
November 26, 2021

# A quick look at inflation in the United States

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## A quick look at inflation

Our research has yielded six key drivers of the current inflationary environment: monetary policy, supply chain tightness, elevated demand, labor force dynamics, housing market, and commodity scarcity. Of these drivers, we have determined that some are purely transitory while others have created structural shifts in our economy. To answer the burning question: yes, we expect a new regime with elevated inflation over the next three to five years, but we do not anticipate runaway inflation.

First, let's define the term "transitory. Transitory inflation is inflation that does not last long enough to change wage- and price-setting behaviors for decision makers.

**Primary Inflation Drivers**

1. Monetary Policy
2. Supply Chain Tightness
3. Elevated Demand
4. Labor Force Dynamics
5. Housing Market
6. Commodity Scarcity

### Transitory Inflation Drivers

**Monetary policy** is expected to be a transitory driver as the Federal Reserve continues tapering bond purchases and eventually transitions to rate increases in mid-2022. That said, the current support being provided to real estate (via the purchase of mortgage-backed securities) is pricing many people out of the housing market. Likewise, purchases of both treasuries and corporate bonds are distorting some of the most commonly used inflation measurements (ie the inflation premium). The downside of this excess stimulus is the possibility that the Fed will need to slam on the brakes faster than the market can absorb, causing undue harm to growth assets. The upside is the notable jump in wages and a financial cushion for some of the most disadvantaged segments of our communities.

The **distortion of market-based inflation measurements is** less cut and dry and is limiting market participants' ability to gauge the true impact of inflation or act on apparent mispricing. From an interview with Mohamed El-Erian, head economist for Allianz, "...market participants understand and respect that they will be steamrolled—as they have been time and time again— by taking the other side of massive Fed asset purchases, even when they're convinced of a fundamental mispricing. So, I would be careful in relying on the usual market measures to gauge inflation expectations, as we don't know how much to adjust for the distortions that the Fed has introduced."

**Supply chain tightness** is also expected to abate before the end of 2023 as factories in Asia ramp up production post-Covid and microchips, one of the most exposed value chains in the world right now, begin to move apace with demand (sourced from an interview with Rick Tsai, CEO of MediaTek). Though the issue of supply chain tightness will be dramatically reduced, there may be a structural change to supply chain administration. According to El-Erian, "Company after company is rewiring their supply chain to prioritize resilience over efficiency." This may signal an increase in the cost of moving goods along the supply chain that will persist beyond the current pressures.

According to Jan Hatzius, Head of Global Investment Research and Chief Economist at Goldman Sachs, "US goods consumption has increased nearly 10% above the pre-pandemic trend, driven by elevated disposable income on the back of **strong fiscal support** as well as a rotation from services to goods spending throughout the pandemic." **Elevated demand** has been a definitive contributor to inflationary pressures and though strong spending and savings numbers suggest the US consumer will hold up well as fiscal and monetary support diminishes, they won't maintain the degree of strength they have now.

## Structural Inflation Drivers

**Labor force dynamics** is perhaps the most important structural difference between pre-covid and post-covid economic regimes. Covid caused three million people to retire early and labor force participation has stayed at a low 61.6% even as unemployment benefits have expired. According to Yelp, almost half a million new businesses were opened in 2020 and more people have left the labor force in favor of non-traditional income streams like real estate, influencer marketing, or paid online content. With fewer possible job candidates, and a rising number of attractive alternatives, companies are hard pressed to retain and hire. Median salary increases have increased only 3% and over four million people left their jobs in July, 2021. In order to counter the workforce's newfound mobility, firms will most likely need to raise wages and benefits. Increases in wages are directly linked to inflationary pressures on both services and goods because they both reduce a firm's ability to produce economic goods while increasing consumer's demand for them. Overall, people may return to the workforce as the financial cushion built up during Covid diminishes, but this trend is expected to continue.

