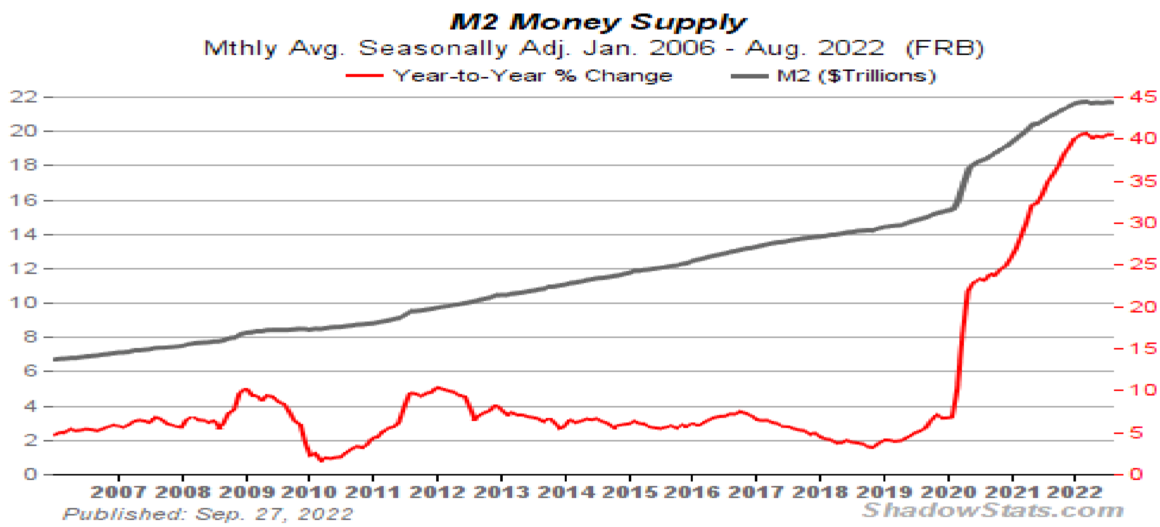
October 11, 2022

“Inflation is always and everywhere a monetary phenomenon”— Milton Friedman, Economist and Author, 1963

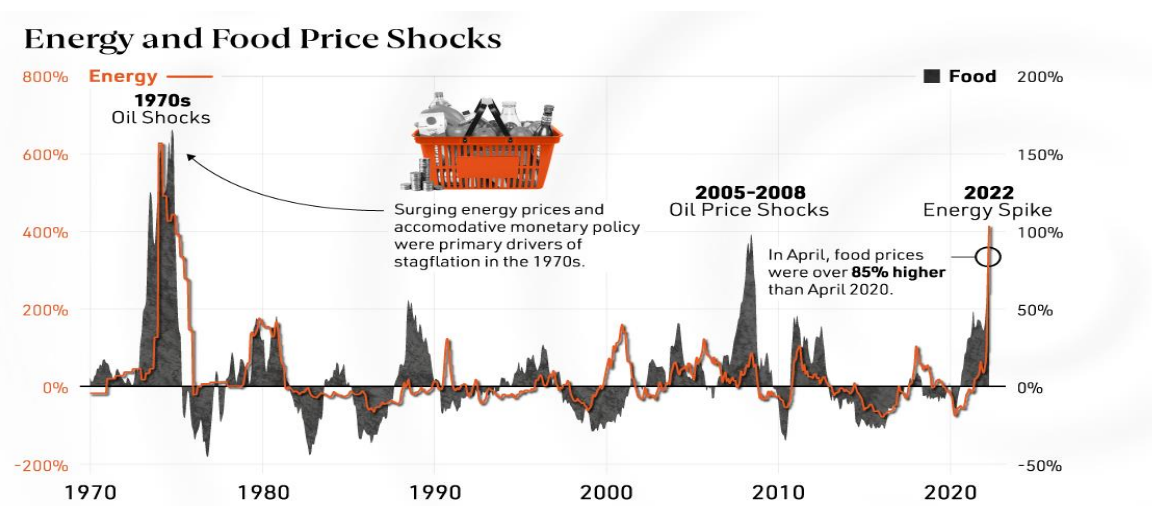
In his magnum opus, *A Monetary History of The United States*, Milton Freidman described how inflation forces are created by the velocity of money flowing through an economy. The relatively simple equation he developed, MV=PQ, related the amount of cash chasing a certain supply of goods (PQ) to the primary influence on inflation. Today, the amount of money in circulation (commonly referred to as “M2”) is at historic levels (see graph below) and it is seeking to buy goods that are typically declining in volume (or static at best) thereby creating the deeply imbedded inflationary forces in our economy.



