

## Special Report - Inflation

I'm not too fond of politics. I prefer capitalism and the profit motive as the decision-making is purer: does the product or service meet a need, and can I make a profit? I force myself to watch the political programs on Sunday mornings from 6 am to 12 pm. I focus on fiscal policies (taxes and spending). On a recent Sunday, every political show talked about inflation. They had economists, politicians on the program, and they tried to explain and provide solutions to the problem in 5-minute interviews. Unfortunately, today's inflation is more complicated than a 5-minute interview.

### Why Inflation and Interest Rates are Important to the Economy and Markets?

Quite simply, when interest rates are low, the economy does better because financing business expansion and buying big-ticket items for consumers is less costly. Also, interest rates and inflation are important variables in determining most asset valuations, especially if the asset has cash flows. In a low-interest rate and inflation outlook, cash flows have more value in a low inflation environment.

Inflation can destroy the standard of living for consumers. It's also bad for the economy, business and investments. Higher interest rates can slow down the economy because they cost companies more money to borrow for expansion and significant capital spending projects. Less spending by businesses slows the economy. Also, businesses tend to sell fewer big-ticket items because the borrowing costs increase the total cost. For investors, cash flows mean less in an inflationary environment. A dollar is worth more today and much less in the future.

I wrote an article about how inflation and especially interest are key to stock valuations. If you would like a copy of the article, you can email me at [danhassey@yahoo.com](mailto:danhassey@yahoo.com). The article includes important valuation models where interest rates are a key variable.

Example of what can happen if inflation is sustained:

The P/E rule of 20:

In a perfect world, the P/E should be 20.

Historically, investors discount a perfect P/E with inflation.

The historical average of inflation is 3, so a 17 P/E is the top of the historical range.

For blue-chip companies, the average earnings growth rate is about 7%, and for blue-chip companies, investors have been willing to pay about two times the growth rate giving us a P/E of 14.

The difference between 14 and 17 is the perceived risk (recession, international tensions/wars, oil supply disruptions, climate risks...) of investors

Here is a long-term chart for the P/E:



Today, the P/E ratio for the S & P is about 22, and the value is currently at about the 4700 level. If inflation remains at 5% a year from now, the P/E could contract to 15, and the S & P would drop to about 3300 ( 15 P/E times 220 earnings estimate). This is why inflation and interest rates are critical to the stock market and stock valuations. We are early in the cycle so prices could grow into fair value.

### Inflation: Historical and Current Inflation Trends

Below is a chart that shows inflation trends for about the last dozen years:



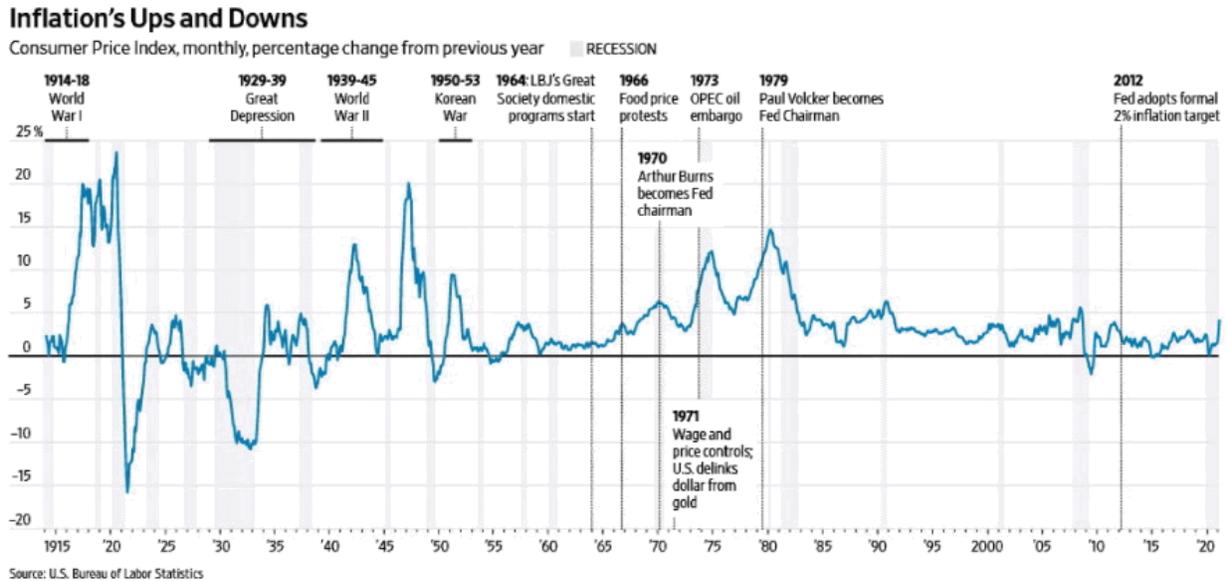
Let's review the chart:

- For the last dozen years, inflation has essentially been below 2%.
- Inflation almost turned into deflation in 2015 and 2020. The Fed is scared of deflation because it's hard to reverse.

