The Outlook: Feb. 20, 2023

"Inflation Watch!" Duller than we think . . . and Main Street will not howl.

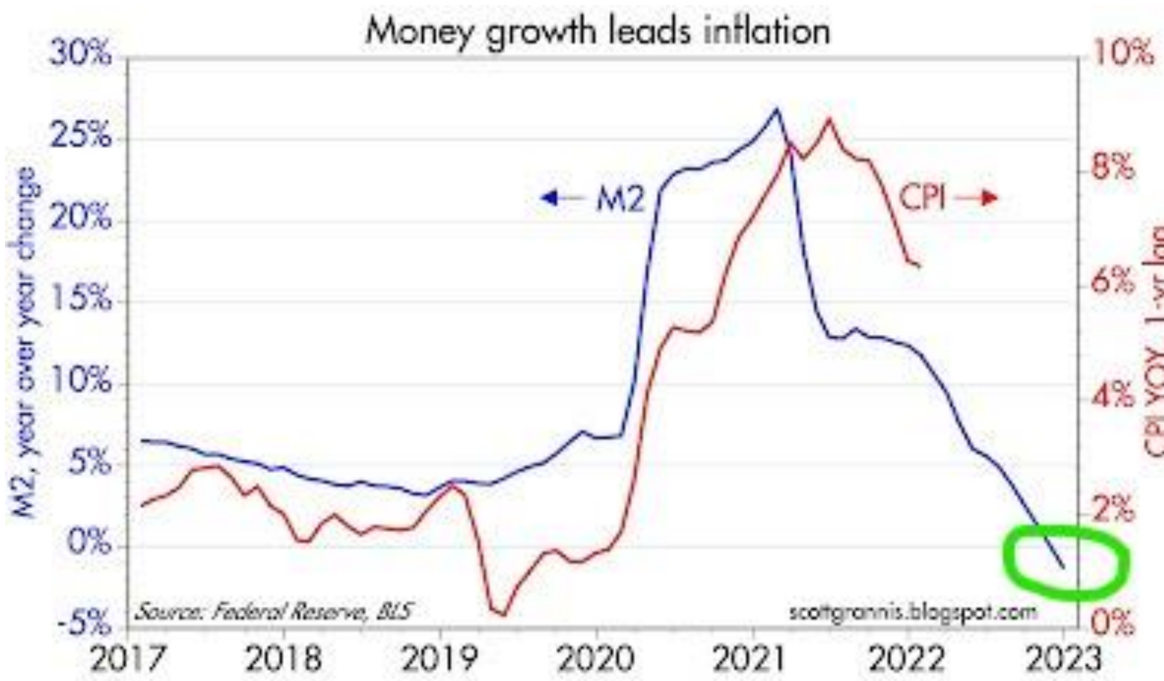
Let's turn, for a moment, from "Recession Watch!" to "Inflation Watch!"

If we can briefly forget about how much we're paying for a dozen eggs, we might admit that 2023's "Inflation Watch!" is pretty interesting. The engines behind it are somewhat unique, compared to history's inflation norms. Oh, the basics are eternal and simple—too much government-printed money chasing too few goods—but the way the money-printing engine was handled was different. Instead of gradually pushing the gas pedal over several years from 25 mph to 40, then 50, then maybe 60, this time Government slammed the pedal from 25 to 120 all at once . . . then took its foot right off the pedal, letting the engine coast back toward "slow" or even "very slow indeed."

That was the "too much money" engine. The "too few goods" engine was pretty unique, too. The economic Lockdowns were a first in world history . . . so Main Street's climb out of those Lockdowns has also been a first in world history. It would take an economist with other-worldly wisdom to be sure of exactly how much inflation those unique engines would produce; how long it would last; and how fast it might drop. Since other-worldly wisdom is scarce on the ground, even the best economists aren't sure . . . and some find themselves sharply differing with their professional friends, with whom they used to see eye-to-eye.

