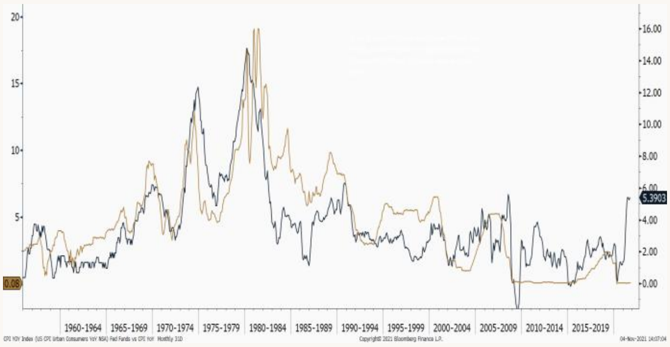
"that's what it's supposed to cost according to the Fed"

I'm a worrier by nature, constantly looking under rocks for things that can go wrong. However, if I take a step back, I see a lot to be positive about, consumers are spending, household wealth is strong, corporate earnings are booming and stock markets are at new highs. Nevertheless, here I go. Everyone is talking about inflation. Whether it's personal, like the cost of tonight's dinner; or macro-economic such that it affects government and central bank policies it's hard to have a conversation these days without the topic of increasing prices being raised. Despite the recent stunning escalation in certain products such as lumber, gasoline and even steak, it is important to remember that inflation has become a government sanctioned policy. Probably prodded by the fear of deflation and led by the Federal Reserve, it has become gospel for central banks to maintain 2% as an appropriate target for inflation. Recently, they have also acknowledged that CPI will exceed 2% occasionally in order to average 2% over time. While that number sounds relatively benign, over the course of every ten years that rate will cause prices to rise 22%. So, if you had paid $30,000 for a car in 2001 and you are looking for a similar model today and it lists at $45,000, don't be dismayed, that's what it's supposed to cost according to the Fed. At any rate no longer do the powers that be see inflation as an evil monster to be fought at all costs, although it is not so long ago that was the case. While the Consumer Price Index can be questioned as an accurate measurement of the cost of living, the recent report for September showed overall prices up 5.4% over the past year in the US. That is certainly not a pleasant number, but it was led higher by a significant rise in energy prices (gasoline 42%, fuel oil 42% and natural gas for utility companies 20%). Those type of increases are unlikely to continue longer term so we should see some amelioration as we move forward. That won't necessarily make our day-to-day budgeting any easier, but the math will cause the CPI to look more palatable when we read future reports. This in no way suggests there is no cause for concern, but rather that headline numbers can be misleading, both on the upside and downside.

Those of us who experienced the excitement that was economics 101, remember well the difference between cost-push and demand-pull inflation. Over the past decade the limited inflation we have observed has been in the latter category as an improving economy, easy monetary policy and government spending have been a support for prices. Currently, however, we're seeing more and more of the cost-push variety as supply chain problems, wage increases, and the cost of product inputs have become larger factors in price increases. As I have often mentioned in these letters, I am much more fearful of costs (particularly wages) as a longer-term inflation concern; demand tends to be a cyclical phenomenon rising and falling with the economy, whereas cost increases can become rather quickly embedded in prices. I have not thrown in the towel on the current surge in inflation being transitory, but I must confess as labour shortages and higher wages become more widespread my resolve is weakening. Where are we, how did we get here and where are we headed are the questions everyone is trying to answer. The effects of the

Figure 1:
CPI vs Fed Funds Rate
Will the FED be able to tolerate higher inflation, or will rising CPI force the FED to tighten?



Source: Bloomberg, Mulvihill Capital

pandemic have made answers even more difficult to find, given that the old theories of wage earner mood and reaction are proving to no longer be relevant. Old timers who think we will return to a pre-pandemic world where workers will return to their jobs as they need money are missing the point (confession - I was one of them). Surveys are indicating that wages aren't uppermost in people's minds; while still obviously important, work/life balance and being valued as an employee have become more important for many. In addition, quitting your job isn't as risky as it used to be given todays environment where job openings are plentiful. The Atlanta Fed recently reported that so called “quitters” on average received a 5.4% increase in pay at their new jobs. As always, the answer to the labour question will be somewhere in the middle. Just because you're tired of flipping burgers doesn't mean you can go to work at Google tomorrow, but to ignore this new mindset and its impact on society and financial markets would be a mistake.

The cure for high prices is high prices. It seems like everyone is dragging out this old axiom, and rightfully so. High prices cause consumers to buy less and suppliers to produce more and the market finds a new equilibrium. As long as the demand destruction or cost escalation aren't severe enough to put the economy into recession, growth will survive.

I don't know how many people saw President Biden on CNN with Anderson Cooper doing one of those so called “town hall” meetings but I found it quite concerning. The editorial board of the Wall Street Journal thought so as well, and felt the need to print an opinion piece about the President's performance. It read in part; “One big problem is that Mr. Biden often doesn't seem to know what he's talking about.” It cited confusing, or in fact incorrect, answers to questions about energy, the supply chain and labour shortages. Most worrisome, he suggested the U.S. would use the military to defend Taiwan if “China attacked”. The White House was quick to clarify U.S. foreign policy does not include such a strong commitment to go to war, which makes one wonder how Chinese leadership will interpret such mixed messages. The concern over the President's handling of the Afghanistan withdrawal, the infrastructure spending legislation, divisiveness within his own party, vaccine mandates, etc. is reflected in a sharp drop in his approval ratings. There is time to repair all that, but in the meantime, I'm seeing more people wondering if a Trump comeback is actually a potential reality. Oh dear!

There are many issues I don't have the time or space to address today but here are some of them in brief:

- “Just in time” inventory management was a boon to margins for decades but now it's a major cause of supply chain problems.
- The debt ceiling debate has not been resolved, merely delayed.
- Unions are in the news for the first time in years and are flexing their new found muscle.
- The possibility (slim I admit) that the U.S. government would issue a platinum coin worth $1 Trillion to provide for more fiscal spending
- Biden’s nominee for Comptroller of the Currency Saule Omarova is quoted as saying she wants to “end banking as we know it”.
- An expansion in nuclear power plants is being proposed to combat the energy crisis

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