Put It on My Tab

"I got a judge that is just aching to throw me in jail. An idiot who wants to fight me for $200. Slaughtered pigs; giant loud whistles; I ain't slept in five days. I got no money, a dress-code problem, and a murder case, which hanging in the balance holds the lives of two innocent kids. Not to mention...your biological clock, my career, your life, our marriage, and let's see – what else can we pile on top of the outcome of this case?"
- Vincent Gambini, *My Cousin Vinny*

Speaking before our investment committee during our March meeting, I found myself summarizing a catalogue of risks weighing on markets. It was not pretty:

- From a rate of change standpoint, U.S. GDP is going to decelerate significantly in Q1 and decelerate again in Q2.
- Commodity inflation has gone vertical – with lumber, metals, agriculture, and rare earth material input costs running at 3 times pre-pandemic levels.
- A barrel of oil has a price tag over $100, forcing drivers to pay nearly $5 per gallon at the pump.
- Rapid commodity inflation coupled with home price appreciation and supply chain bottlenecks led headline inflation to reach 40-year highs.
- The Federal Reserve is aching to raise interest rates into a growth slowdown to chip away at inflation.
- The yield curve is now inverted, with the 5-year treasury yield exceeding that of the 30-year treasury yield.
- Mortgage rates are up over 50% in the last 3 months, and with higher rates the housing market is showing signs of rolling over.
- Labor supply and supply chain bottlenecks still persist.
- An autocrat with a nuclear arsenal invaded a sovereign nation threatening to shift the tectonic plates under several decades of relative global stability.

A quiet room provided the unasked question – "anything else?"

Perspective

Without having to plumb the depths of history, it may be helpful to look back to just two years ago when the world was in panic, the U.S. stock market was -33% off its highs (the largest decline since 2008/2009), and nobody knew what would come next. At the time, client conversations revolved around when (or even, if) markets would recover. The conversations and the concerns are not too dissimilar today.

But as you remember, less than five months after the market bottomed on March 23, 2020, the stock market reached a new all-time high. It was clear then, as it is now, that there are times when even the optimists are too pessimistic – and admittedly I was amongst them.

Fast forward twenty-four months, we enter another difficult period for our economic, geopolitical, and social systems, and sentiment is once again at historic lows. At times like these, we feel that it is important to break down the various challenges to determine what may be temporary and what might become systemic.

The Road to Inflation

The underlying paths to the current headline inflation level are as numerous as they are varied. In February, U.S. Headline CPI report came in at +7.9%, which was the highest level since 1982 (when the Fed Funds rate was at 15%!). The history, as we know, is that easy monetary policy has been in place since the Great Financial Crisis (GFC). Quantitative Easing versions 1-3 kept borrowing rates pegged near 0% throughout the 2010's and monetary stimulus injected trillions into the system. While the loose money periods of the 2010s did not result in the much-predicted runaway goods and services inflation as reported in the CPI, inflation could be seen in asset prices (stocks, bonds, real estate, etc.).

The onset of the pandemic threw gasoline on the monetary bonfire, with the Fed's response to not only pin the short-term rates back to zero, but to begin an asset purchase binge well in excess of the prior period. Over the past two years, the Fed balance sheet expanded by $4.4 trillion. The move inserted stability into markets and successfully bridged the gap of a shutdown economy, but it also created a vast new supply of money.

The substantial influx of new money has exacerbated to the second leg of the inflation stool - broad-based input cost inflation of goods and services due to supply constraints. Leading the charge in the most recent inflation print was energy, which jumped 25.6% on the heels of the Russian invasion of Ukraine.The world's third largest oil producer, and the largest natural gas exporter to Europe was immediately removed from the global marketplace.