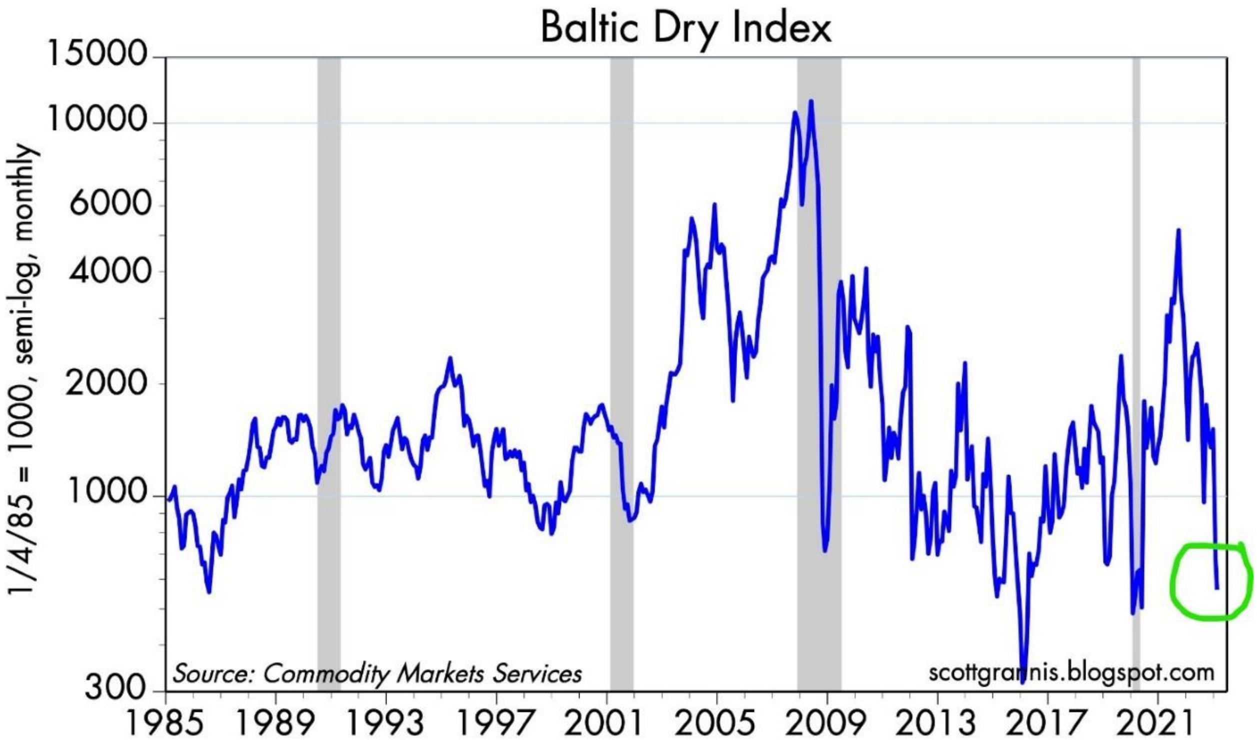
That's the case with two of Outlook's favorites: Brian Wesbury and Scott Grannis. Mr. Wesbury thinks the inflation nightmare will be both ferocious and stubborn, and won't be tamed without a painful recession. Mr. Grannis thinks it's already been tamed, mostly—and the Federal Reserve is blundering Main Street into a recession because it can't see that fact.

The engines are unique . . . so neither economist (nor Outlook nor anyone else) has the right to be sure. But we're leaning toward Mr. Grannis' point of view. Here are some pictures.



That blue line diving below 0% money-supply growth is historically startling. "Inflation lags behind money-supply changes" is Milton Friedman's Law . . . and Mr. Friedman understood very much indeed about money and inflation. If he's right again, that red CPI line will be nosing down pretty sharply as this year goes along.

The green circle is national housing prices, whose inflation rate is falling sharply. It is nearly impossible to forecast anything except a further plunge for that line . . . not just toward 0% housing inflation, but toward negative inflation. There is just too much evidence that buyers have gone away . . . while builders kept building and finishing contracted homes. Yes: plunging demand, rising supply . . . and falling prices. But the red circle and red line are startling. More than 30% of the CPI is based on a strange calculation called "Owners' Equivalent Rent", which estimates (out of thin air, partly) the rent all homeowners would pay on their own homes, if they were renting them. Yes, a strange calculation. The main engine driving "OER" (Owners' Equivalent Rent) is house prices. They are falling. But "OER" always lags behind those prices, and we can see it's still rocketing up. So unique situation or not, we can be pretty sure "OER" has only one way to go later this year: down. That's Mr. Grannis' point with this chart, and we think he's seeing the truth.



Here are global shipping costs. One of those "unique" engines—Lockdown!—created Supply Chain Chaos in its wake, and created that near-tripling in shipping costs we see around 2021. That helped "Inflation!" rise to frightening levels. But note the green circle, which we could label "Down, down, down!" Main Street World gradually fixed Supply Chain Chaos . . . so shipping costs plunged.

As always, we might wallow in a hundred charts on this subject rather than only three. But these get the idea. They persuade Outlook to lean pretty hard toward Mr. Grannis' opinion: inflation is already licked, mostly . . . it just doesn't know it yet. Unfortunately the Fed doesn't know it either; and we're also pretty sure it will indeed "go too far" with hiking interest rates until Main Street howls, more or less. If so, Main Street will bounce back as always, and it won't howl as loudly as the headlines say it's doing. None of that actually matters to us genuine investors. We own exceptionally strong companies which will not howl, higher rates or not. If they slow down, they'll accelerate again pretty fast. We will hold on regardless.

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