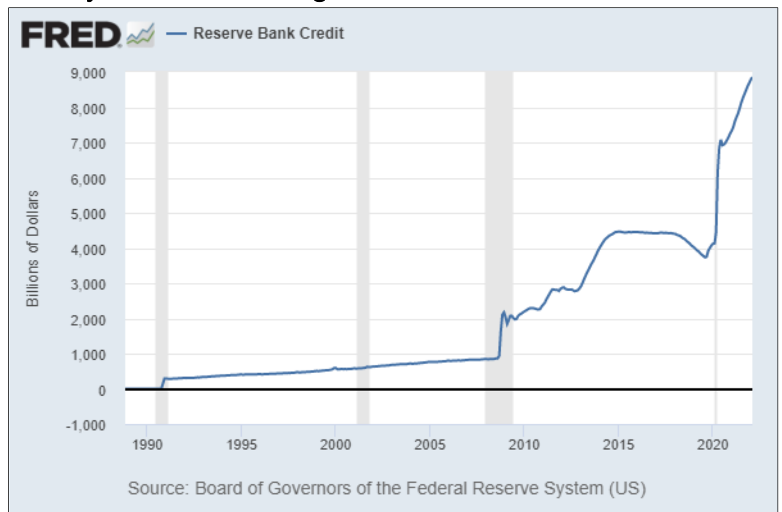
**The Long & Short of It**
Quarterly Newsletter
First Quarter 2022

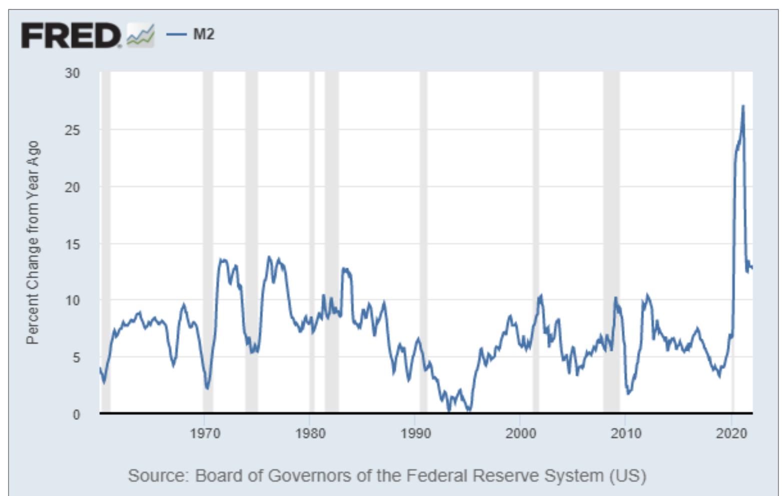
***Inflation: Left to FAIT***
In August 2020, the Federal Reserve implemented flexible average inflation targeting (FAIT). FAIT is a monetary policy that allows inflation to "average" 2% over an undefined time frame versus strategies that "target" 2%. This tactical adjustment seemed innocuous at first as Federal Reserve Chairman Powell promised to allow inflation to rise higher than his recent predecessors. Played forward 18 months, this change of approach by Mr. Powell has resulted in the dramatic increase of the Consumer Price Index (CPI) by 7.9% over the last year.

On March 16, 2022, the Fed responded by increasing the Fed Funds rate a quarter of a percentage point. For the first time in nearly two years, the Fed eased up on the proverbial gas pedal. It appeared to be the beginning of a series of difficult steps for the Fed and the economy.

It is our opinion that the stimulus of the last two years will be with us for longer than we wish. In this newsletter, we will discuss how loose monetary policy continues to create inflation that hasn't been seen in decades. Given the leverage in the economy, the Fed raising rates to tame inflation will make it more difficult to engineer a soft landing and as a result, the Fed will be forced to overtighten to the detriment of markets.




***The Thread of Life***
Inflation's life cycle is tied to changes in the money circulating in the economy—specifically, too much money creates inflationary pressures. How loose exactly was monetary policy? Let's look at Reserve Bank Credit and Money Supply in the Fed's models to understand the impact of easy money.



