement** which has enabled increased productivity per worker has also reduced the aggregate need for and bargaining power of labor which has weakened the ability of workers to command higher wages.



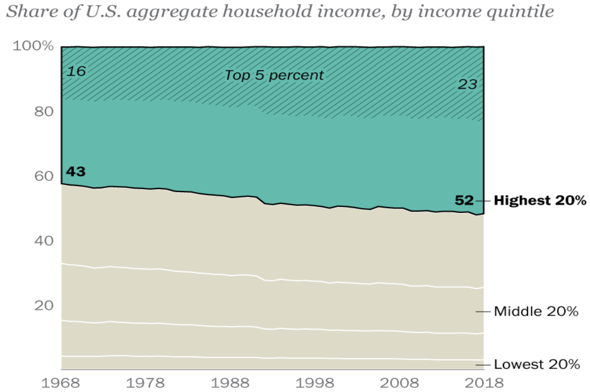
- Unemployment Gap: This is defined as the distance between the current unemployment rate and maximum employment. The unemployment gap tends to limit compensation growth and inflation. Nonfarm payrolls are still more than 8.0 million short of what they were at their previous pre-pandemic peak.

Source: St. Louis Federal Reserve FRED database, using annual data as of 2019. Share of Labor Compensation in GDP at Current National Prices for United States (LABSHPUSA156NRUG).

- Concentration of Income Among High-Propensity Savers: What is often referred to as 'income inequality' in the popular lexicon, holds implications for the anchoring of inflation. The top quintile of earners account for the majority of all U.S. household income.

The highest-earning 20% of families made more than half of all U.S. income in 2018

Share of U.S. aggregate household income, by income quintile



Note: Figures may not add to 100% due to rounding.
Source: U.S. Census Bureau, Income and Poverty in the U.S.: 2018, Table A-4.

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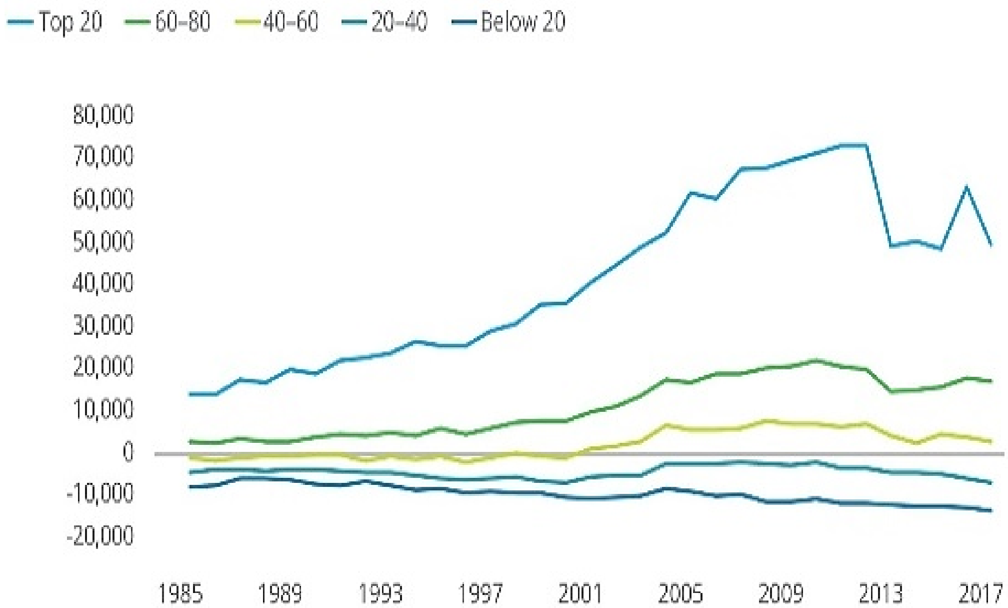
- The savings rate for the majority of Americans is minimal or even negative- meaning most of what they earn is spent rather than saved which has a stimulative effect on the economy and potentially inflation.