The Federal Open Market Committee (FOMC) is responsible for both price stability and full employment as their primary duty. They primarily rely on an inflation indicator known as the Personal Consumption Expenditure index (PCE) to inform them of the relative level of price variability in the U.S. economy. Recently, the Bureau of Labor Statistics (BLS) released their PCE headline number along with the “Core PCE” data (eliminating food and energy inflation). Both the PCE and the Core PCE came in well above expectations with PCE growing at a 6.2% annualized rate and Core PCE also well above the expected rate producing 4.9% “core” inflation.

Graphically, the chart below (going back 42 years) shows the alarming rate of increase in both inflation indicators over just the last 12 months:

While the above inflationary data are troubling, the bad news is that those numbers actually underestimate the significant inflationary pressures existent in the “real” economy. The following chart depicts the dramatic rise in just the food and energy component of the PCE (or the CPI for that matter) as commonly held measurements of inflation.

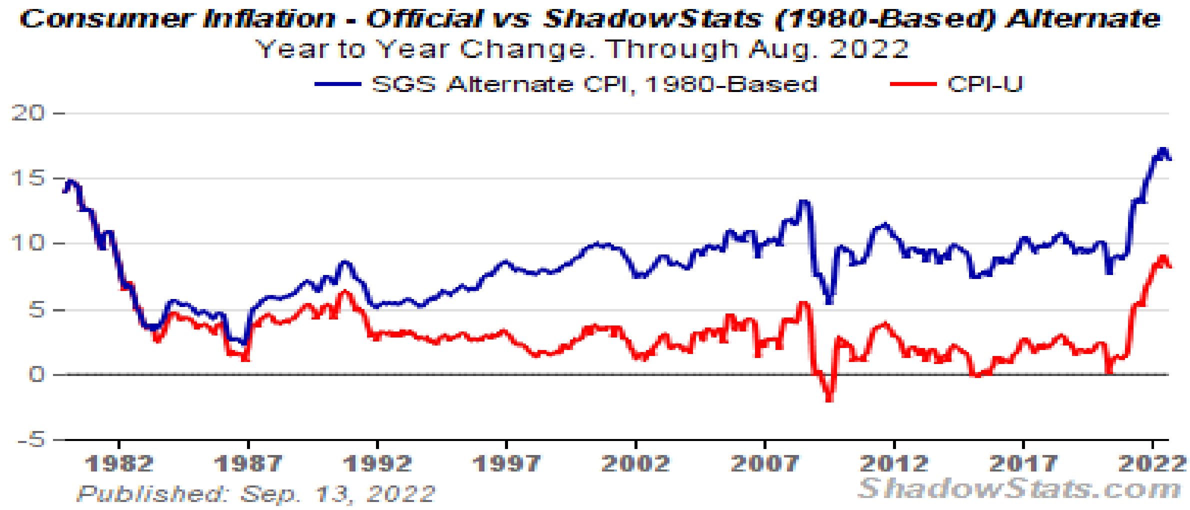


With food prices alone spiking over 85% since April 2020, its hard to imagine how the popular measurements of inflation (generated by the BLS) are actually coming in at relatively benign, yet still troublesome, high-single digits.

One way to look at actual, non-adjusted inflationary forces is to consider the data promulgated by a well-known organization called Shadow Stats. Since the early 2000’s they have been archiving and commenting on the significant changes the BLS made to inflation calculations, beginning with the CPI in the 1980’s, and then again in the mid-

1990’s. The concept back then was to reduce the impact to the U.S. Government inflation adjustments (COLA) by re-basing (from the original 1980 base calculations) and apparently intentionally under stating actual inflation.

