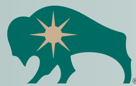
THE CHAPTER 3 PROJECT

HEALTH WEALTH PURPOSE

2023 Outlook: (Dis)Inflation Head Fake



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2023 Outlook: (Dis)Inflation Head Fake

There are risks and costs to action, but they are far less than the long range risks of comfortable inaction. - John F. Kennedy

2022 was marked by several notable headlines. Russia invaded Ukraine. Queen Elizabeth II's 70-year reign ended with her passing. China continued with severe lockdowns to confine the COVID-19 virus. The U.S. midterm elections. The downfall of crypto-currency "executive" Sam Bankman-Fried.

Though for most Americans, the most meaningful headline has been the economic one—acute inflation. Inflation rose to over 9% in June (year over year) before posting a series of monthly declines to just over 7%[1]. Policy bureaucrats will likely take credit for getting inflation under control and offer future guidance of an economic soft-landing.[2] While this narrative may hold for the short term, assuming these same bureaucrats have successfully put the inflation genie back in the bottle would be jumping the gun.

Inflation by definition increases the prices consumers pay for daily living expenses, but its broad reach across all aspects of the economy makes inflation an especially insidious phenomenon. It affects consumer spending, business investment, employment rates, tax policies, and interest rates. At the same time, inflation reduces the investment returns of traditional financial assets. It works against both bond and stock market valuations.

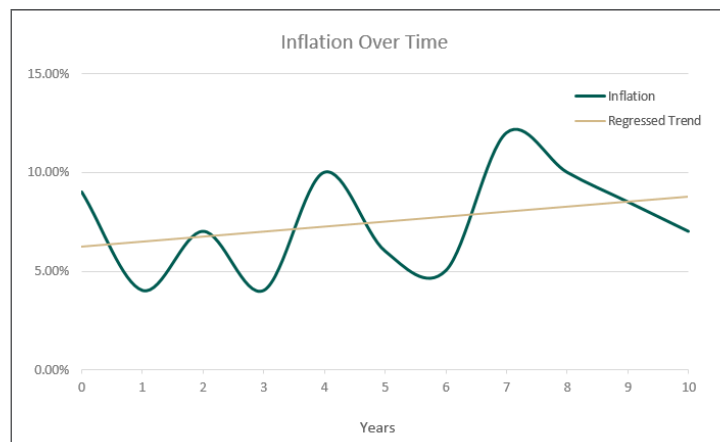
Looking at both the 1970s and the 1980s demonstrates this point well. The 1970s experienced increasing inflation, eventually peaking in excess of 11%. Conversely, in the ’80s we experienced the opposite: declining inflation, ending the decade at less than 5%. The following table shows the difference in performance of stocks, bonds, treasury bills, and commodities during those decades (all are average annualized returns).

Decade	CPI Inflation	3 Month T-Bills	Bonds	Stocks	Commodities
1970s	7.06%	6.30%	5.41%	5.93%	32.36%
1980s	5.48%	8.79%	11.96%	17.34%	5.31%

Sources: Federal Reserve Bank of Minneapolis, NYU Stern School of Business, Bloomberg

The difference between the two decades illustrates the importance of getting the answer to the inflation question right. Will it be trending higher or lower for the remainder of the current decade? The key word in the question is trending.

It’s a tricky issue because inflation has both longer-term secular trends and shorter cycles within those trends. As we see in the chart below, inflation often oscillates in cycles over the course of a decade. Depending upon when you take note of it, inflation may seem as though it is falling. But the more important observation from the perspective of evaluating investments is how it is trending higher over time—averaging 7.5% annually.

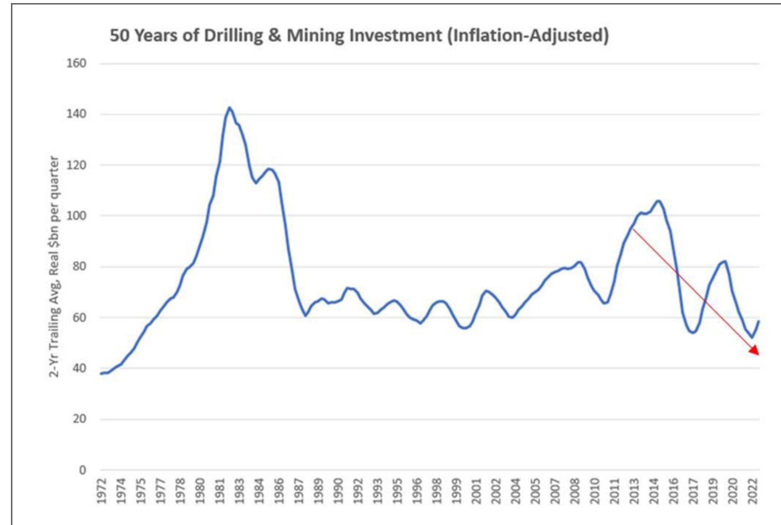


This chart is for illustrative purposes only and does not represent historical data.