FIGURE 3

Average savings for consumers in the bottom two income quintiles have remained negative

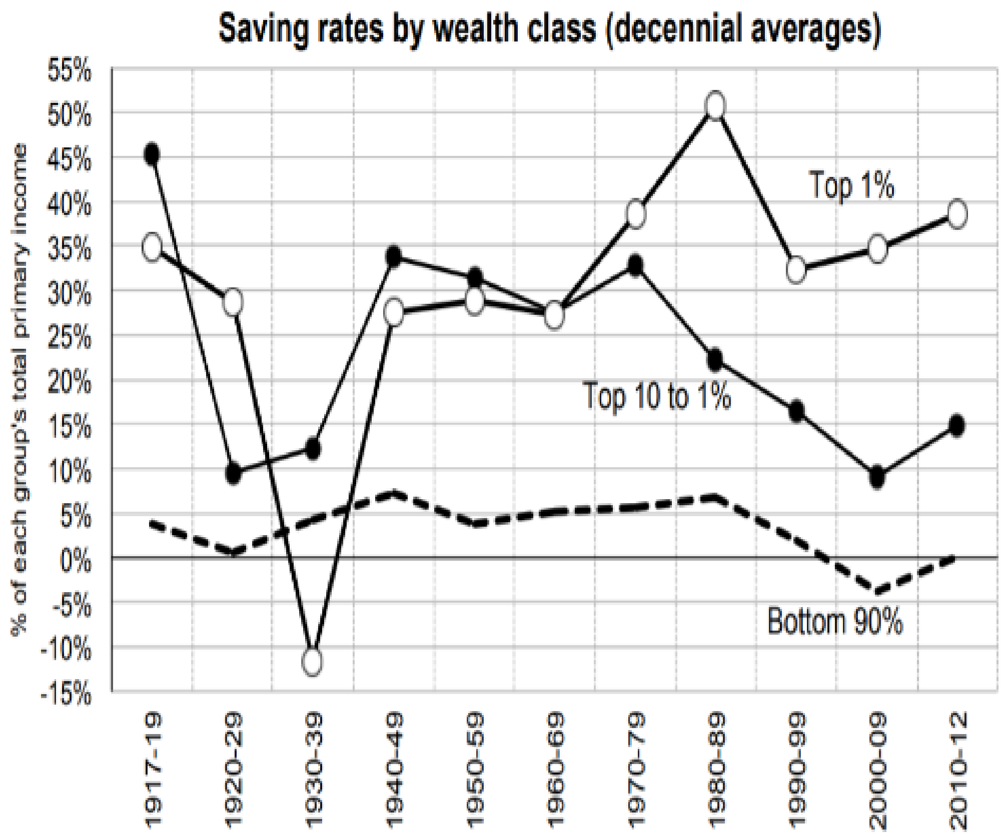
Average savings, including spending on pensions and social security (US$), by quintiles of income



Sources: Bureau of Labor Statistics (Consumer Expenditure Survey), sourced from Haver Analytics; Deloitte Services LP economic analysis.

Deloitte Insights | deloitte.com/insights

- However, those in the top economic strata, who generate the most income and wealth have double-digit savings rates.



Saez, Emmanuel & Zucman, Gabriel. *Wealth Inequality in the United States Since 1913: Evidence from Capitalized Income Tax Data. 2014.*

- A larger share of U.S. income landing with wealthier individuals who have a higher propensity to save, rather than spend, creates a substantial impediment to inflation in the price of goods and services.

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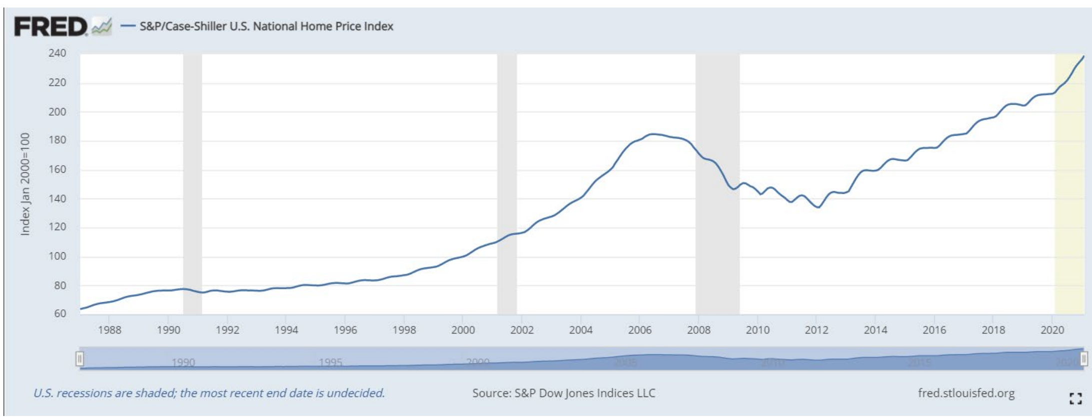
The Cost of Easy Money