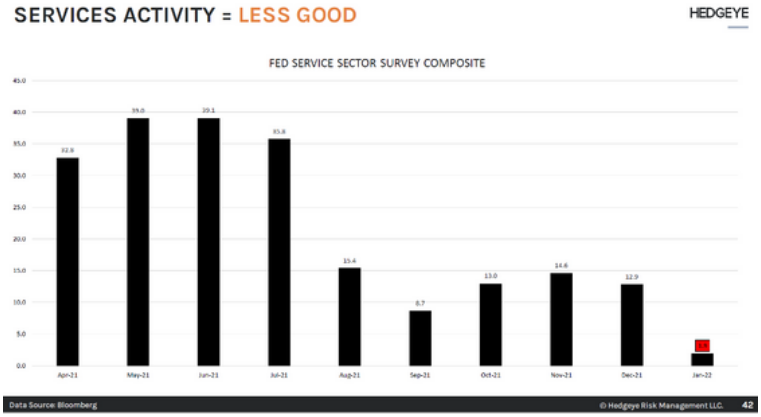
As expected, oil prices soared to $130 per barrel, and average gasoline prices neared $4.50 per gallon. Beyond energy, the charts of the broad basket of commodities sensitive to transportation and production costs (which includes lumber, metals, grains, etc.) spiked, rising 12.4% in the 12 months ended in February 2022. Meanwhile, additional supply / demand undercurrents continued to contribute more subtly. Home prices have been appreciating at ~20% clip as demand for single family homes, and the ability to finance purchases with low rates and high (often cash) offers, overwhelmed existing home supply. Accelerating home price growth is finally flowing through into rent inflation. Though less discussed, shelter inflation has been a significant underlying driver to the headline CPI number, contributing 25 – 50% of the gains in Core CPI since September.

The third and more recent leg is the post-pandemic labor shortage. You can lump the various reasons for the "Great Resignation" into one big pot – fear of contracting the virus, government stimulus paying individuals as much or more than their regular paycheck, inability to find childcare, baby boomers taking the leap into retirement, some rethinking the meaning of work altogether – all these factors have led to a shortage of workers for open jobs. Currently, the Beveridge Curve (job opening rate vs. unemployment rate) is nearly 2x above its prior peak, as the job openings rate is approaching 8% while the reported unemployment rate is sub-4%. This puts labor in the driver's seat for the first time in a long time, and many are now demanding higher wages or switching employers.

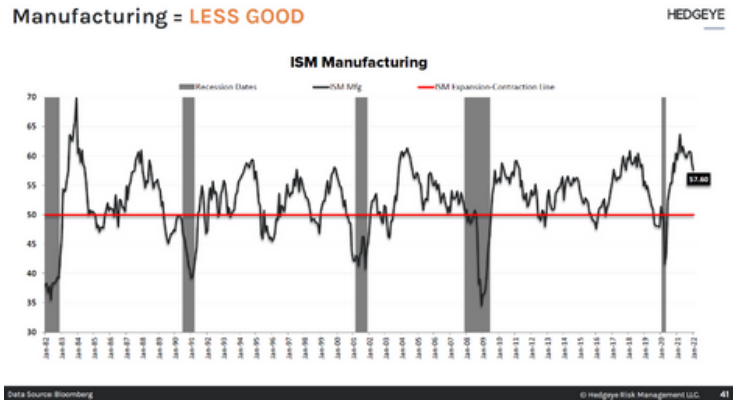
The question of course, is what these higher prices will do to growth?

The Outlook for Growth

One of the major bull themes in 2021 was the amount of cash consumers had in their bank accounts. With the pent-up demand story fully playing out, consumers enjoyed a strong personal balance sheet, with almost $600 Billion of excess cash being held in checking accounts when compared to pre-pandemic levels. The "institution" of inflation is a direct assault on that cash cushion. Instead of being consumed on "wants," the excess cash families had socked away is now earmarked for being spent on "needs."

