Founder's Commentary

The inflation problem and why many economists are struggling with this

Inflation is picking up and the great debate of the 20's is centered on the permanency or transitory nature of inflation. Parallel to that is the question of the Fed's ability to control inflation. The "market" says yes, they will raise rates quickly to somewhere in the 1.5-2.5% range, inflation will come down and we will all live happily after. Hmmmm.

The first thing that makes me skeptical is the concept that inflation is purely a function of interest rates. In the period since the early 1980's, it certainly appears to be that way. This is a long time and not a lot of traders or economists have been around that long. It has become standard practice to use statistical models to predict all kinds of economic indicators. But is it that simple? Don't think so.

Inflation and interest rates have taken a long ride down over the last 40 years. But what else has gone on during this time frame. 1. Globalization. Competition from workers in other countries has kept a cap on wage growth in the U.S. This is changing due to a couple of things, equalization of wages and nationalism. 2. Supply chain issues. Most see this as transitory but it's probably not. As companies have changed to shorter and shorter lead times on supplies, they have made themselves more vulnerable to the smallest supply chain disruption. The solution is to hold more inventories, inflationary. 3. Growth of 2 earner households. This has probably been a big factor in keeping wages down, with the workforce growth growing faster than population growth.

What's changed? 1. Supply chain issues. 2. Equalization of wages to the extent that when you add in shipping costs, local workers are competitive again. 3. Decrease in two earner households. This is just a guess, but between the soaring cost of childcare and quality of life issues, this appears to be what's happening. This flies in the face of the basic rule of economics that people always act in their economic interest, but that never made sense. 4. Day trading. Yes, this is probably a transitory factor. When the Fed takes away the punchbowl, many day traders will need to work again.

The path forward. The Fed will taper and probably nudge up short term rates. At some point the equity and credit markets will panic and so will the Fed, backing off from their tightening. Inflation will continue and eventually force the Fed to continue to raise rates. The thing to keep in mind is that world has changed in the last 10 years and is continuing to change. Statistical models do not work well when the paradigm changes because the underlying relationships change.

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