It is becoming more apparent that the 2020s will be a decade where inflation trends higher even though there will be shorter-term cycles where it is declining.

The trend of rising inflation stems from shortages of key economic inputs. The world is currently living through an energy crisis with prices in parts of the word rising by not just several percentage points, but by several multiples in price. These increases are, in large part, rooted in a corporate and investment philosophy known as ESG which promotes Environmental, Social, and Governance issues. In the area of environment, ESG promotes renewable energy (primarily wind and solar) to the complete exclusion of more traditional hydrocarbons (oil, natural gas, and coal). Large pools of capital

(pension funds and university endowments) are in the hands of people who are strong adherents of the ESG philosophy[3]. As such, investment in finding and developing new reserves of hydrocarbons, to replace those which provide the majority of energy consumed in the world today, has been shunned for years and is illustrated in this chart provided by Recurrent Investment Advisors:



This condition alone led to higher energy prices globally and has been further exacerbated by Russia's invasion of Ukraine. Sanctions against Russian oil and natural gas have shown just how misguided Western governments and their supporting bureaucracies have been with their energy policies. For example, an overreliance on wind and solar energy, to the exclusion of traditional natural gas, will force many Europeans into deciding between keeping the lights or the heat on this winter.

Because energy is the "master" commodity, it is directly responsible for the quality of life we can enjoy. We need energy to build and heat our homes, to produce and transport the food we eat, to navigate and maintain the roads we travel, to build the machinery we manufacture, and to wield the labor we organize. All of these activities require energy. In fact, it is not hyperbole to suggest energy is not only necessary for life, but is life itself as we know it. And yet the energy policies of Western government bureaucracies have failed to recognize that fact and instead have created an environment of energy scarcity. Given the dearth of investment in this sector of the economy, reliable energy from hydrocarbons will remain scarce and the effects of this shortage will spill over into many other sectors of the economy as well, thus causing inflation to trend higher for years to come. When inflation reaches levels that roil the economy (like now), attention turns to the statements and actions of the Federal Reserve Bank (The Fed).

The Fed has a dual mandate for its existence:[4]

1) Price Stability

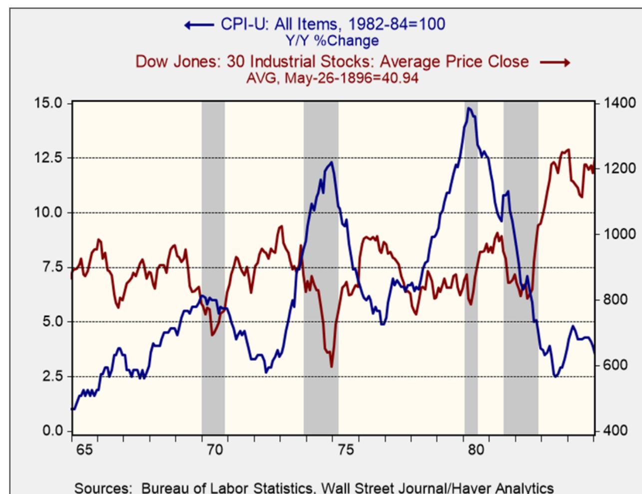
2) Full Employment

While the Fed has responsibility for stable prices, which are determined by both supply and demand

factors, the tools with which they exercise this mandate primarily affect the demand side of the equation. When business activity is getting frothy and prices are rising, the Fed attempts to “tap the brakes” of the economy. As a result, fewer people are able to afford buying homes or cars. Homebuilders and automakers need fewer workers and layoffs begin. The effects of these layoffs ripple throughout the economy and business activity slows down, thus slowing inflation. This process is referred to as demand destruction.