- Inflation has spiked this year. The Fed has more experience dealing with high inflation. Raising interest rates tends to do the trick. See Federal Reserve section below.

As I wrote above, higher interest rates tend to slow down the economy and inflationary pressures.

Below is a long-term chart to put today's inflation in perspective:



Let's review the chart:

- Notice that inflation was much more volatile in the first half of the chart, with spikes in inflation and bouts of deflation.
- The shaded areas are recessions. There were more recessions in the first half of the chart.
- In the 1970s, an Arab oil embargo and the Iranian Revolution caused oil prices and inflation to spike. The cost of living went up so much that it required two people in a household to work to maintain the same standard of living.
- The Fed got better at managing inflation and the economy by using monetary policy: raising/lowering interest rates, raising/lowering reserves at banks/brokerage firms, increasing its balance sheet to provide liquidity to the U.S. financial system....

### **Causes of Current Inflationary Trends**

The choice between inflation or a deep recession

There are basically two types of inflation: demand-pull (too many dollars chasing too few goods) and cost-push (rising costs). Currently, we are experiencing both. What caused both are rooted in the pandemic.

Again, current inflationary trends have their roots in the pandemic, and therefore there is a global inflation problem.

## Covid

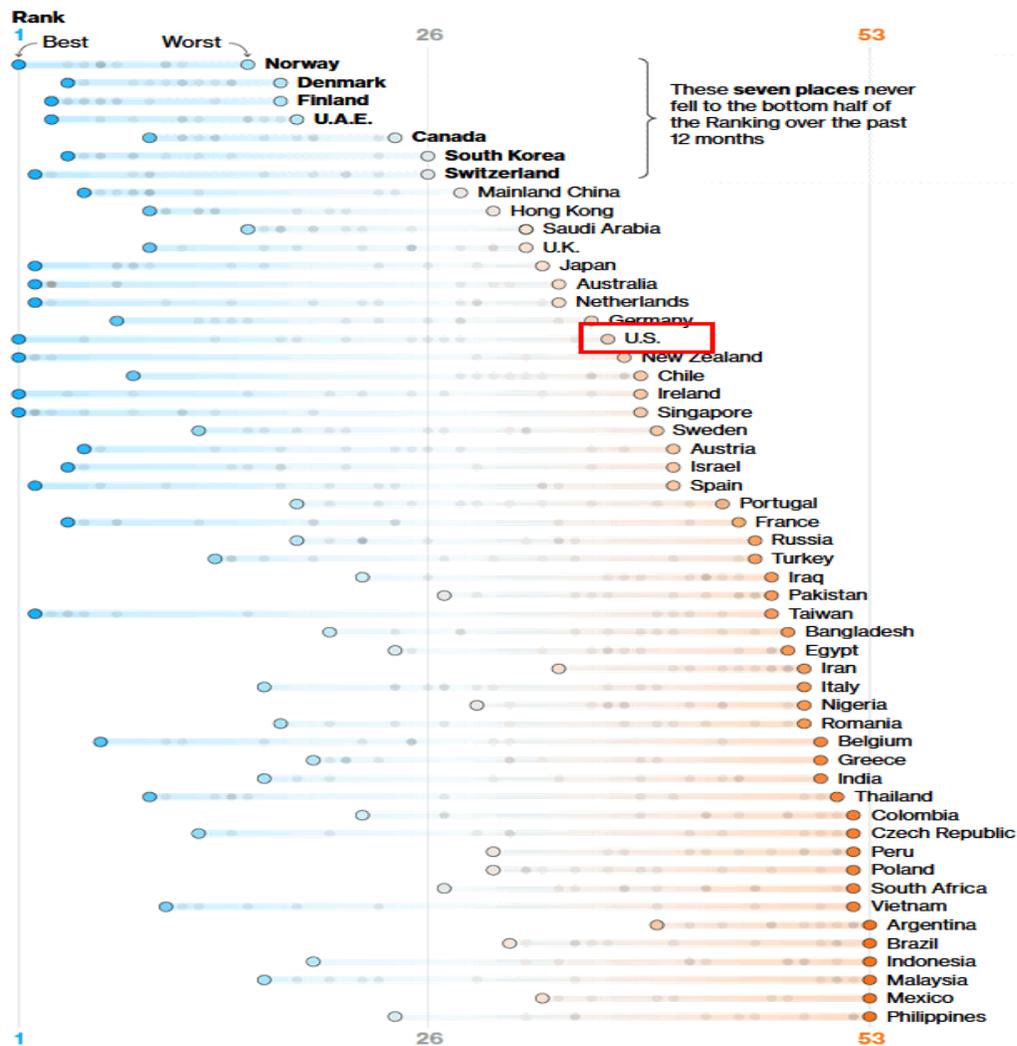
We are almost two years into the covid pandemic. The U.S. is in better shape than most of the world. We are close to 70% herd immunity if we count individuals who got infected.