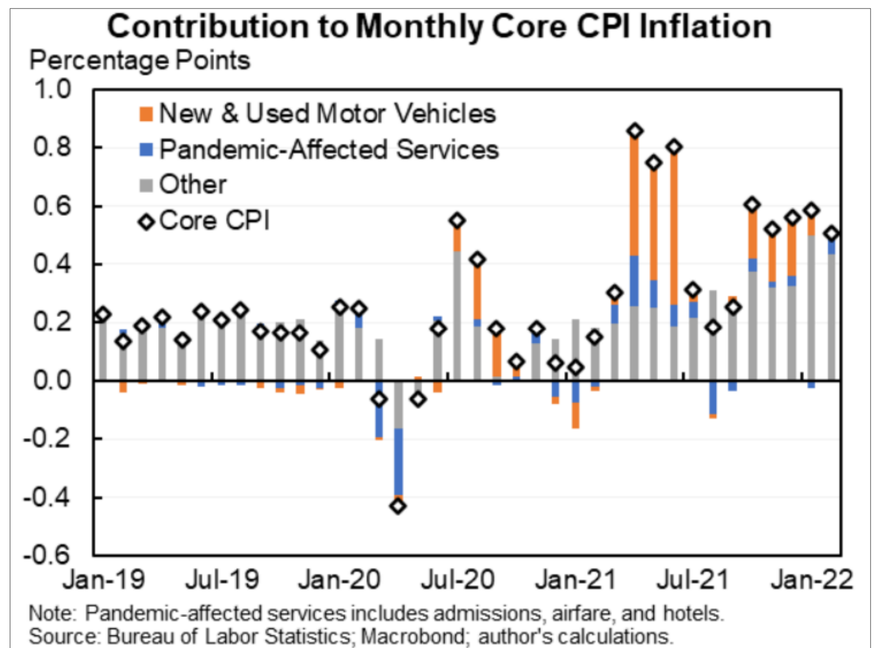

Reserve Bank Credit refers to funds lent by the Federal Reserve on a very short-term basis to member banks so they may meet their liquidity and reserve needs. Reserve Bank Credit now sits at $8.9T, up 17% annualized for the last 15 years and up 41% annualized for the last 2.5 years. Interestingly, while relatively stable prior to 2007, this measure has become volatile and grown at rates so high they lack historical analogy. Money Supply (denoted as "M2") now sits at $21.8T, up 8% annualized for the last 15 years and up 16% annualized for the last 2.5 years.

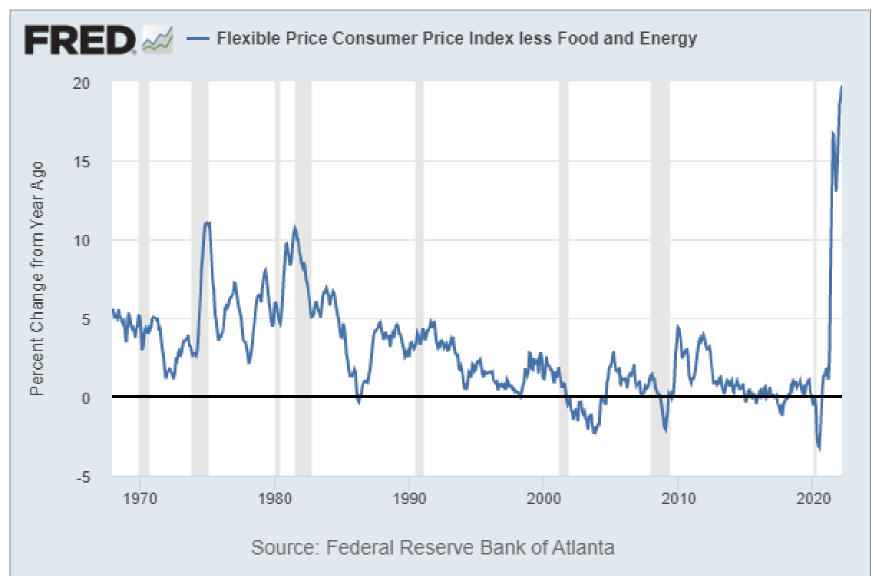
***Signs of Fraying***

Analysis of when this unprecedented expansion of the money supply will affect the economy tends to align with the Fed's own models; that is to say, the economy appears right on track for a lagged impact. In the February 3, 1995 edition of the Federal Reserve Bank of San Francisco's Weekly Letter, an article entitled "What Are the Lags in Monetary Policy" described the Fed's four econometric models that estimate the lag between when monetary policy is enacted and its eventual impact on the economy, saying:

> Overall, all the models appear to provide fairly consistent evidence that **a monetary tightening or loosening has the greatest effect on the growth of output during the first eight quarters, and that this effect is fairly evenly distributed between the first and second years** [emphasis ours].