After holding the interest rate on Federal Funds at zero for two years, the Fed began raising rates in March 2022. As a result of their campaign to slow the economy, new home sales and existing home resales fell sharply as the process of demand destruction began. However, because this cycle of inflation has its source in supply shortages, and the Fed cannot print important economic inputs like oil, wheat, or copper, as soon as the economy begins to recover, inflation will very likely snap right back again. As the new cycle of inflation becomes a political liability, the Fed will be pressured by elected officials to deal with it again and the demand destruction process will begin anew. In a supply constrained environment, the Fed’s monetary policy becomes a metaphorical game of whack-a-mole. Until the supply side of the economy is constructively addressed inflation will remain a recurring problem.

The on-again, off-again cycles of inflation will lead to an increase in the frequency of recessions and to increased stock market volatility much like what was experienced from the mid-1960s to the early-1980s. The chart below shows the Dow Jones Industrial Average for that time span versus the trailing 12 month CPI with the periods of recession shaded. The Dow Jones first touched the 1000 level in 1966 and then fell lower. It flirted with that level multiple times over the next 16 years before finally breaking through it for good in 1982. During that same time, there were three major waves of inflation, each peaking higher than the last, and four different recessions. Those people longing for “the good old days” are about to realize their memories of those times may not be as complete as they thought.



This significant shift in macroeconomic trend changes the investment landscape. This new landscape

is one which can be successfully navigated, but doing so requires understanding how the economic terrain is changing and then choosing the investment vehicles best suited for it. Imagine the investment journey of your adult life as a surface race (no aircraft permitted) from Los Angeles to Paris, and you just arrived in New York City. The ocean now confronting your investment journey is inflation. You can still get to Paris safely and on time, but the vehicle that got you to New York is no longer an appropriate vehicle for the next stage of your journey.

The 40-year era of disinflation from 1982 to 2022 favored financial assets, traditional stocks and bonds. The current change in trend has historically favored alternative classes for investment such as hard assets and the equities of companies that produce them. Hard assets are tangible things such as energy (oil, natural gas and uranium), other commodities, precious metals, infrastructure, and real estate. A popular investing theme over the last decade was the so called FAANG stocks, shorthand for the popular growth-oriented technology companies: Facebook (now META), Apple, Amazon, Netflix, and Google. But now that we are transitioning to a new macroeconomic environment, it may be time to turn our attention to a new FAANG. A FANNG 2.0 might include these sectors: Fuel, Agriculture, Aerospace and Defense, Nuclear, and Gold.

Successful investment income strategies over the past 40 years included simple coupon clipping[5] and systematic withdrawals[6]. Alternative income strategies may include flooring and/or siloing investment assets relative to income timing requirements. Both of these strategies take potential volatility of investment returns into consideration and are highly customized to an individual's or family's unique

needs and objectives.

To summarize these thoughts, the United States is going through a generational shift in its macroeconomic environment, one of a magnitude not experienced in 40 years. The primary trend of this new environment will consist of higher inflation with shorter-term cycles where inflation abates somewhat. These shorter periods will be (dis)inflation head-fakes initiated by the Fed's reactionary whack-a-mole monetary policy of demand destruction creating more frequent recessions along the way. This era of higher inflation and economic volatility will continue until the supply side of the economy is addressed in a meaningful way. Inflationary environments have historically treated traditional financial assets (stocks and bonds) harshly while hard assets have historically fared well during those times. Income investors will be wise to consider alternative income strategies that take increasing volatility into account.

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1. As of the release of November 2022 CPI
2. The equivalent of an arsonist claiming credit for being the firefighter who got the blaze he actually started under control.
3. https://www.planadviser.com/pension-plans-among-esgs-biggest-proponents/ https://www.investmentmonitor.ai/institutional-investment/university-endowments-embrace-esg-funds
4. https://www.investopedia.com/articles/investing/100715/breaking-down-federal-reserves-dual-mandate.asp
5. The simple practice of using dividend and interest payments to provide retirement income. This strategy was viable until the Great Financial Crisis of 2008-09 sent interest rates to low single digits.
6. Relying upon the total return of a portfolio instead of just the income component. This strategy assumes consistent capital gains in the markets.

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Dan is a financial advisor with D.A. Davidson in Roseville, California. He holds the Certified Financial Planner™, Certified Investment Management Analyst®, Certified Private Wealth Advisor®, and Retirement Income Certified Professional® credentials.

Dan's professional mission is to inspire thriving longevity through health, wealth, and purpose. With this mission in mind, he completed the Integrative Health Coach Professional Training Program, offered through Duke Integrative Medicine. Dan Cairns and D.A. Davidson do not provide health coaching or wellness advice.

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