Market Note

February 2021

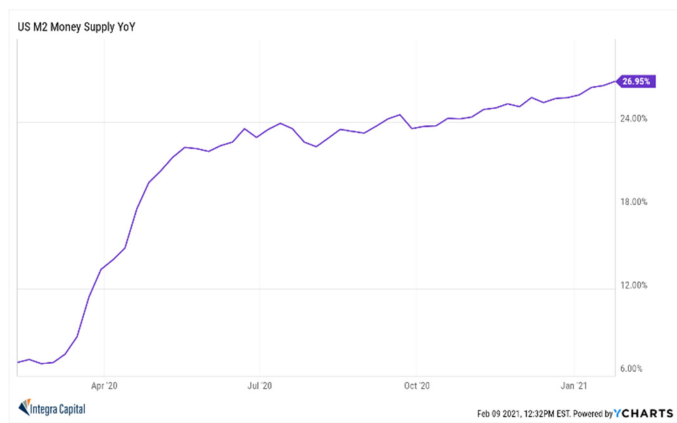
Is Inflation Already Here?

As the U.S. emerged from the Great Financial Crisis (GFC) of 2008 - 2009 many experts, such as global bond giant PIMCO founder, Bill Gross, warned of runaway inflation resulting from the Fed's quantitative easing measures to stimulate and support the economy. Fast forward a few years and inflation never materialized. Mr. Gross lost his job over this failed prediction.

In 2020, the global pandemic hit, and here we go again with Fed stimulus measures and government support of the economy. The question is will consumer prices now inflate to levels unhealthy for the economy? We think the answer may be yes.

What's different this time? During the GFC, the Fed provided stimulus and support by buying government bonds because of the nature of the crisis. With banks struggling to stay in business, regulators increased capital requirements for the banks. As a result, the monetary base of the economy was increased but the M2 money supply didn't budge. Translation: Money injected into the economy by the Fed during the GFC never circulated through the real economy, getting stuck on bank balance sheets.

Contrast the GFC stimulus with today's stimulus measures which involved direct payments to individuals and direct financial support to businesses via the Paycheck Protection Program (PPP) loans in addition to other direct lending programs. This money is taking a more direct route to the economy this time. Evidence of this can be seen in the chart below that shows a 26.95% increase in the M2 money supply on a year over year basis. We haven't seen that type of increase ever in history. And, we haven't seen high inflation in a long time either. There is a big difference between increasing the monetary base and increasing the money supply in the hands of individuals and businesses who will actually use the money.



How does a dramatic increase in the money supply cause inflation? To answer this, consider a simple definition of inflation; too much money chasing too few goods that cause prices to rise. For inflation to be held at bay, the output of goods and services must rise to balance out supply and demand. So far, evidence of this increase in output has not materialized. The chart on the next page shows the ratio of US business inventories to business sales. Back in March of 2020, sales dropped but inventories were already stocked so the ratio spiked.

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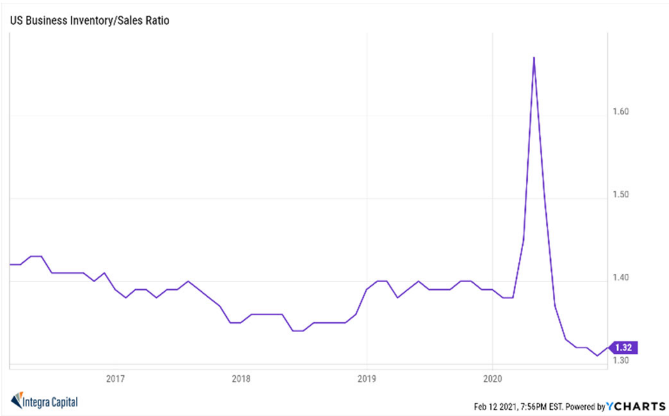

Now, while sales (in some industries) have stabilized and increased, inventories have diminished and have not been replaced (lack of supply) as COVID has disrupted supply chains and manufacturing. This has resulted in an annualized rate of inflation over the past 6 months of 3.6%. It is too soon to say we have an inflation problem brewing, but for the first time in a long time it bears watching.

The implication for stocks is the potential for this dynamic to create a near-term rise in stock prices, as we have been seeing recently. Because company earnings look good so far there probably isn't any reason to fret at the moment. But if the supply of goods and services doesn't rise to meet demand as more stimulus is added, inflation could increase even more. This will lead to a rise in interest rates which could dampen the rally in stocks.


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