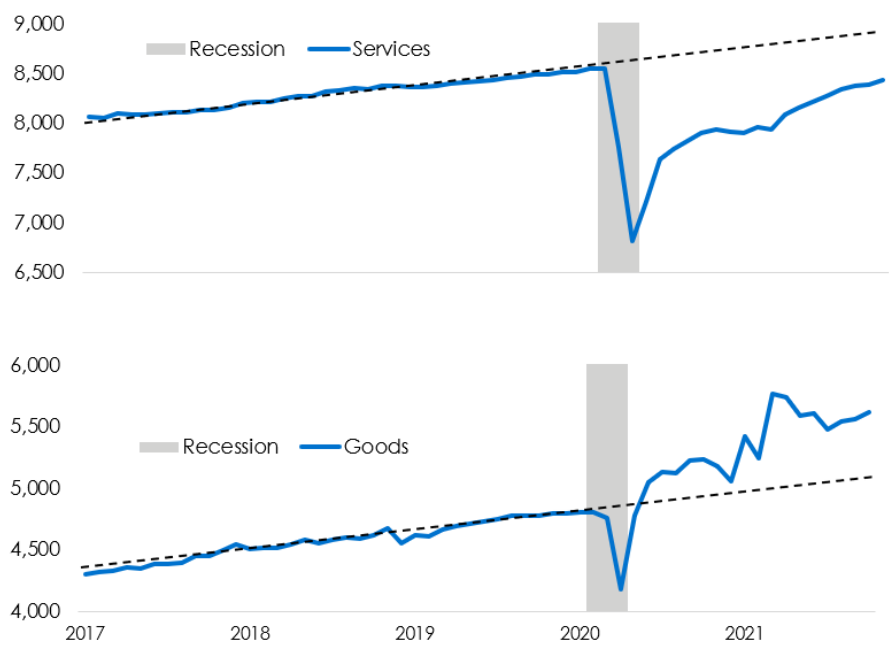
Double the Cause, Twice the Problem?

Any Economics 101 class spends a great deal of time on the relationship between supply and demand, and how that relationship impacts prices. Many economists are attempting to explain the current inflation situation in America as a result of either increased demand – blaming too much stimulus being provided by Washington and the Federal Reserve – or limited supply – citing pandemic-related bottlenecks and malfunctioning supply chains.

In reality, neither demand nor supply can be blamed as the sole culprit. Rather, this inflation was made possible only by strong demand interacting with restricted supply. The last time the US saw inflation like this was in the period following World War II. As noted by the President's Council of Economic Advisors, pent up demand coincided with war-induced shortages in the aftermath of the war. This dual causation makes solving the problem doubly difficult: fixing the supply issues is largely beyond the means of the White House and Fed, but treating the problem as one of only demand could damage the economy.

Many economists note the boost to inflation is concentrated in goods. That's because the pandemic diverted consumer spending away from services such as restaurant meals toward goods such as groceries. This increase in demand led to more money – in some cases, a lot more money given the federal stimulus checks – chasing the same amount of goods.

Americans: Fewer Services, More Stuff
Real Personal Consumption Expenditures, $ Billions



Source: Bureau of Economic Analysis

For the US, total real personal consumption expenditures have recovered to pre-pandemic levels, but as you can see in the chart at right, the mix of spending has changed. With many Americans still hesitant to venture out of the house, spending on services is still below pre-pandemic trends while spending on goods has spiked well above trend.

This demand-driven inflation is particularly acute in the housing market. Since Covid hit, many

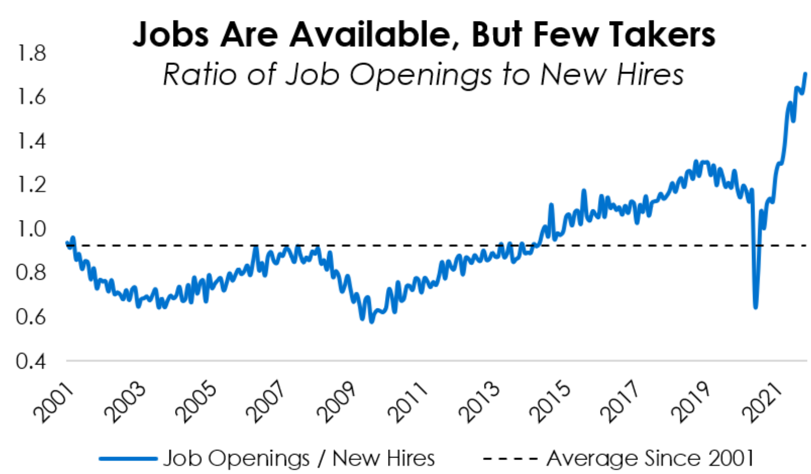
Americans have viewed the pandemic as a reason to relocate to more suburban areas. This demand for a relatively fixed supply of homes has driven prices up significantly in many areas; nationwide, house prices are up 14% according to Freddie Mac. Of course, record-low mortgage rates have contributed to this rise, but the Federal Reserve Bank of New York asserts that cheap money is only responsible for about a third of the appreciation.