Covid remains a significant risk for the global economy and inflation. Europe covid infections are surging again. Poor countries don't have enough money for vaccines and don't have the infrastructure to vaccinate their citizens. Here is a list of the countries that are doing the best and worst:

## Bloomberg

### Pandemic MVPs

Only seven places never fell into the bottom half of the Ranking



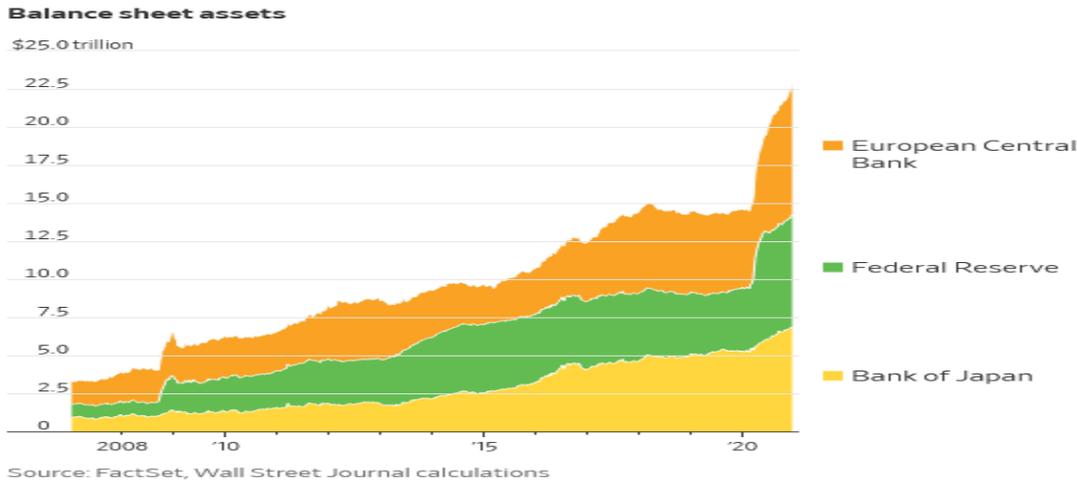
Source: Bloomberg's Covid Resilience Ranking

There are close to 200 countries in the world, so most countries aren't listed. Only about 1% of the population of poor countries are vaccinated.

Many health experts believe we are going to have to learn to live with covid. The worst-case scenario is that the virus could continue to mutate into more insidious forms of covid in countries with low vaccination rates. Because of global mobility, the virus mutations could spread globally quickly.

Covid caused lockdowns around the world, and this included many businesses.

First, global central banks provided trillions of dollars of liquidity to help the global economy:



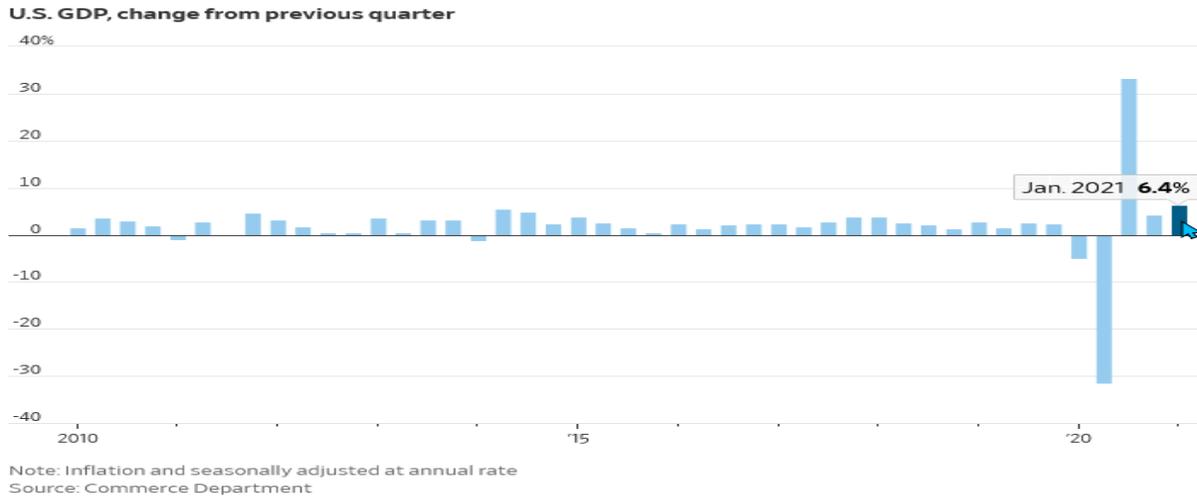
In the U.S., a credit crunch usually happens during a recession. The Fed lowering rates, adding liquidity by buying government paper and some corporate bonds minimized a credit crunch. Again, all this liquidity and lower interest rates help stabilize the U.S. and global financial system.

Lawmakers also provided lots of support, aid, and lately, stimulus to help workers and small businesses to get to the other side of the pandemic:



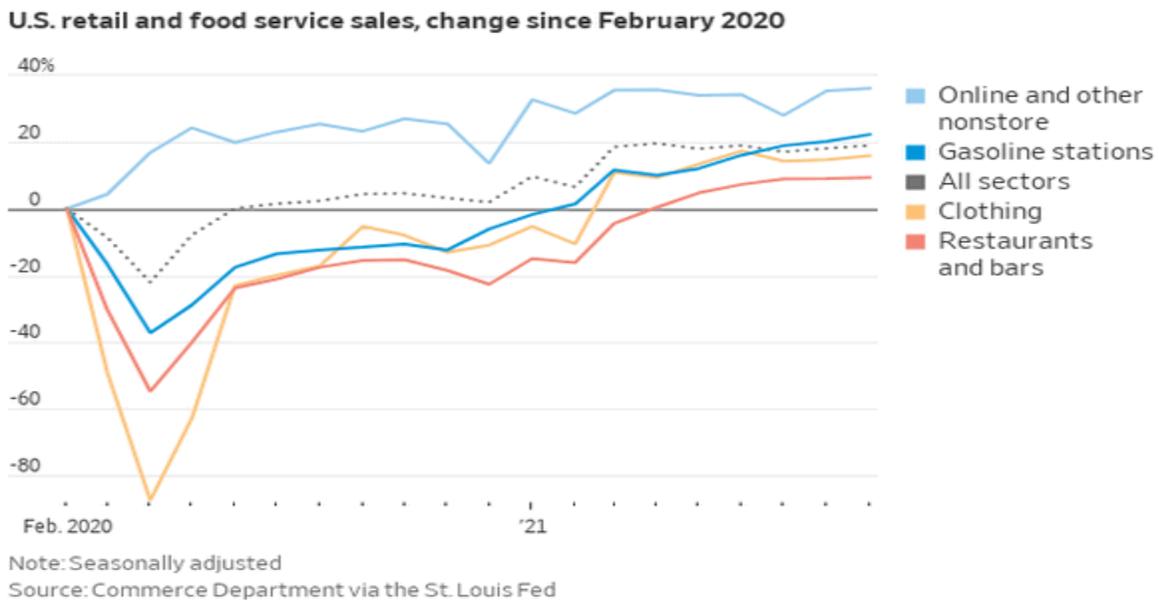
About \$5 trillion has been provided to workers, small businesses, and other entities to help them get through the pandemic.

All the liquidity and financial support did help the U.S. economy. We did have a recession last year, but it was the shortest on record. According to the National Bureau of Economic Research (the NBER is the official organization that tells us when a recession starts and ends), the covid recession started in February and ended in April. Below is a chart for GDP:

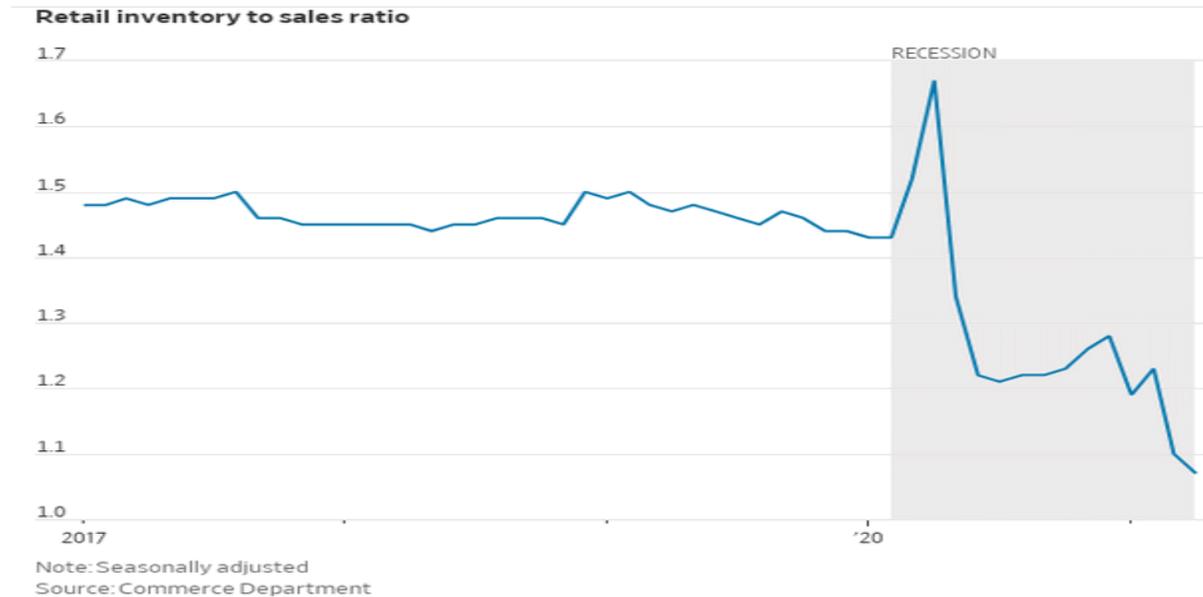


GDP crashed at the beginning of last year. Thanks to all the liquidity and support, and aid, the recession was short-lived. Without the Fed liquidity and aid/support/stimulus from lawmakers, the recession could have been much, much worse.

Demand, retail sales have increased to above pre-pandemic levels:



Just-in-time inventories are at very low levels:



The liquidity and aid/stimulus have caused strong demand, but the global economy was not ready to meet this demand.

Here is what consumers, businesses need to consider, what would be worse, a severe recession or inflation that the Fed can probably handle? There is a chance that inflation would have occurred after a deep recession because of the pandemic. If there was not covid, I seriously doubt we would have had all this liquidity and aid.

Other causes of inflation include:

- Labor shortages and labor costs are rising
- Supply chain bottlenecks
- Oil prices rising

Below I analyze labor shortages and oil/energy. Both could continue to be inflationary problems. Supply chain bottlenecks are probably “transitory.”

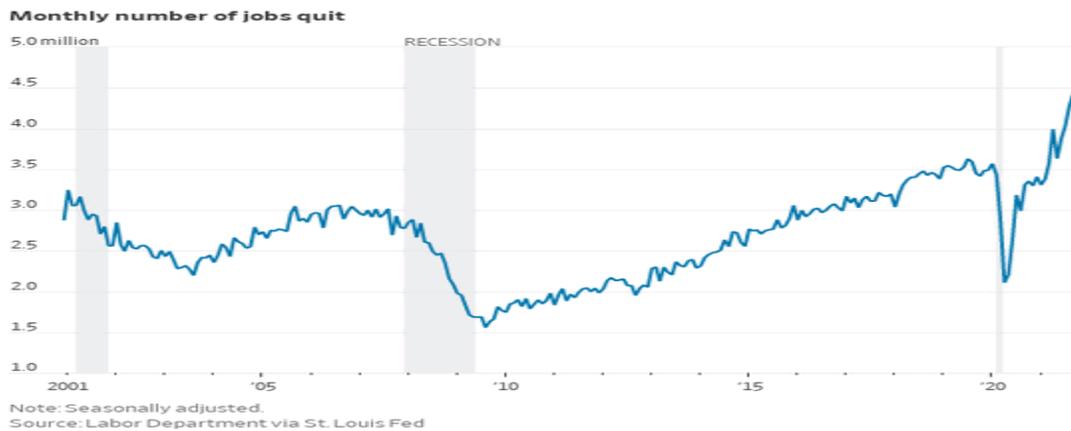
### **Labor**

Labor shortages and rising labor costs contribute to inflation as labor is the biggest expense for most businesses.