Consider the graph below which compares the published CPI inflation calculation to the estimated inflation factor if the inflation calculation methodology was consistent throughout the decades:



The “Man-on-the-Street” can vouch for the fact that inflation in what the typical person buys is well into the mid-teens when you consider just the basics of food, energy, transportation and housing costs today (which was the original intent of the CPI calculation – to measure the costs of a consistent standard of living). This suggests that inflationary forces are well ensconced in our everyday lives and are likely to continue to produce high inflation readings and therefore, higher induced interest rates from The Fed for some time to come. These continued hikes will depress stock and bond prices further and lead to a stronger dollar, making imports even that much more expensive here.

How Has the Fed’s Interest Rate Policy Been So Far?

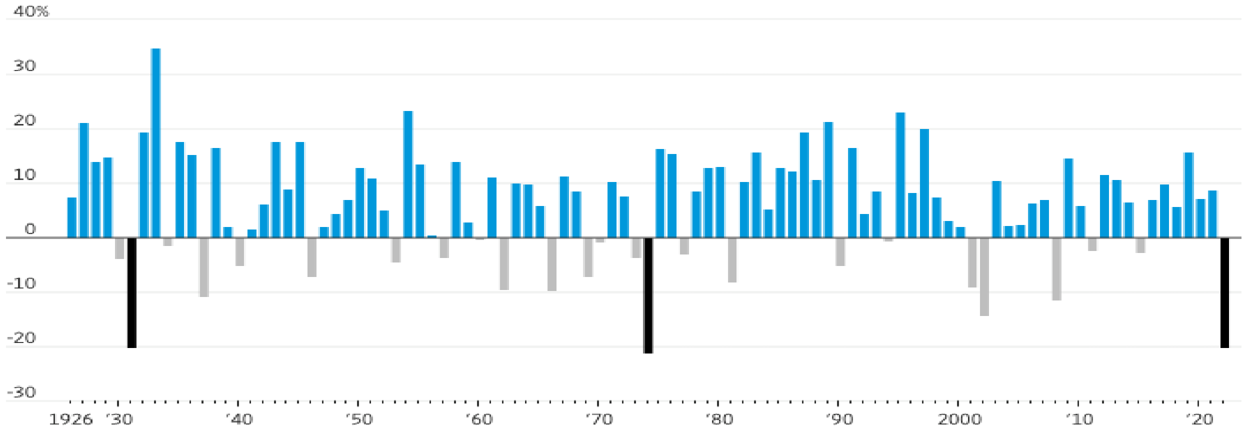
All three major benchmarks finished the week, the month, and the quarter lower, after the Fed's aggressive interest rate hike at their last meeting sparked a prolonged selloff. This marks three-straight losing quarters for the indexes - the S&P 500 and Nasdaq's lengthiest quarterly losing streak since 2009, and the Dow's longest since 2015.

Many consider a portfolio with 60% allocated to stocks and 40% allocated to bonds to be a good “all-weather” portfolio that should provide participation in the rise in stock prices and hold its value fairly well when stocks decline.

The chart below indicates the performance of this 60/40 portfolio over a first three quarters of each year since 1926:

No Shelter

Here are the returns on a portfolio of 60% stocks and 40% bonds in the first three quarters of each year since 1926. Only two were worse than 2022: 1974 and 1931.



Note: Total returns of U.S. stocks and bonds measured by S&P 500, Bloomberg Barclays Aggregate Bond and predecessor indexes.
Source: Ned Davis Research

Notice that the aggressive rate increases mandated by the Fed's Open Market Committee (FOMC) have taken their toll on stocks and bonds almost equally in a way that has not been experienced since 1974! Only one other time in the last 100 years that this occurred and that was in the aftermath of the Great Depression. The bottom line is there has been nowhere to hide from the interest rate hiking policy of the FOMC and there's a high likelihood that the next six to nine months won't be any better.

In fact, this morning the International Monetary Fund (IMF) issued a dire warning for the world economy stating that it is headed for "stormy waters" while slashing their Global GDP projections for the remainder of this year and lowering next year's projection to a tepid 2.7%. Further, it projected inflation worldwide would remain elevated for longer than previously expected closing this year at 8.8% and declining only slightly to 6.5% for 2023. "The worst is yet to come, and for many people 2023 will feel like a recession. With the Fed so far behind the curve as their administered short-term interest rate sits at less than half of the IMF inflation projection, there will likely be many interest rate increases to come resulting in lower stock and bond prices.