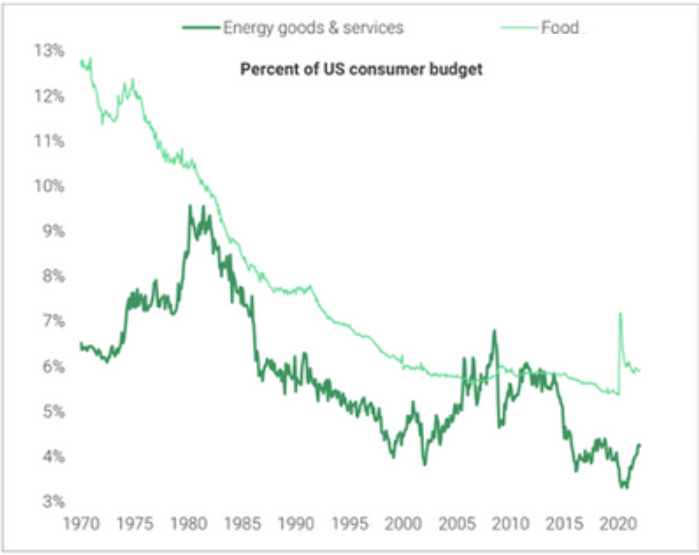


It's not just individuals that must now contend with higher costs. Businesses, especially those manufacturing the goods we consume, are being forced to either eat higher input prices (through margin compression) or pass those increases on to consumers.



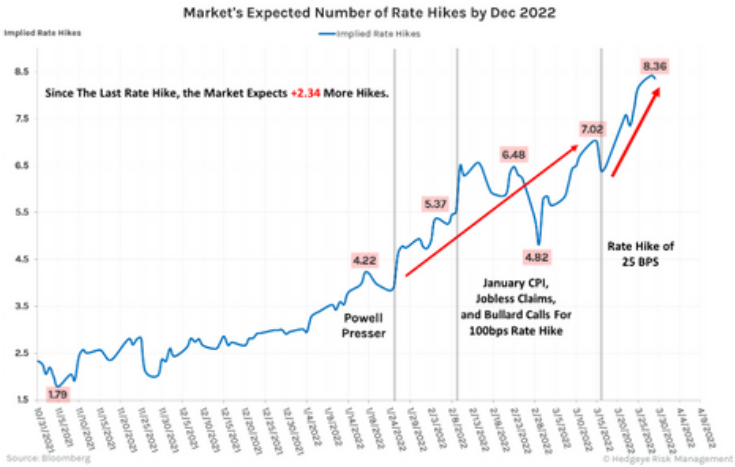
On the surface, the inflationary picture should throw a wet blanket on our growth outlook. Higher costs do indeed punch a hole in consumer's wallets and eat away at cash balances on the sidelines. Interestingly, consumers have been able to take this inflationary cycle in stride. Demand remains strong as we emerge from the Omicron wave into the spring / summer travel season. And importantly, food, energy, and goods/services as a percent of consumer budgets remains in line with ~20 year run rates and nowhere near the 1970s and 1980s. This is potentially one explanation as to why the consumer has been able to keep up with rising prices.

Relating to recession risk, employment is a more important driver than inflation. And employment remains very tight. As we emphasized, labor demand is strong, resulting in plentiful jobs for those in the workforce and wage growth is supporting consumers' ability to absorb higher costs at the pump or grocery store.



Dousing the Inflation Fire

The Federal Reserve has two mandates: Full employment and price stability. With the current unemployment rate sitting at 3.8% and labor demand remaining strong, the first mandate is on solid footing. In November 2021, with inflation accelerating every month for nearly a year, the Federal Reserve finally announced that it was time to start working on mandate number two. Rising from their initial lethargy, the Fed formulated an extremely hawkish stance to combat the highest level of inflation, and climbing, in four decades. Currently, the market is pricing in between 8 and 9 interest rate hikes by year end. Just three months ago, the market had been pricing in 2-3 hikes.



The impact of the anticipated rate hikes has led 2-year treasury yields to triple in three months: from 0.60% to 2.40%, with half of that move coming in March alone. For context, the Federal Reserve raised interest rates 5 times in 2018, before the market forced them to pivot back to a more dovish monetary policy.

