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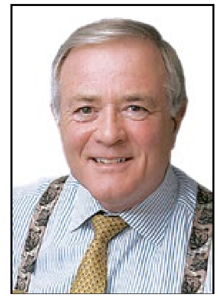
William Rutherford

OP-ED: Inflation confounds Federal Reserve and the economy

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The Federal Reserve has embraced stopping inflation as its burden. Indeed, stopping inflation is one of its mandates. Why inflation? Because it is an insidious tax on all persons that quietly eats away any savings one might have. Inflation raises the price on everything by debasing the value of money. Historically, it has led to social upheaval, political upheaval and even, indirectly, to war. Classic cases are when money becomes almost valueless, and both working and retired people find themselves bereft.

How can inflation be stopped? One way is to slow the economy so much that only hard assets retain their value. The trick is to slow the economy, but not send it into reverse. Currently, the Fed is trying to balance a slowdown without causing a recession or worse. The Fed's tactic is to slow economic activity by raising interest rates, which tamps down consumer spending (roughly 70 percent of the U.S. gross domestic product), real estate activity and business investment. At the moment, the Fed raises interest rates every time strong economic indicators are reported for the prior period. The Fed is always looking in the rearview mirror.

When inflation first appeared, the Fed chair dismissed it by calling it "transitory." However, due to households' relatively strong financial conditions, record low unemployment rates, and historically high money supply levels (M2), inflation appears to be persistent and growing stronger. So, the Fed feels bound to continue to raise interest rates to such a level that the economy is stifled. Then, as demand slows, inflation should abate.

So far, the economy is not cooperating. It has remained strong, stronger than it should be under the current monetary policies. Consumers entered 2022 with the highest personal savings rate on record, but much of those pandemic savings are gone, as reflected in the January decline in M2. Credit card debt is rising – up more than 11 percent in January to record levels close to $1 trillion – and delinquencies for all consumer debt are increasing. This debt and the increasing cost of carrying it will curtail spending and thus inflationary pressures.

Investors see a pattern of stock market ups and downs as the Fed tries to get the economy on track for stable growth without inflation. Once the inflation horse was out of the barn, it has been hard to corral. When inflation appears to maintain its upward progression, the Fed raises interest rates, which discourages economic growth and the markets. When inflation appears under control, the market gets a lift. And so we settle into a scenario where bad news is good news and good news is bad news, which is perplexing to investors and the markets; that causes volatility.

A key challenge to the taming of inflation is the dramatic growth in the M2 money supply orchestrated by the Federal Reserve during the pandemic. As a result of stimulative monetary policy, M2 reached an all-time year-over-year growth rate of 26.9 percent in February 2021, ever so slightly offset by a record drop of 1.7 percent in January 2023. The level of M2 reached an all-time high in January 2022 and has remained at historically high levels.

M2 includes M1 (checking deposits) plus savings deposits, CDs and money market funds – in other words, cash available for individuals and businesses to spend. Growth in money supply is needed to support growth in the economy, but if its rate of growth exceeds growth in economic activity, it fuels inflation as more money in circulation causes prices to rise. Growth in the money supply is good for the stock market, but inflationary for the economy, since it raises prices of all goods and services, not just stocks.

A Nobel Memorial Prize winner, the late Milton Friedman of the University of Chicago School of Economics, pointed out for years that growth of M2 is essentially inflationary. Clearly there is still a long way to go to return M2 to levels that will not continue to fuel inflation – yet cracks such as the January decline are beginning to show.

It is not just the growth in money supply that is affecting inflation. Increased government spending and payouts to individuals and businesses during the pandemic fueled demand for goods and services far beyond levels that economic activity supported, driving up prices of everything. Higher wages and prices of goods are sticky. No one wants to give up the pay raise. Politicians are under pressure to provide more government support to families impacted by the inflation that government payouts caused. Putin's war in Ukraine has also had a serious impact and continues to be deleterious. Supply chains are disrupted, which costs money. A rise in the price of oil is fundamentally inflationary.

So, what is wrong with inflation? Does it have any good effects? It does make repayment of debt easier over time. It encourages current investment because the prices of goods will be higher tomorrow. So maybe just a little bit of inflation is not so bad? That is what the Fed implies when it means that its target rate of inflation is 2 percent – i.e., just a teensy bit of inflation can be good. And so it goes. Back and forth. Also, the velocity of inflation is important. Slow and steady can be OK, but not rapid or runaway inflation.

What can an investor do in volatile times like these? As Will Rogers once said, in times like these it is good to remember that there have always been times like these. What an investor needs to remember is that the tendency of the economy is to grow. There are many reasons to support this growth, and so history demonstrates this premise.

Of course, one also needs to remember that past performance is no indication of future performance, especially in a finite time frame. Nevertheless, history shows that the economy tends to grow and with it grows the market. Aim for the best sectors and then the best stocks.

Be patient. Don't trade in and out of stocks, as attractive as that might appear. Slow and steady is the best approach. Keep a long-term perspective on investing. Historically, the market goes up more times than it goes down. Be diversified. Not putting all your eggs in one basket is still wise. It worked on the farm. It has worked on Wall Street over time.

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