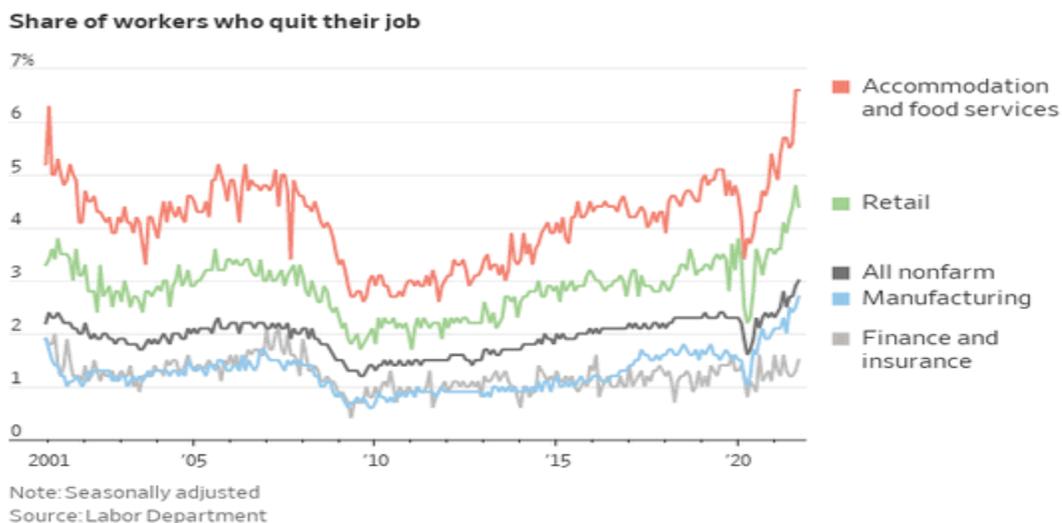
Let's look at some labor trends.

## Quit Rates, "The Great Resignation"

Workers are quitting their jobs at record numbers:



Over 4 million workers quit their jobs in September. Below are the industries that are losing the most workers:



First, the industries with the highest quit rates also had the highest layoffs at the start of the pandemic. These industries also have the lowest pay, the least benefits, and job security.

Some analysts suggest the reason for the high quit rates is money. Workers have choices now for better pay, bonuses, working conditions, and better benefits. Other analysts are saying that during the pandemic, workers were able to reassess their employment future and are not returning to their former jobs or are quitting.

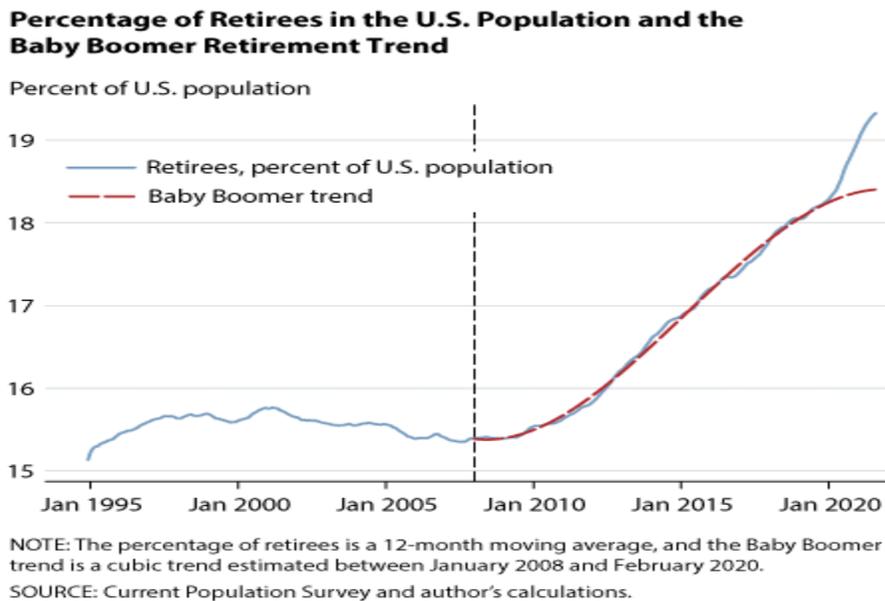
Companies have been able to have historic profits because of cost-cutting, restructuring, and better management. Companies have been automating where they can, merging with other companies and cutting staff.

Below is a chart that shows the share of labor compensation to the national income:



Employee compensation as a share of national income will probably reverse due to labor shortages. Companies will have to continue raising wages and provide other incentives and benefits to attract and retain employees. This is squeezing corporate profit margins and is causing a selloff in some stocks.

