Andrew 0:00

Hello and welcome to the JGUA Financial Commentary Podcast. Today is Monday, July 26th, 2021. I'm your host, Andrew Baron. And in this episode, I talk to Bill Armstrong about inflation. But before we begin, a short disclaimer.

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And with that, welcome to the podcast, Bill.

Bill 0:51

Thank you. Glad to be here.

Andrew 0:52

I want to do a podcast about inflation, because it's been in the news a lot. But before we talk about the future of inflation, which is probably what people are interested in, I did want to put a little historical backdrop.

So high inflation, meaning double digit, typically follows things like major wars, as we've seen in modern times after World War One and World War Two, followed by more stable, lower inflation periods in between. In the more recent era, since 1970s was the last time we've really seen high inflation.

Bill, could you talk to us about what was going on then and the reasons for that?

Bill 1:42

Sure. Inflation really started moving upward in the mid-60s, and at first no one was really very concerned about it. Now, the war in Vietnam was going on back then. Government was definitely spending money. Economy was generally pretty good, but, you know, not as strong as it was in the 50s. In 1970, I think, or somewhere right around there. President Nixon took us off the gold standard, and that really accelerated inflation.

The same time in the 70s, economic growth really slowed down. We had the recession in 1973, ‘74, and another one in 1979. You also had two oil shocks in ‘73 and ‘79, which had a knock on effect on all kinds of other prices, you know, whether it's plastics, petrochemicals, et cetera, in addition to gasoline and heating oil and crude oil. So you just had the worst of both worlds. You know, stagflation, stagnant growth and rising prices.

In the end of the ‘70s. Jimmy Carter appointed Paul Volcker as chairman of the Fed, and he knew what to do, and that was to tighten monetary policy, which had the effect of causing a recession in 1980. Interest rates rising dramatically. But it broke the back of inflation, and that was the goal. So inflation steadily lowered throughout the 1980s after the initial recession. And actually there were two sort of short lived recessions, as I recall, ’79-‘80, and then also in 82.

But then through that, economic growth started to improve. Inflation steadily came down. Interest rates steadily came down. And by the end of the ‘80s, things were looking a lot, lot better, you know, in the ‘90s and there we had good growth, low inflation.

We had increasing globalization, which really had a dampening effect on any potential inflation. You had a lot of manufacturing leaving the developed economies, including the United States, moving to low wage economies in the Far East, China, and Latin America.

That lowered inflation. Of course, it had other negative impacts as well, but kept inflation low. I remember early in the 00's and economists figuring that calculating that Wal-Mart alone because of its sourcing in China, had lowered the rate of the US economy by one percent per year for a decade, which was pretty eye-opening.

That pretty much continued through the 00's. And then obviously, the financial crisis. Interest rates have now been coming down for the last decade, and inflation all this time has remained under control until very recently. And that when I say recently, you know, we're only talking about the last couple of quarters, and that is as our economy and the world economy is rebounding from the Covid shutdowns, my opinion and I agree with the Fed and a lot of economists think this, too, is that this is going to be transitory. There's still a lot of supply chain disruptions that are preventing supply from catching up with demand.

Demand has suddenly gotten very strong from very low demand a year ago, and nothing was going on 'til now. But, you know, companies can't get supplies or inventory from overseas and to this country. And so when you have high demand and restricted supply, you get higher prices.

But that is not going to last every day. Covid infection rate, you know, is going to have fits and starts. But slowly but surely, it's going to come down and we're going to see supply opening up and getting more plentiful again. And I think that will take inflation back down to the low single digits.

Andrew 5:40

A lot of the numbers you see are also comparing year-over-year. So, yes, 2020 was an exceptionally down year. So it's almost like we're getting back to normal. So to compare a bad year versus a normal year, it looks higher than it really is, right?

Bill 5:56

That's correct. It probably makes more sense to look at the two year trend rather than just a one year trend.

Andrew 6:01

And to follow up on your supply chain, a lot of the demand is people were unable to spend. So they're kind of catching up to what they may, what is spent or supposedly some of that.

Bill 6:14

Yeah, not only could they not spend, they ended up saving a lot of money. So savings rate went way up. Now the people are willing to spend.

They also have the money to spend. So because they didn't spend any money last year. Yeah--all of those things are sort of happening at the same time. And that's causing a near term—I still think what will be transitory—increase in overall prices.

One area that I think could see sticky price increase is in rent. Apartment rents, I'm hearing, are going up high single digit, low double digit, depending on what market we're looking at. And that tends to only go in one direction.

So if landlords are able to put in an eight or 10 percent increase and their tenants don't move out and they pay it, they're not going to lower them the next year. So that area of inflation could be more permanent.

But I think in general, though, the inflation rate for goods and most services will come down again as the supply increases.

Andrew 7:25

The other areas of the economy that I've seen have major increases are child care, wages in some places as well.

Do you think that will add to the inflation?

Bill 7:37

To an extent, wages are another area where if you raise somebody's pay. Good luck telling them a year later. You know what? I'm taking that back. That doesn't go over too well.

I think companies are obviously resistant to doing that, but they've got to do what they've got to do. I think when economists refer to inflation as transitory, I don't think they mean it's going to reverse at some point.

