# Hyping Inflation

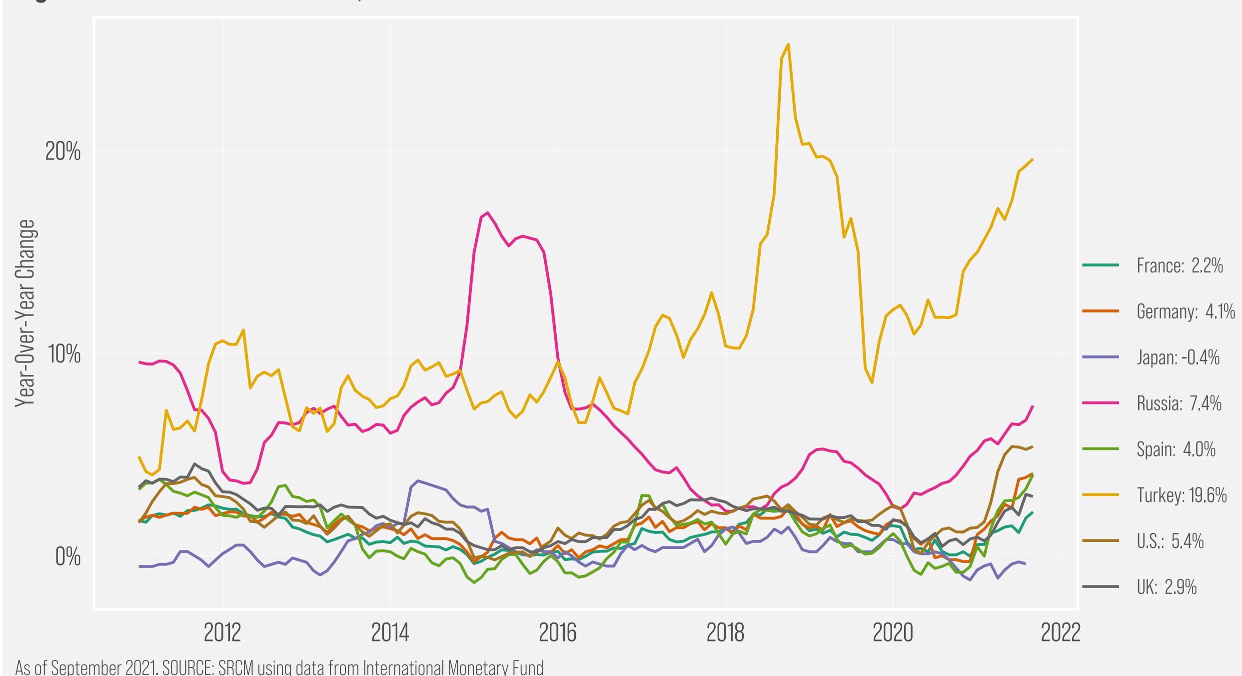
COMMENTARY
November 2021

When something new comes along in Finance, it can be fun to watch market participants line up to present themselves as experts, quick to provide "insight" into what the future will hold. Over the past few weeks, voluminous ink has been spilt over the confluence of rising inflation and nascent digital currencies, both of which remain conceptually new for the related industries. Within the intersection of the Venn diagram representing the two conversations is the suspected ability of digital currencies to provide protection against inflation. While there may be some semblance of protection against dollar-based inflation offered by the inflation of digital assets, that's likely to be proved a mirage. Indeed, the price action in Bitcoin, alone, over the summer months suggests as much. But such data likely will prove weakly influential for crypto-apostles. And while our takes on digital currencies are not entirely negative, more comprehensive (and more nuanced), we find the weakness of the "protects against inflation" argument is another reminder that investors should seek always the best tool for specific tasks within the portfolio.

## Curious Extrapolation

Jack Dorsey was not entirely incorrect when he tweeted, "Hyperinflation is going to change everything. It's happening." Depending on your definition, there are a few countries in the world where, unfortunately, prices are rising at a terribly rapid pace. And, if not exactly "everything", rapid price increases are likely at least to greatly change consumer behaviors in those places where high inflation or hyperinflation exists. But a quick review of latest statistics from the International Monetary Fund shows that only three countries have latest-reported data that include year-over-year inflation rates above 50%: Sudan (702% as of March 2021), Suriname (58.9% as of July 2021) and Argentina (51.4% as of August 2021). It made sense, then, that Mr. Dorsey, CEO of social media platform Twitter and digital payments platform Square, followed that presumptive tweet with, "It will happen in the US soon, and so the world." Looking at only those countries with data through September, the U.S. is ranked 19th highest of 60, at 5.4%, with Turkey the highest at 19.6%. Inflation is relatively high in the States, for sure, but far from highest and nowhere near hyper.