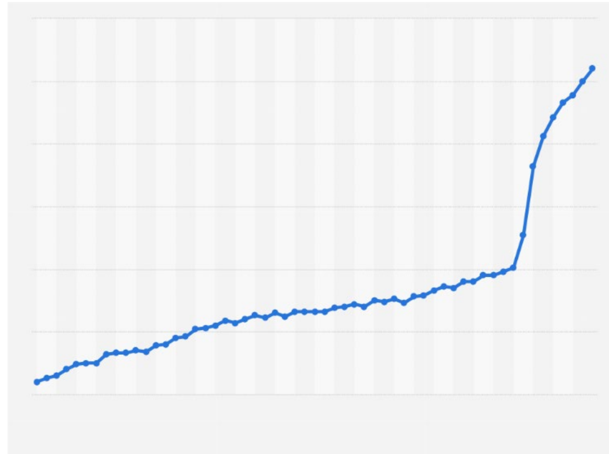
**Commodity and energy shortages** are expected to continue well into 2023, causing these two forces to walk the line between transitory and structural. Demand for industrial metals, oil & gas, and electricity have all outpaced supply and are resulting in energy crises globally. Jeff Currie, Global Head of Commodities Research at Goldman Sachs, attributes the undersupply of commodities and energy to chronic underinvestment in the "old economy", particularly energy companies and miners. Currie -"As infrastructure aged and investment waned, so did the old economy's ability to supply and deliver the commodities underpinning many finished goods."

Because commodity and energy shortages are not directly related to Covid or any other transitory force, it's expected these drivers will be sources of lasting economic change.

## Inflation Curveball - Cryptocurrency

Cryptocurrency adds an interesting wrinkle in the inflation debate. The total market cap of all cryptocurrencies sits near $3 trillion, 80% of which has been created since November 25, 2020. By definition, currency circulation causes inflation when the supply of cash (or equivalents) increases artificially and exceeds economic production. This "demand-pull" inflation has been top of mind for economists and consumers alike because 40% of all US Dollars have been printed in the last twelve months.


Market Cap of Cryptocurrency
2010-2021
Statista



M1 Money Supply
2016-2020
Statista

Essentially, cryptocurrencies have artificially created valuable currency without a direct link to economic output and it may have a levering effect on any inflationary pressures already present.

We believe cryptocurrency's effect on the cash supply has gone relatively unnoticed by market constituents, particularly as it relates to inflation-protected securities. This leads to a fundamental mispricing in TIPS and I-Bonds, which presents a catalyst for repricing.

## Inflation Curveball - Fiscal Policy

Despite the generally hawkish tone by the Federal Reserve, fiscal policy remains loose. The Build Back Better act would introduce an additional $2 trillion and, while there are speed bumps in the Senate, the increased spending would contribute to the continued stimulus for the economy and businesses. Though monetary policy may tighten, it appears fiscal spending will remain unchanged or even increase. Tax rates are one of the main tools the government has to control inflation, but the bill contains only accommodative language on tax support and incentives.

## Wrap-up - Inflation but no hyper-inflation

It has become apparent that some of the inflationary pressures in the US economy are transitory and may even shift to a drag on inflation in the coming years. Conversely, it seems other factors are structural and will drastically affect the market environment for years to come. The two mentioned curveballs are concerning, but we will have to wait to see the role they will play.

Overall, we believe the structural drivers of inflation will result in an annual rate of inflation to the tune of 4-6% annually for the next five years, well exceeding the break-even rate for the current 5-year TIPS issues. To caveat this claim, we do not expect the rate of inflation to increase from its current levels, rather it will most likely decline modestly over the next few years before moderating in the 4-6% range.

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# Inflation Primer 11-27-2021

Final Audit Report 2021-11-28

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| Created: | 2021-11-28 |
| By: | Nathaniel Hoskin (nghoskin@gmail.com) |
| Status: | Signed |
| Transaction ID: | CBJCHBCAABAATfSpV51aX45JYvG3UDZiIFzai3CesE03 |

## "Inflation Primer 11-27-2021" History

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Document e-signed by Mina Girgis (mina@hoskincapital.com)
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