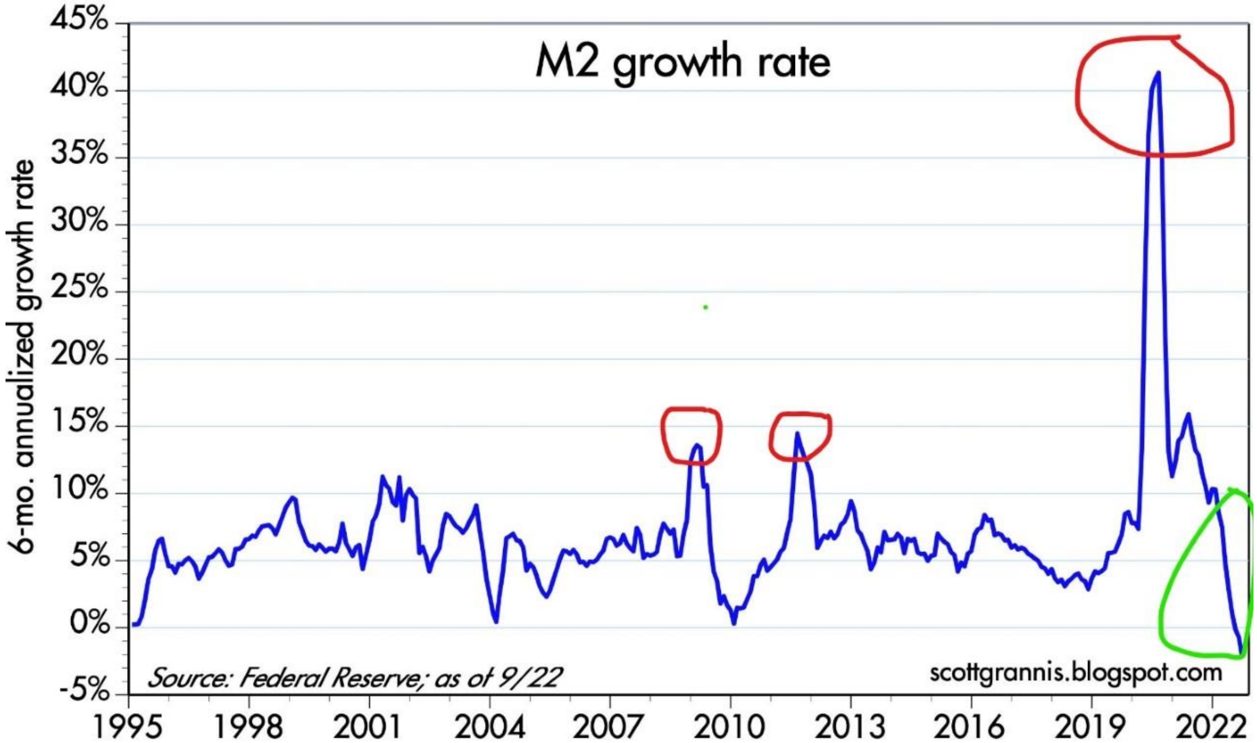
The Outlook: Nov. 4, 2022

The inflation fight.

Let's try to do the almost-impossible, this Friday afternoon: explain the Federal Reserve and its attack on inflation . . . but do it short and quick, with easy words. (Yup, almost impossible.) Here's where we start:



Inflation happens because the government (using its central bank, the Fed) has printed money much faster than the stock of goods and services has grown. It is always "too much money chasing too few goods." When any government wants to spend money, it's really tempting to just print more of it rather than borrowing it (by selling bonds.) Borrowing it pushes up interest rates—or tends to, eventually—and that's unpopular with most voters and weakens Main Street, eventually. The Federal Reserve is supposed to stand apart from whichever politicians happen to be in charge in Washington, and insist on making the government borrow rather than printing the money. Through history, sometimes it has stood apart and insisted government do it the hard way. Much more often, unfortunately, it has waffled and taken the weak road. When it's done that, sometimes it's tried to live up to a certain standard of behavior, printing too much money but less than the politicians would like; but sometimes it's caved in completely, printing money as if the "too much money chasing too few goods" rule had been canceled by some higher power.

The Fed picked "cave in completely" during the Lockdown Calamity and Recession. We can see that unbelievable spike to 40% growth in the money supply. The Fed did this, of course, when the stock of goods and services was not only not growing 40% to match the new money . . . but shrinking hard, due to the once-in-history shutdown of the US economy. So we had the most shocking case of all time (in the US, that is) of "too much money, ready to chase too few goods."