Baby boomers have been retiring, leaving the workforce for about a dozen years:



The pandemic accelerated the trend of retirements.

Below is a very interesting chart that sheds some light on the long-term and future trends for labor force participation:

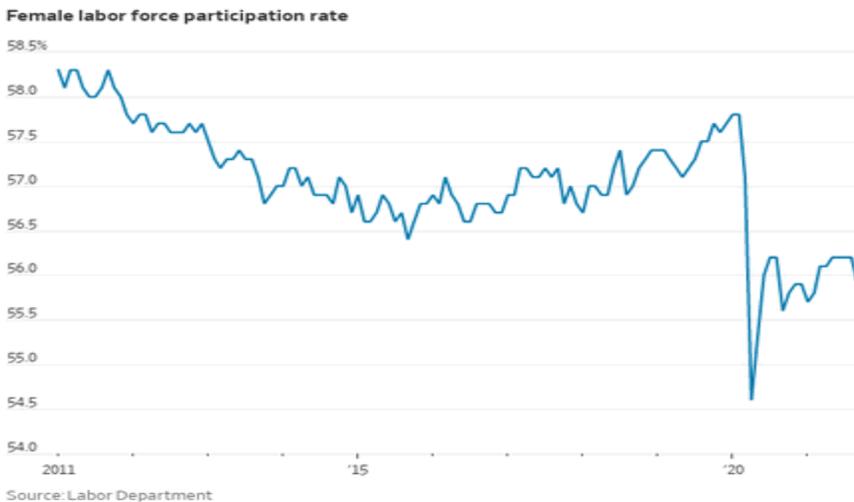
## U.S. Labor Force Participation Rate



Data: Bureau of Labor Statistics

Notice that the labor force started to grow from 1970 and peaked in the early 2000s. Baby boomers, including women, started entering the workforce in larger numbers in the 1970s. Compare this chart to the previous chart, *Baby Boomer Retirement Trend*. Baby boomers began to retire about the same time the participation rate, the chart above, started declining. This is important-baby boomers probably won't be returning to the workforce. We will probably continue to see labor shortages. The economy also loses productivity because many baby boomer workers leave with their experience and knowledge. Low productivity can also cause inflation.

Women are slow to return to work:



The main reasons given for the low participation rate of women include cost and availability of child care and schools that open and then close due to infections at schools.

When analysts and economists talk about the labor market during the pandemic, they suggest a reassessment by workers of work-life. Many employees want changes for their work-life and careers.

Some workers decided to open up their own businesses:

### **New Business Boom**

The pandemic has minted a record number of entrepreneurs



Source: Federal Reserve Bank of St. Louis

Small businesses have a high failure rate, so some entrepreneurs may return to their former careers/jobs.

### **Conclusion for Labor**

There were labor shortages before the pandemic. Then, the cause was a skills gap: workers didn't have the right skills for specific job openings. The skills labor gaps remain. Baby boomers will probably not come back to the workforce. Employers will have a difficult time in this competitive environment unless they provide better pay, benefits, and working conditions

### **Energy**

The energy picture is more complicated to explain. Below I analyze some of the major reasons for the increase in energy costs. There are other causes besides the ones I analyze below, like rising corn and ethanol prices, but I will focus on the main reasons.

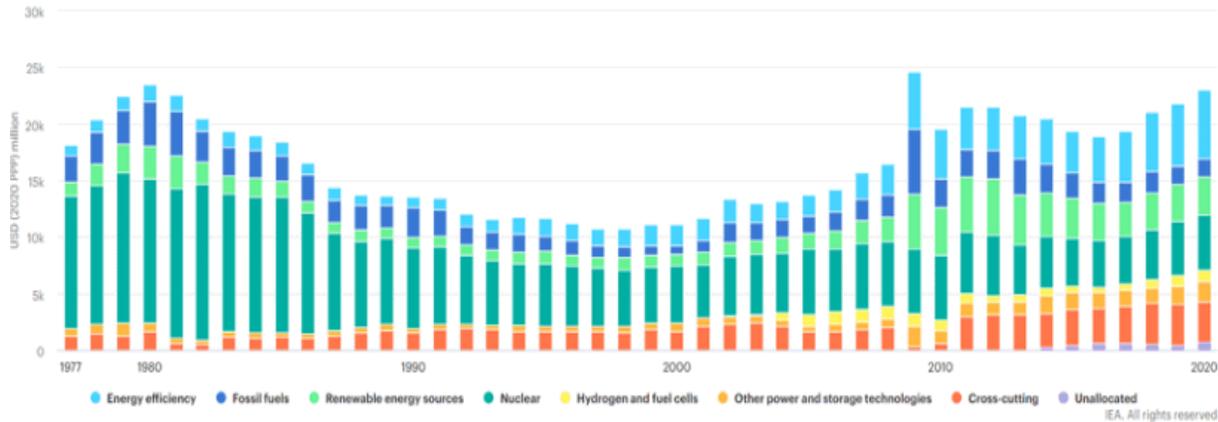
### **Energy Investors Want Energy Companies to Drill Less and to Be Shareholder Friendly**