It therefore makes perfect sense that the balloon of money dropped on the economy from early 2020 to late 2021 would create inflation in 2021, 2022, and even 2023. It is just hard to know how much is due to monetary policy versus COVID-related supply chain disruptions. In addition, the war in Ukraine just started; its impacts are forthcoming and war is typically inflationary. Indeed, that war could end soon or be the beginning of a wider global conflict or just a transition to a different world order. As ever, the future remains uncertain.

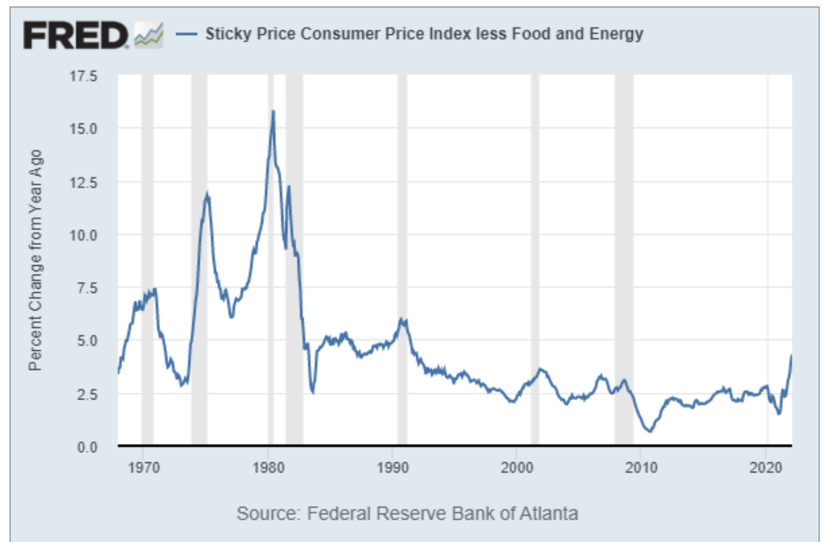



The inflation resulting from this monetary policy can be analyzed in several ways. It is helpful to break down CPI into some of its component parts. For instance, delineating volatile segments such as Motor Vehicles and Pandemic-Affected Services explains much about the last two years, though it is strongly suggested that broader inflation is also creeping in (note how extensively "Other" sits above zero in the chart at top right).

Another useful method of studying inflation data is to define products as either flexible in price or sticky in price. Flexibly priced items (like

gasoline) are free to adjust quickly to changing market conditions, while stickily priced items (like motor vehicle fees and insurance) are subject to some impediment or cost that causes them to change prices infrequently. Research indicates that the Sticky Price Index appears to have an embedded inflation expectations component that is useful in forecasting future inflation. In other words, over time, if increases in the Flexible Price Index subsequently manifest in the Sticky Price Index, it is indicative of longer-lasting inflation. But in a potential scenario where flexible item prices drop suddenly and rapidly, inflation may not have time to embed itself and take hold in stickily priced items.