**Figure 1: Consumer Price Index, All items**




As of September 2021. SOURCE: SRCM using data from International Monetary Fund

## Hyperpromotion

Need not really read between any lines, except those retweets from cryptobulls echoing dire warnings and praising Mr. Dorsey for his foresight and bravery and counter-tweets from what we'll broadly term their thematic opposites, to see that the tweet likely was in large part driven by the grander desire to frame cryptocurrencies as the saviors to all that's wrong with modern finance (perhaps with the creation of exchange-traded funds that facilitate indirect access to cryptocurrencies being high on that list). Furthering the notion that the dollar, the euro, the yen and all other fiat currencies are dead, those in favor of a crypto-takeover have added to their promotional lists the inflation-protective natures of Bitcoin and other cryptocurrencies, likening the cohort to digital gold.

We suppose many may have missed our recent commentary on gold and inflation. The take of that commentary was that, though gold remains a prized store of value, it offers little in the way of reliable protection from inflation. We might offer a similar critique of Bitcoin and the rest. While it's difficult, one might at least be able to formulate a basis for some cryptocurrencies to prove a store of value. That presumption rests on the belief that there always will be a taker (merchant or speculator) for any seller of the coin. With no taker, the value is zero. That's similarly true for the U.S. dollar. Though the dollar has the backing of the "full faith and credit" of the U.S. government, if you can find no one who will accept it in exchange for product or service, it's value, too, is zero.

And that's the fear of hyperinflation. That the dollar sinks in value to such an extent that it becomes close to worthless. Think the Papiermark in the Weimar Republic, where a loaf of bread demanded the proverbial wheelbarrow of paper. As for protection against inflation, fans are quick to point out that the dollar price of a Bitcoin soared 340% in the year ended October 31, while the dollar lost more than 5% of its value on account of inflation. What you might not learn is that Bitcoin also lost more than 50% of its value in dollar terms in the middle of that 1-year run before rebounding to a higher peak. We'd have a tough time suggesting Bitcoin was protective against inflation amidst the potential for such losses. Further, we found 41 stocks held in the iShares Russell 3000 ETF (IWV) that have returned more than 340% percent over the twelve months through October end, seven that doubled that return, four that tripled it, two that quadrupled it and one that turned in more than five-times Bitcoin's 1-year gain. We'd similarly suggest that not one of them is an inflation hedge on its own. Even the whole of the U.S. stock market, up more than 44% in the twelve months ended October, can be seen as having provided a balm against inflation. But we should be careful not to characterize that salve as protection.

And that's because offsetting the effects of inflation is not the same as directly protecting against it, given that the offset was not—or even close to—guaranteed. Echoing the sentiment of our commentary on gold, an unintended (read: unreliable) benefit in hindsight is not the same as a guaranteed benefit in advance. Given the relatively far more efficient means to include inflation protection in portfolios now available, we think folks truly worried about potential inflation may wish to seek more direct means to safeguard against its impact.