You know, if the average wage goes from fifteen dollars an hour to 16 dollars an hour, it's not going to go back down again, but it's not going to keep increasing at that same rate. So it might stay at 16 or might go up very slowly, very slightly.

Once the near term inflation has calmed down.

Andrew 8:20

I'm kind of catching you off guard with this question. But what about in our profession, we hear lots about baby boomers retiring, which means oftentimes it means that high level positions, director level positions that they're retiring from and the next generation is taking over.

Wouldn't that be a place where you could see salary compression? You know, if someone was making 200 percent of what the person below them was, if you only give that person a 50 percent raise, it's still an increase to them. But the company saves money.

Bill 8:52

Absolutely right. So, yeah, that's a good point. That is one way, a sort of a stealthy way that wages can actually go in reverse and decline paying less for the same job. Exactly.

Andrew 9:06

Looking ahead, what's in place now that's different than the 1970s, 1980s? Than the current time, 2021?

Bill 9:13

Well, we have a very low interest rate. Unemployment, even though it obviously spiked up because of the Covid. It's come down a lot. A lot of those jobs have returned. And so unemployment, even though unemployment today is still higher than it was, you know, immediately preceding the pandemic. It's still far lower than it was in the 1970s. 1970's had, you know, was not only stagnant growth, it was also high unemployment.

They used to have a misery index where they would add unemployment and inflation in the late 70s. Both of them were double digits. You know, those were bad times back then, I think the Fed is much more cognizant of how to deal with that today than they were back then, and more willing to be accommodative, obviously to keep the economy moving along. I think that's very, very big difference.

Andrew 10:08

And I'm kind of making these terms up. So I feel like we maybe had a “stage one of globalization” in the early 2000s of companies becoming more international. But with the growth in Internet and the future of 5G and technologies like that, I can see individual workers kind of getting more competitive in the global environment. Would that also kind of hedge inflation, since you're more competitive globally?

Bill 10:37

Yes. At the same time, the supply issues that a lot of international companies have confronted since the pandemic have made them realize that while buying from China, and places like that, is very cheap, the supply chain isn't always dependable.

And you're seeing a lot of countries and companies taking another look at their overall supply chains. And I think you might see some repatriation of production and out of jobs. Back to this country and Europe and other developed economies.

As companies want to hedge their supply risks a little bit more than they did, realizing that putting all their eggs in one basket, so to speak, in terms of, you know, ordering everything from the Far East while it works most of the time, sometimes it doesn't when it doesn't. Then you got, you know, you've got a big problem.

Andrew 11:38

What are your thoughts on population decrease and stagnation, especially in and advanced economies? And how that plays a role in the future of inflation?

Bill 11:48

It would certainly lead to fewer people going after the same number of jobs or the same or even possibly growing number of jobs. But yeah, less competition, less workers out there. So they would be able to pick and choose their jobs more easily and probably demand higher wages. Now, as population declines, on the other hand, you're going to have less consumer demand for a whole host of things that consumers buy because there are going to be less buyers. Now, the United States has always been able to get around that through immigration. And, of course, that that goes in cycles depending on which way the political winds are blowing. But that's one way to get around that particular issue.

You know, it's interesting. You know, China had the one child policy going back 30 or 40 years now, and they suddenly realize they've got a demographic problem now because their population is going to start actually shrinking if it hasn't already.

Even though a number of years ago they upped the one child policy to two children and then very recently up to three. But because it's very expensive to have children. Population hasn't generally embraced that. So they're still at reproducing at below replacement level, as a demographers call it.

That's going to be an interesting development, as you know, in future decades, especially as you have fewer working age people and more retirees that have to be supported by those working age people in terms of, you know, pensions and Social Security and medical payments.

Those are issues that China, as well as the more developed world in Europe and North America are going to be looking at.

Andrew 13:36

We've talked a lot about different mechanisms and different pressures that add to the inflation environment. But I've also heard something about an “everything bubble” - the fear that all assets, not just houses, not just stocks, but even things like the U.S. Treasuries, which are supposed to be risk free, might be overvalued. Could you just talk a little bit about what that is and how that would play out?

Bill 14:00

Honestly, I have a hard time getting my head around the idea that everything all at the same time can be overvalued because people in institutions have assets to invest or, you know, they have their dollars or pounds or euros or whatever to invest.

You've got to put them somewhere. And it's a choice of how you allocate those investable funds if you're investing in one asset class. And by necessity, those funds are not being invested in some other asset class. So I'm not sure how it's possible for all assets to be overvalued.

I mean, I've heard of that, but I'm not quite sure that I buy that.

Andrew 14:43

Well, I guess that's good to know.

Bill 14:47

And I'm not an economist. I mean, it might be I'm just too simple, but I'm not sure how that would work.

Andrew 14:51

Did you have any closing thoughts, Bill?

Bill 14:53

No, not really. Other than I don't think we're looking at a new era of long term inflation. That's not something that I see in the cards.

Andrew 15:06

Thank you for being a guest, Bill.

Bill 15:07

My pleasure. Anytime.

Andrew 15:09

We appreciate all of our listeners and there's a lot more information that we didn't cover. So please send questions to info@JGUA.com and follow us on social media or visit our website for additional content.

Until next time, stay smart, everyone.