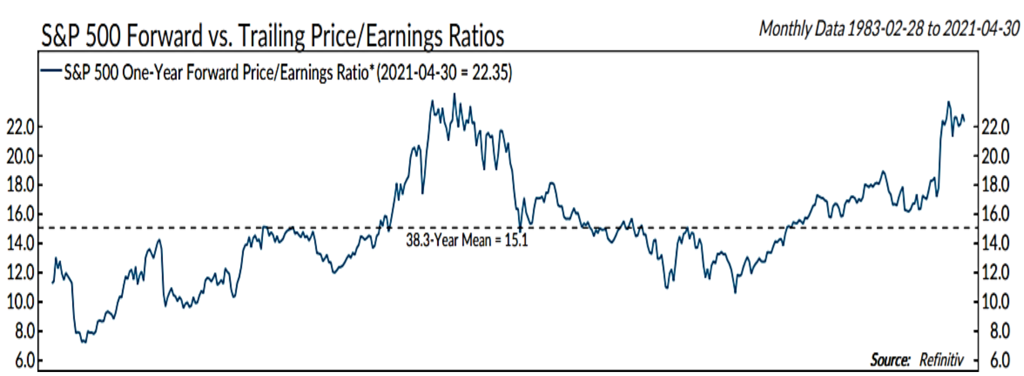
Inflation of a Different Kind

When economists speak of inflation, they are usually addressing increases in consumer prices. In this context, it is reasonable to argue that longer-term structural factors will keep 'inflation' "anchored". This is not to say that other areas of the economy have not experienced enormous price increases in an alarmingly short period of time. The money saved by wealthier Americans may not contribute to increases in the Consumer Price Index, but it is undeniably swelling asset prices as it is deployed to investments.

- Home prices have risen at the fastest pace since 2006 and are now at levels well beyond those that preceded the housing crisis.



- The S&P 500 Index forward price to earnings ratio is near an all-time high, exceeded only by the level reached prior to the Dot Com Bubble of the late 1990s and nearly 50% above the historic mean.



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The True Cost?

It may seem counterintuitive that an economy rife with excess liquidity could not manifest hyperinflation. However, there is a historical precedent to support this claim.

- The explosion of sovereign debt issued by Japan commencing in the 1980s has resulted in a present debt to GDP ratio of more than 250%. Yet inflation over this period *decreased*!

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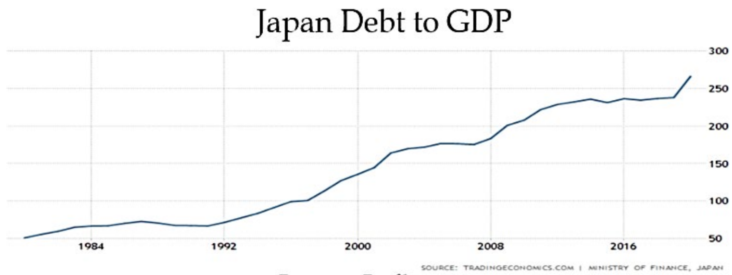
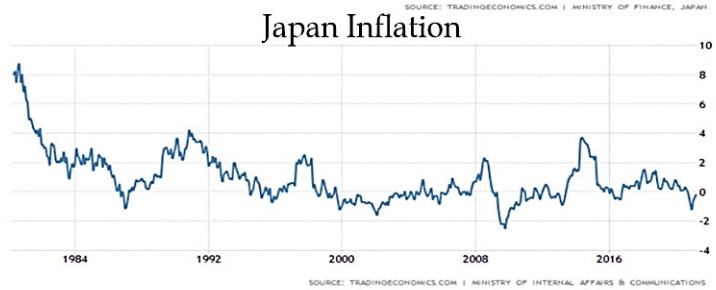
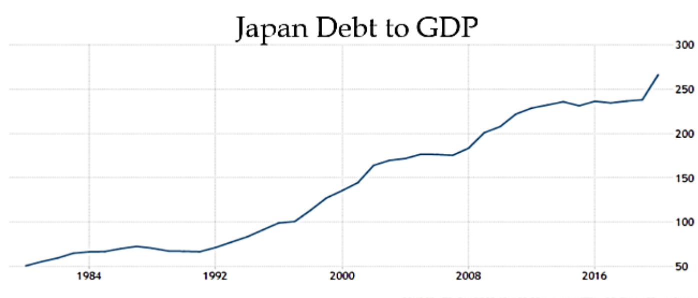
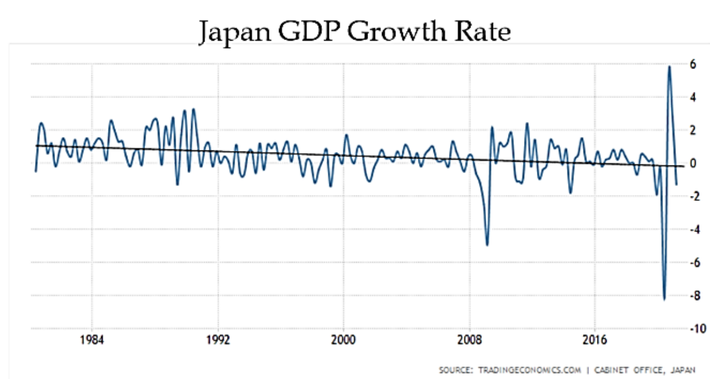