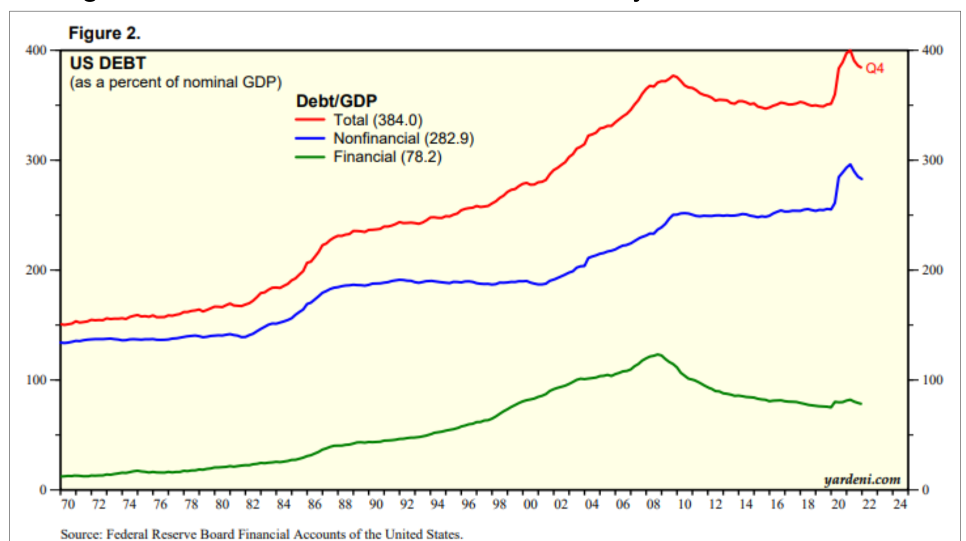

***Inflation's Destiny Cut Short?***

Given these multi-decade highs in inflation metrics, it is hard to imagine the Federal Reserve holding the Fed Funds rate far below the rate of inflation as it does today. Similarly, it seems even less sensible for US Treasury rates to be in the low single digits while inflation runs in the high single digits. This unusual environment only makes sense in the context of the Federal Reserve's manipulation of monetary reality and the great distance the Fed must cover to return to a normal rate environment.

In Greek mythology, every mortal's thread of life was set by the Fates. Not even the gods could interfere with it. Anyone foolish enough to try would be pursued by the Furies. As the Fed attempts to cut short the life it gave to inflation and thereby stokes the Furies' ire, we are driven to identify the unintended consequences of the Fed's actions and invest accordingly.

***It's the Credit Cycle***

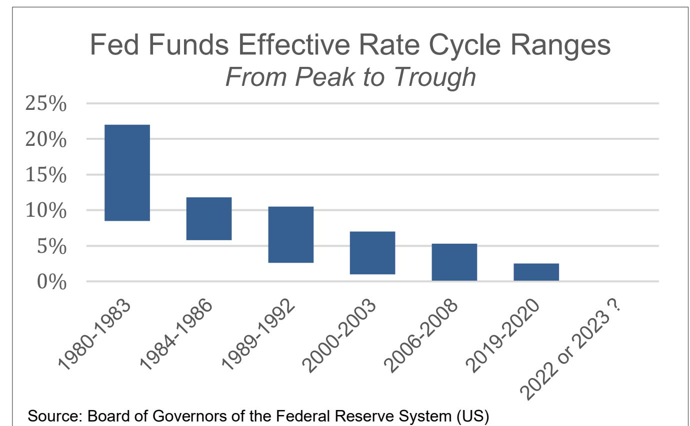
History has proven it impossible for an economy to grow without credit cycles. Once established, a credit cycle always ends up expanding faster than can be sustained for a myriad of reasons known only by behavioral economists. Even today, these reasons are usually referred to as "animal spirits," a term that fits in more with the language of Adam Smith in the late 18th century than our 21st. In the current cycle, debt levels have once again reached record highs as a percentage of GDP. Though they have recently dropped ever so slightly, it is not due to a decline in debt but rather the expansion of GDP caused by inflation.



So what drives creditors to lend in excess? A lender likes anything of value that others are willing to borrow against. A borrower's assets protect a creditor against today's problems and this income also protects a creditor over time. A lender having a sense of stability or reliability in these matters is where the human element really takes hold. As humans, lenders tend to have a short memory. They expect the future to look a lot like the present, or at a minimum the very recent past.

A credit cycle tends to expand at a more-than-sustainable rate until it collapses. After each downside of a credit cycle comes some base building and stability, followed by an acceleration to get back from low to normal levels of activity. Then people experience the economy as stable and the unsustainable growth rate that brought the economy from low to normal **feels normal**. It creates an expectation for future growth beyond sustainable growth that everyone ascribes to, thereby sowing the seeds of the expansion's eventual excess and failure.

Given that the yield curve is already inverting in places and close to doing so in others, how high will the Fed Funds rate go before ending this cycle? Since the inflation of the 1970s, the Fed Funds rate has ended lower each subsequent time with less and less monetary tightening employed before entering a recession. The current cycle will likely continue this trend, but the recession may take longer to manifest as the significant stimulus of 2020 and 2021 will have a lingering impact.




Valuations remain high and solid balance sheets are rare. The incentives to take on debt have been profound. With the Fed tightening monetary policy and facing political pressure to do so more rapidly, it seems a good time to be guarded and protective of one's purchasing power. We focus on owning attractively priced high-quality industry leaders that are currently out of favor, as well as employing mechanisms designed to perform well in difficult market environments.

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