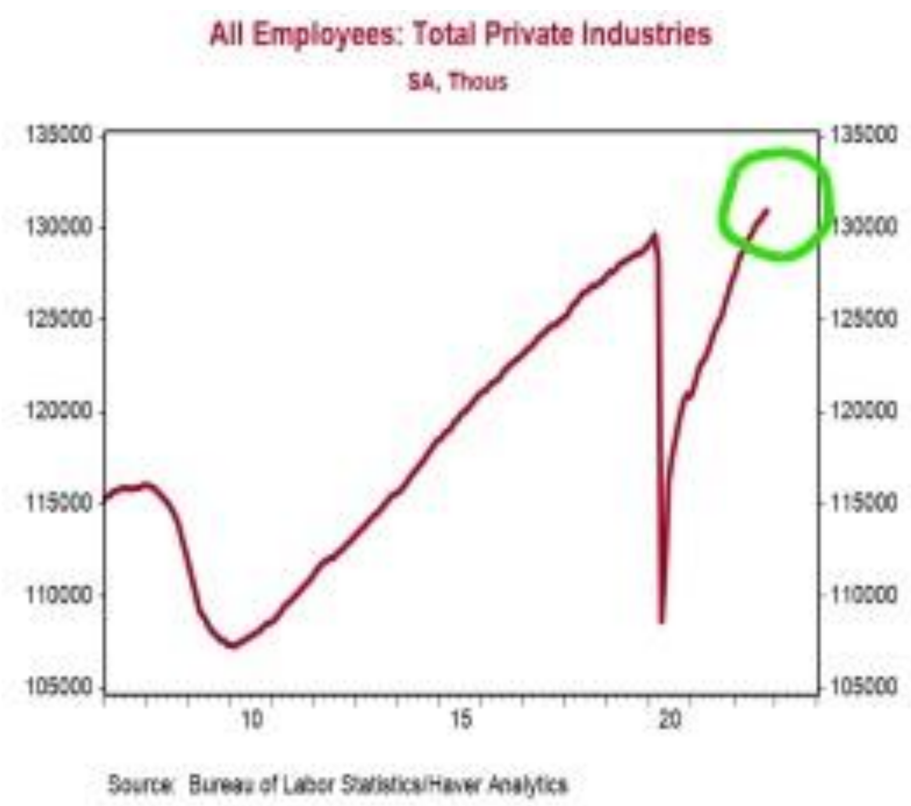
“Ready to chase” captures the last piece of the inflation formula. If the government mailed one million dollars in cash to every single citizen—but every single citizen dug a hole in the back yard and buried the million—we’d see a fantastic spike in money growth, but no inflation. The “too much money” would be out there, all right; but none of it would be chasing a single good. So as far as inflation was concerned, the “too much money” wouldn’t exist. Inflation comes alive if there’s not only “too much money” but also the money is circulating around Main Street: being spent by consumers and lent by banks (allowing even more spending.)

Let’s glance at the first 2 red circles up there. They show big spikes in printed money (big back then, anyway) during the Lockdown Calamity, and 3 years later: 13% to 15% spikes. Yet no inflation. It stayed stuck at the near-zero levels of the whole decade from 2010 – 2020. Why? We know. The new money didn’t get spent, or lent . . . because Main Street and its banks had been scared out of their wits during the Financial Panic of 2008 – 2009, and they spent the decade building Rock of Gibraltar financial strength for themselves, so they’d never feel in such danger again. Yes, they acted like normal human beings. They’d been frightened, so they saved instead of spending and lending. But then, after 10 years of this, we arrived at 2020 and its 40% money explosion . . . and Main Street and its banks began spending and lending: not all of it, but some of it. They felt strong enough to do that because they were strong enough; and because Main Street had shrugged off the once-in-history economy lockdown (and recession) so fast.

So “too much money” was finally being spent, and inflation’s fire flared up. It flared a lot higher and faster, because the once-in-history Lockdowns had created once-in-history Tangles up and down the whole economy (Supply Chain Chaos.) That brings us to this moment. The Fed (and the European Central Bank, and others) have had their noses rubbed in the consequence of “caving in completely” in 2020 and 2021 (and 2009 and 2012): startling inflation, high enough to frighten everyone. So now they’re saying, “Count on us, we’ll fight inflation to death no matter how much it hurts.”

The market’s betting crowd (cynics to the last man and woman) is trying to figure out how much the Fed really means it (how high it’ll hike interest rates, killing inflation by half-killing the economy), and when it’ll cave in again (because half-killing the economy will bring a storm of protest.) Now comes the jaw-dropping part. The Fed has no idea when inflation’s fire will die down. It has no idea that any particular interest rate will do the job. Most of all, it has no idea of how half-dead Main Street might have to be, to suffocate the inflation fire. It plans to go along from month to month, making random guesses about the heat of the fire and whether it’s cooling down, while anxiously hoping Main Street doesn’t get too sick.

And Main Street, as usual, is paying a lot less attention to the Fed’s agony of indecision than to the things it can control: its financial strength, investing for its future, and being extra-careful about costs. The result of all this, so far, we can only call “stubborn growth” on Main Street. Today’s payroll employment report, below, was a good example: 261,000 new jobs, well beyond the experts’ guesses.



So the big picture heading into 2023 will be the Fed, trying to choke off inflation without choking Main Street too badly, but basically clueless about how high to push rates, to do that. We investors wonder, too. Let's draw something useful from the picture on top. Notice that money-supply growth has plunged from 40% to zero, and below? That's a good thing. Back in the hyperinflation of the Seventies (compared to today, anyway) money growth was too high, and stayed that way for years. To kill inflation the Fed (in the very best of its "standing apart" moments in history) had to half-kill Main Street for almost 2 years: with near-20% interest rates. It does not seem to Outlook Capital Management that anything remotely close to that kind of death blow will be needed today. The "chasing too few goods" part of inflation—when "too much printed money" is actually spent and lent—has been a snapshot in time compared to the hours-long horror movie of the Seventies. And the Lockdown Tangles which are temporarily tossing more gas on the inflation fire are being untangled, believe it or not: slowly but fairly surely.

Even if we were living through the money-printing horror movie of the Seventies, at Outlook we'd be buying and holding. It paid off tremendously, back then . . . we just had to wait longer. We're a long way from that horror now, and the companies we own are infinitely stronger, and valued with fear by the market. That means only this: buy, hang on, and refuse to be fazed by the usual uproar.

Dave Raub
Outlook Capital Management, LLC
125 S. Wilke Road, Suite 200E
Arlington Heights, IL 60005
847-797-0600