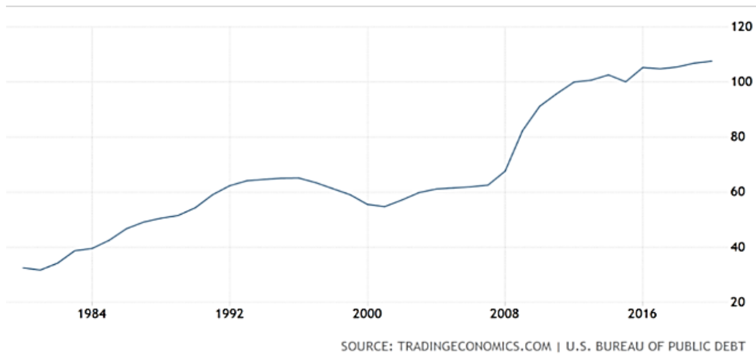
- For Japan, the cost of easy money was not inflation but reduced growth.



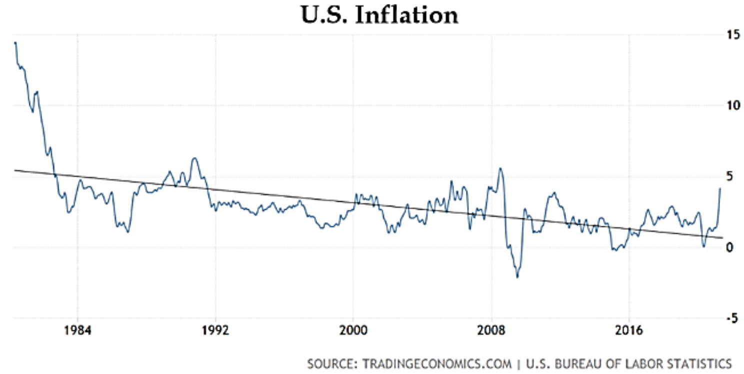


- Similarly, as the U.S. has increased its debt to GDP ratio to a present level of around 130%, inflation has trended downward.

U.S. Debt to GDP

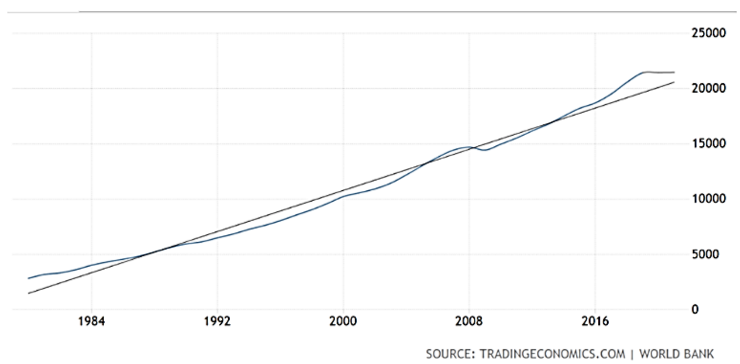


U.S. Inflation



- To date however, U.S. GDP growth has maintained its upward trajectory.
- With the U.S. federal debt burden projected to double over the next 30 years, reaching 202% of economic output in 2051, the question remains: is the U.S. destined for a similar entrenchment of a low-growth economy saddled by massive sovereign debt?