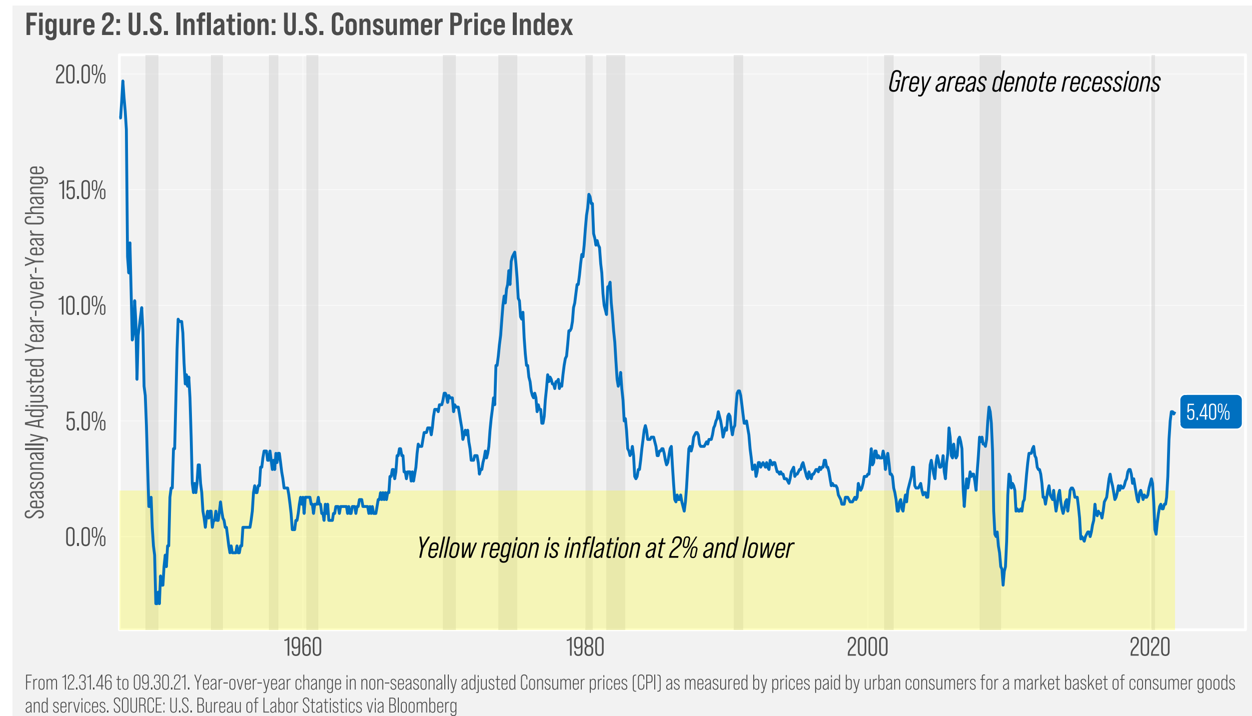
## Inflation There Is

And that impact has been relatively large over the past year. We have not seen the domestic price level change this much since a brief period in the summer of 2008 and before that a longer stint in 1990-91. On the flip side, inflation dipped below latest readings only for a few months near the end of 1976 during what was the last period of high inflation in the U.S. that lasted from April 1973 to October 1982. In between then and now inflation has been relatively benign in the States, as we show in the Figure 2 chart of the Consumer Price Index (CPI).

In fact, the Federal Reserve has fought hard since the Great Recession to lift inflation to its target of 2% (The Fed prefers to use a different inflation metric than we show in Figure 2, the Personal Consumption Expenditures Price Index, which tends to show different values than, but trends similar to CPI), with investors at times fretting the Fed's ability to protect against deflation (falling prices). How quickly fears have turned about. While not without reason, we

think there remain more defensible rationale to believe that present levels of inflation were ignited by the pandemic and have been sustained by a combination of its aftereffects.

**Figure 2: U.S. Inflation: U.S. Consumer Price Index**




From 12.31.46 to 09.30.21. Year-over-year change in non-seasonally adjusted Consumer prices (CPI) as measured by prices paid by urban consumers for a market basket of consumer goods and services. SOURCE: U.S. Bureau of Labor Statistics via Bloomberg

## Stuck at the Port

Included in that rationale is the monetary policy stance of the U.S. Federal Reserve. In comments from its November meeting, the Fed offered a still reasonably optimistic view that inflation would ease once the effects of the COVID pandemic subside: "Inflation is elevated, largely reflecting factors that are expected to be transitory," officials said in the statement. "Supply and demand imbalances related to the pandemic and the reopening of the economy have contributed to sizable price increases in some sectors."

We can see the effects of these imbalances very clearly off most ports on the east and west coasts. Labor shortages borne of a host of observable and arguable reasons contribute to and exacerbate supply chain challenges. Weather, too, has played a role. A Brazilian freeze, a Canadian drought and ensuring wildfires, Chinese floods and others have both crimped the supply of raw materials and hampered distribution of ingredients and finished products alike.

After the release of the Fed statement, folks focused on the difference in language this month, versus the September note. The latest version softened, "largely reflecting transitory factors," to, "largely reflecting factors that are expected to be transitory." Readers will note that we do this sort of thing often. Since we can guarantee very few things in investments, we tend to soften any phrasing that could be read as predictive or promissory. So, while "transitory factors" could be read as, "these, too, shall pass," the new phrasing of, "expected to be transitory," reiterates their take on the matter, while allowing for some room for readers to note a level of caution as to the duration of (or even the inevitability of) the transit.

## What to Do?

Made pretty clear in comments afterward, monetary policy can't really alter supply chain dynamics, such that a steadier course from the Fed should continue to provide the support the broader economy needs to sort out the kinks. Inflation's ebb, thus, remains more of a waiting game we're guessing most hope doesn't last too much longer. For sure, sustained

higher inflation (e.g., still 4%-5% a year from now) would create challenges for the Fed with regard to monetary policy. The pressure might be there to raise rates in order to dampen inflation, but balancing the effects of less-generous policy on growth, versus inflation might require a nuance in touch that the Fed may not have…or that may not be possible to have.