What about the supply side? Global developments that pushed up oil and gas prices explain some of the rise in inflation; core inflation, which excludes energy and food, was 4.6% in October. Core inflation has been heavily influenced by supply chain bottlenecks (such as those for oceangoing freight) and for shortages of inputs, such as semiconductors for automobiles.

Ordinarily, auto manufacturers can meet increased demand with ease by tweaking production volumes at their facilities. But this year, however, supply has largely been limited because of a lack of semiconductor chips. Images of new cars, ready to go except for semiconductor chips, have become symbolic of these supply shortages.

Whether it is due to covid-related production delays or logistical bottlenecks, the lack of semiconductors has limited production such that the demand for new cars and trucks far outstrips supply. The result: a huge jump in prices that, according to IHS Markit, explains roughly a third of the rise in the Federal Reserve's preferred core inflation measure.

The labor market is being impacted by both supply and demand forces. As Americans trend towards a more "normal" daily life, businesses are reopening. With stimulus checks and stock market gains having many consumers feeling flush with cash and ready to spend. Restless consumers are venturing out again, leaving service-oriented businesses in need of more help. According to the Labor Department's most recent survey of job openings and turnover, there were 11 million job openings at the end of October (these government figures lag behind the more closely watched monthly jobs report and private sector data by a month).



Source: US Bureau of Labor Statistics, YCAG Research

This increased demand for workers has not been matched by increased supply, especially of lower-paid workers on which many service industries depend. In the hotel and restaurant industry, even though demand and employment have yet to return to pre-pandemic levels, a severe shortage of workers has caused job vacancies to double from their pre-pandemic level. As a result of this increased demand and limited supply, both wages and prices in the sector are rising briskly.

The combination of "supply" and "demand" factors behind the current inflation means that the solution could be complicated. In a perfect world, supply chain bottlenecks will correct themselves as time passes. Rising semiconductor output will eventually cure the shortage of cars. A receding virus and less generous federal relief should coax some workers to fill job vacancies. Households may find that they don't need any more "stuff", cooling demand for goods relative to services.

Such a natural process could take a while, and there is the risk that this inflation could become self-perpetuating if a "wage / price spiral" kicks in (rising wages lead to greater demand which leads to higher prices, which leads to rising wages, and so on). Two other factors could prolong this inflationary environment: a reversal of globalization to bring supply chains "back home" at greater cost but increased security, and Baby Boomers evolving from a generation of savers to a generation of spenders.

If this environment persists, the most practical solution to this unusual brand of inflation would be one investors are painfully familiar with – tighter monetary conditions (via rising interest rates) and perhaps even a recession.

These inflationary pressures have continued to place heightened scrutiny on the Federal Reserve. Markets have continued to press higher, stretching valuations further and in our view creating some risk for moderating future returns. We continue to believe that the macroeconomic picture is one of robust – yet moderating – growth and inflation. As such, we will continue to focus on "value" and "quality" as this economic cycle matures. Throughout this year, we have trimmed "riskier" assets in client portfolios (stocks and alternatives) in order to maintain a relative balance with lower volatility securities, like fixed income and hedges against market volatility.

We have become more neutrally positioned across equity classes, though we continue to slightly favor smaller companies in the US as well as "value" and "quality" within the large-cap domestic market.

In the fixed income area, we remain focused on more credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates.

Within the alternative market segments, we have maintained an emphasis on "real assets" (think commodities and real estate) as a hedge against the potential for higher inflation. We have also maintained our exposure to the diversified alternative sector as a hedge against potential market volatility.