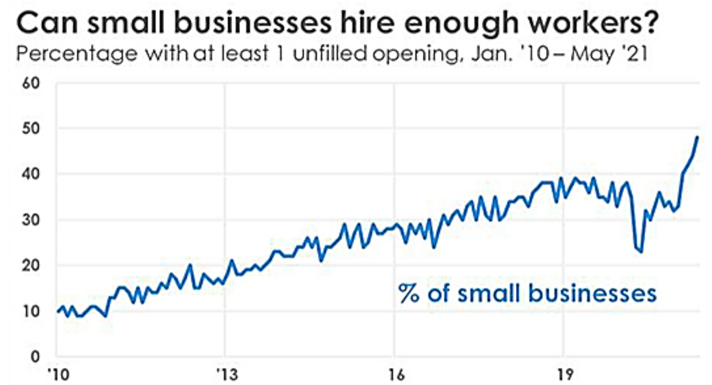
U.S. GDP to Trendline GDP



Our Approach

Monitoring Inflationary Signals

- Labor Costs: Labor costs represent roughly two-thirds of the total costs to private U.S. businesses. The average gain over these past two months was the largest since data started in 2006. In April, the number of job openings surged 12.0% to 9.286 million, a new record high. In May, average hourly earnings (AHE) increased 0.5%, following a 0.7% gain in the previous month. A record-matching 57% of small-business owners reported difficulty finding qualified applicants. The scarcity of labor supply has already begun to transmit to price increases, with a net 40% of firms, the most since April 1981, raising their selling prices, and a record net 43% planning further hikes in the coming months.
- Consumer Price Index (CPI): 71% of the CPI weighting is attributable to just four categories. Three (Food, Energy, Commodities) of these four categories are experiencing massive inflationary pressures. The only category which has declined is Shelter, which is likely a reflection of lockdown prohibitions against evictions. As the eviction moratorium expires this month, and with home prices at all-time highs and with new home construction impeded by the astronomical rise in lumber prices, the largest component of the Shelter category, Owners Equivalent Rent is likely to experience a substantial increase as well.



Goods prices lead the way on higher inflation

Major CPI Components	12/2019 Y/Y Rate (%)	04/2021 Y/Y Rate (%)	04/2021 CPI Weight (%)	04/2021 Contribution to CPI Y/Y Rate
Food	1.8	2.4	14.0	0.3
Energy	3.4	25.1	6.9	1.7
Commodities (ex. Food and Energy)	0.1	4.4	20.1	0.9
Apparel	-1.2	1.9	2.8	0.1
New vehicles	0.1	2.0	3.7	0.1
Used cars and trucks	-0.7	21.0	2.8	0.6
Medical commodities	2.5	-1.7	1.5	0.0
Household furnishings and supplies	0.3	3.2	3.7	0.1
Recreation goods	-0.9	2.9	2.0	0.1
Other core commodities	2.8	3.0	3.6	0.1
Shelter	3.2	2.1	33.0	0.7
Medical Care Services	5.1	2.2	7.3	0.1
Transportation Services	0.6	5.6	5.1	0.3
Education & Communication Services	2.0	2.0	6.2	0.1
Recreation Services	2.7	1.8	3.8	0.1
Other Services	1.8	1.5	3.7	0.1
CPI				4.2

Source: Bureau of Labor Statistics, NDR
Ned Davis Research T_BEC_O2021051811

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Conclusion

The unprecedented fiscal and monetary response to the global pandemic has reduced bond yields to historic lows while simultaneously ripening the economic conditions for inflation. Bonds, which historically present less risk than equities are less productive today than ever before and are generating negative returns year-to-date. As rates begin to rise, perhaps significantly to combat potential inflation, the risk of loss to even the most conservative bond portfolio is accentuated.

Our data-driven approach to asset allocation decisions is attuned to the hazards of this unique environment and will continue to respond tactically to the dynamic market conditions as they evolve.

Sound Management for *your* Secure Future

Pacific Wealth Management is a fee-based, fiduciary firm offering comprehensive Retirement Planning expertise.

Our disciplined retirement planning process includes:

- Goals-Based Needs Analysis
- Social Security Planning
- Long term Projections
- Monte Carlo Analysis
- 401(k), 403(b), 457 retirement plan analysis
- Retirement Distribution Strategies

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