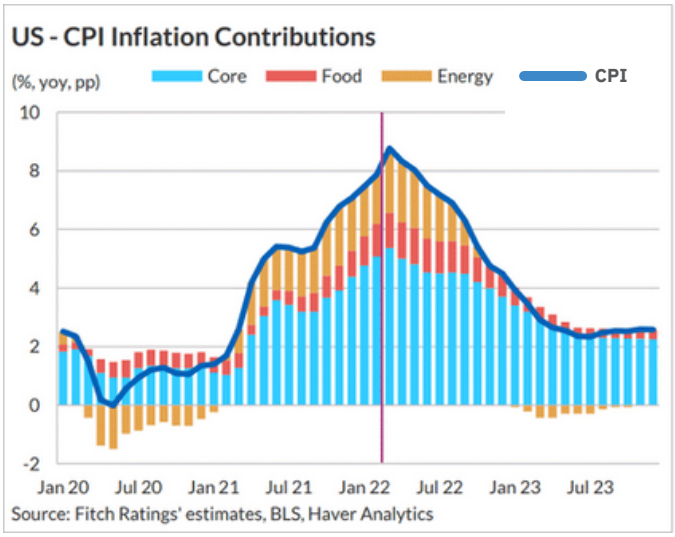
The difference, of course, is that the level of inflation today is 3 times as high as it was in 2018. So, this time, the bond market believes (in terms of current yields) that the Fed will follow through on its interest rate hike plan. Using history as a guide, 1994 may serve as a better corollary for the central bank policy shift than does 2018. In 1994, the Federal Reserve (headed by Alan Greenspan) accomplished the rarest of economic feats – a soft landing, curtailing inflation without causing a recession. At that time, the Fed imposed an abrupt series of larger-than-expected rate hikes of 50 basis-points (0.50%) culminating with a 75 basis-point move, effectively doubling the key rate in less than a year. Astonishingly, inflation came down below 3% without throwing the economy into recession.

Summary

Will this time be more like 1994 or 2018? Simply put, it is too early to tell. This cycle is seemingly more fluid, as geopolitical events can directly imbalance critical commodity supplies and exacerbate an already difficult inflation picture. Further, the unemployment rate is already at historic lows; while job openings are currently plentiful, openings can evaporate quickly, and unemployment may rise due to tighter financial conditions and continued inflation.

In our opinion though, today's Fed may be talking a much tougher game than they actually can/want to pursue. The risks of inflation becoming more psychologically entrenched within the minds of consumers and businesses may be the biggest battle the Fed is fighting. So far, businesses have been able to pass on the higher costs, and consumers have been able to absorb those costs with relative ease due to strong employment, rising wages, and strong balance sheets. Of course, there may be a breaking point at which point consumers will no longer have the financial resources or internal fortitude to consume.

Again, while unsettled due to conflict, we may likely be at peak inflation rates. Inflation is very likely to begin receding in 2H2022 and be on its way to more "normal" levels over the next 12-18 months. As we listed the drivers of rising inflation – commodity prices, supply chains, home prices, etc. – these trends are evolving into disinflationary tailwinds as base effects become steeper and steeper to climb. While fickle, commodity prices, specifically energy, appear to have reached firmer footing (if only temporarily) and the futures curve suggests future supply / demand balance as oil futures for December 2022 are currently sub-$90 per barrel. The rapid backup in rates has contributed to a cooling in home prices. Should the inflationary descent materialize, peak hawkishness (and peak rates) may be in, and the Fed could back off its highly aggressive stance that so spooked both equity and fixed income market.



While "cautious optimism" continues to be an overused platitude, we optimists at DBR humbly submit that it is in your financial best interest not to let your highs get too high or your lows too low. From a portfolio positioning standpoint, we remain conservatively positioned given the instability of the current cycle and continue to anticipate volatility in the near term. As always, please don't hesitate to reach out to us with any questions or concerns. Enjoy the start of your Spring!

Respectfully,

Michael J. Aroesty, CFP®
Investment Committee Chair
Senior Financial Advisor

436 Seventh Avenue, Suite 2800
Pittsburgh, PA 15219-1818

Phone: 412.227.2800 / Toll Free: 888.227.0913

Fax: 412.227.2805 / **www.dbroot.com**