The Outlook: April 12, 2024

Inflation! Dead or Alive?

We've had a lot of fun for a couple of months, haven't we? Micron led the way, but almost all the rest of our companies tagged along in the game of "Up, up, how high is up? The sky's the limit!" It isn't, of course; just as six feet underground—with a headstone on top—isn't the end of the other game the market plays: "Down, down, how far is down?" Both the "Up!" and the "Down!" games end because enough of the players—that market betting crowd we always talk about—suddenly get the feeling they've gone too far, and yank their cash off the table while it's still there, so that they can wonder whether to plunk it back down again tomorrow.

There is always some real-world fact that floats into view and triggers that "we've gone too far" feeling. In this case the "fact" was Wednesday's CPI report. It was a tick or two higher than expected. That was all the betting crowd—and the media and plenty of experts—needed to jump on the "Party's Over! Run for the Hills!" bandwagon—on the idea, as always, that untamed inflation means the Federal Reserve will keep interest rates higher, longer . . . and no party can go on without the Fed's permission!

Of course the real facts are that Main Street does <u>not</u> need the Fed's permission (falling interest rates) to keep working, creating earnings and growth; and the "Inflation! It's Alive!" report that triggered the betting crowd's "Party's Over!" feeling has enough holes in it to drive a truck through. Here they are, courtesy of the investment firm Wisdom Tree.

No matter how it's measured, inflation began plunging two years ago, as we see. This week's hysteria was triggered by the thin black line up there, with the CPI bumping up to 3.5%. And that "truck-sized hole" in the CPI is the blue line, which tells us inflation is only 1.9%. That happens to be below the Fed's supposed target of 2.0%, while the 3.5% version of inflation is far enough above the target to seemingly justify all the handwringing anxiety and the "Stubborn Inflation Derails the Market!" headlines.

The difference is a fairly fantastic measurement—built into the CPI—called "OER" (Owner's Equivalent Rent) which we've touched on before. OER tries to estimate housing costs by saying, "If every homeowner rented their house to someone, here's the rent they'd probably be charging." Yup. "Huh?" is the right reaction to that. And OER is a jaw-dropping portion of the CPI—a third or so.

Instead of asking that, ah, "interesting" question about what we all might charge for our houses, Wisdom Tree thought it would try to measure the actual rents being charged in the real world . . . and put the changes in that number into the CPI. The blue line—and the current 1.9% inflation rate—is the result.

That bring us right to the deep point about all this, which we might call "The Elephant in the Room," or maybe "The Emperor's New Clothes." The deep point is an age-old question: "Why do so many intelligent people—not just now but forever in history—ignore glaringly obvious facts which go against their opinions and beliefs?"

There is more than one reason . . . but a big one is just that we never feel like admitting we were wrong. It's not only humbling, but if we're experts or media who make our living asserting that we're right—well, admitting we were wrong feels kind of dangerous: "Why would anyone pay us or listen to us if we tell them we aren't always right?" So we don't hear many such humble confessions. Instead, experts quietly drop their old "models" and trumpet their new ones; economists and market analysts simply ignore their failed forecasts; and the media just refuses to ever be embarrassed by yesterday's headlines. All that ever matters to the media is eyeballs, today. And "Stubborn Inflation! Market Dives!" is an infinitely stronger magnet for eyeballs than, say, "Meaningless Bump in Rent-Adjusted Inflation!"

And so the Elephant in the Room never leaves, and the Emperor keeps parading around without clothes. But of course we investors—if we want to both survive and thrive—absolutely have to look much deeper than the headlines. We don't have to look all that deep, when it comes to this week's "Stubborn Inflation! Run for the Hills!" headlines to understand that the cold, hard cash being earned by our companies is not going to dry up because the reported CPI bumped up, or because the Fed won't lower interest rates as fast and far as the betting crowd hoped.

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