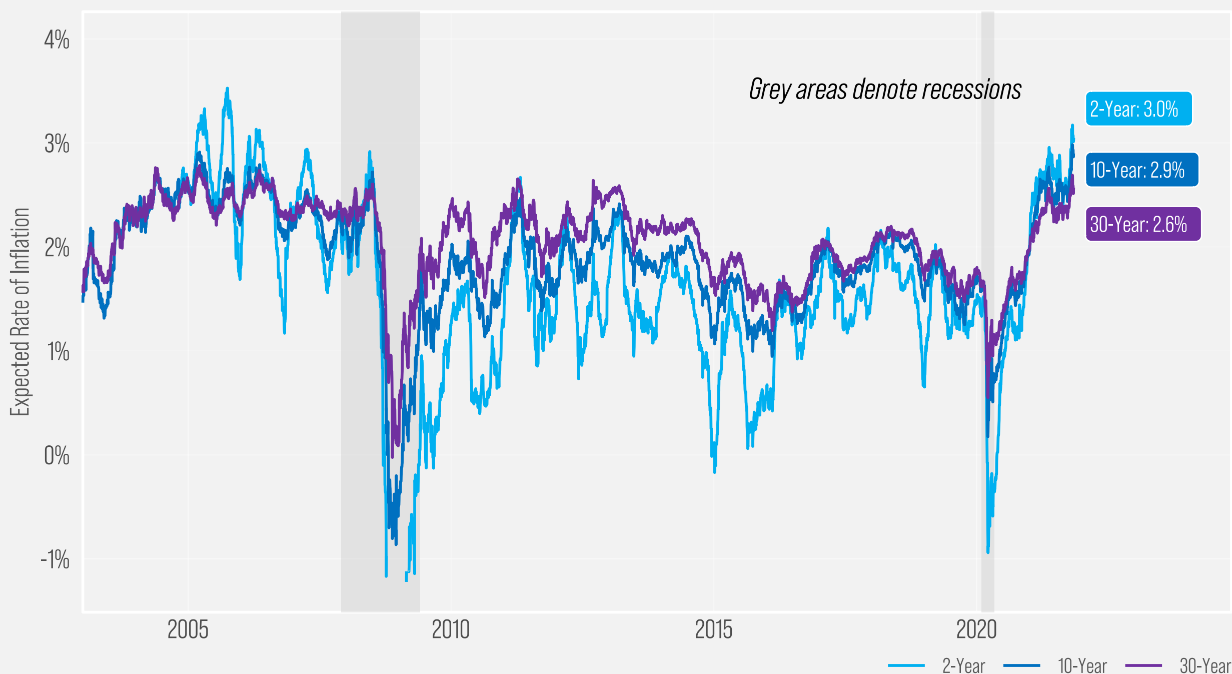
## Whom to Believe?

To aid those conversations, we still think the market may provide a better gauge of what's likely to happen to inflation over time than takes provided by certain individuals here and there, even if those individuals happen to be in charge of the world's most prominent digital soap box or leaders of the world's most powerful central bank. In the U.S. Treasury market, one can find two otherwise very similar risk-free bonds, the only differences between them being that, at maturity, one pays the greater of its original face value or that value adjusted for inflation. The differences between the yields between those two bonds at any time can therefore be seen as reflective of expectations for inflation from now through maturity.

This difference in yield often is referred to as the "breakeven" rate, as one would be mostly indifferent to buying one or the other if the difference in yield equated to the buyer's expectations for inflation. Looking at those values for 2-, 5- and 10-year nominal and inflation-protected bonds, we see that expectations are well higher than the years prior to the pandemic's outset and remain on the rise. But the levels still are nowhere near what one might consider high or hyper.

The upshot from an investment standpoint, then, is that we continue to believe it's prudent to be positioned for unexpectedly higher inflation in portfolios that might need to be. That is, those with more stringent income needs, short-term time horizons, less-aggressive tolerances for market risk and others may wish to consider whether additional safeguards against longer-term and/or more onerous inflation may be warranted.

**Figure 3: U.S. Inflation Expectations from TIPS Breakevens**




From 01.01.03 to 11.04.21. Y-axis is trimmed for clarity. Full details available upon request. Breakeven rates are U.S. breakeven inflation rates. They are calculated by subtracting the real yield of the inflation-linked maturity curve from the yield of the closest nominal Treasury maturity. The result is the implied inflation rate for the term of the stated maturity. SOURCE: SRCM using data from Bloomberg

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Publication: 11.05.21 2021-SRCM-78