Investors in energy companies want them to shift from high capital spending for oil and natural gas exploration and production to a shareholder-friendly focus. Investors want them to focus on increasing free cash flow, stock buybacks and, dividends.

Most energy investors have this wrong. Energy companies' value is in their valuable assets (oil, natural gas reserves). Their fortunes are basically based on their reserves and energy prices. Companies that have low costs, huge reserves and, high energy prices become more valuable.

The chart below shows how global energy producers are shifting their R & D spending from fossil fuels to energy efficiency and renewables.

### IEA member countries total public energy RD&D budget\*



Source: International Energy Agency

Below is a weekly long-term chart for oil:

### Crude Oil WTI (NYM \$/bbl) Front Month

CL1 (U.S.:Nymex)

USCL1



Let's review the chart:

- For the last dozen years, prices have traded from highs of \$75 to \$100 to the lows of about \$25
- Fracking technology has helped energy producers produce more natural gas and oil from shale deposits stuck between rocks thousands of feet below. Fracking started with natural gas, and its success led to using it for oil. It dramatically increased exploration and production, and the increased supplies led to lower prices. The fracking trend accelerated in 2014.
- Prices are starting to reverse. See Price Discovery section below

- Typically producers explore and produce more oil when prices get this high to try and sell at higher, more profitable prices. The shortage leads to higher production, that then sometimes leads to gluts and lower prices. Sometimes the cure for high prices is high prices. When prices are below breakeven, energy exploration and production companies drill and produce less. The chart below proves the point that when prices are high, more drilling happens. When prices fall like last year, drilling can collapse:

## Baker Hughes Crude Oil Rigs

Summary Calendar Forecast Stats Download Alerts

Crude Oil Rigs in the United States increased to 467 in November 24 from 461 in the previous week. source: Baker Hughes Company



Compare this chart with the previous historical oil price chart. When oil prices were above \$100, the rig count rose to around 1,600. Again, oil companies are trying to capture those high prices. Last year at the start of the pandemic, when prices collapsed, so did the drilling.

We may not get more drilling because of pressure from investors, ESG, a transition from hydrocarbons and combustion engines to electric vehicles, EVs. More explanations are given below.

The good news is that other goods with shortages and higher prices could lead to higher supplies/gluts and lower prices.

### Price discovery in the futures market

Most assets (gold, real estate, stocks, bonds....) can be invested directly. You can't buy oil directly. You can buy oil stocks, and you would essentially own the reserves of the company.

You can also buy a contract of oil in the commodities market. Here the leverage is about 8 to 1. The high leverage attracts speculators. In the futures/commodities market, participants focus on price trends. They will sell short weak trends and buy strong trends. This leverage and trend following tends to exaggerate price movements. This partly explains how oil prices fell to around zero last year and moved up over \$80 this year. The commodities/futures market is a lousy way to determine price discovery for essential commodities and financial assets.

The Fed has the power to increase margin requirements in the commodities market, and they should do that to minimize the speculation and large swings in oil prices.

## ESG

Ethical investing has been around for a long time. Ethical investors usually won't invest in gun, cigarette, alcohol, and other companies deemed unethical or harmful to society.

ESG (environmental, social, governance) investing goes further and prefers not to own hydrocarbon and combustion engine companies or companies whose products/services hurt the environment.

Some environmental groups have been pressuring banks not to lend to energy companies. Some of the biggest U.S. banks have agreed not to finance new drilling projects.

The ESG movement could reduce funds to find new oil/natural gas reserves. Oil companies have other sources to finance their drilling.

When a barrel of oil is consumed, it must be replaced by new reserves, or we will have shortages. The ESG investing movement may cause fewer funds for oil production in the U.S.

### **We import oil from countries that have higher costs**

Around 1975, during the Arab oil embargo energy crisis, exporting U.S. oil was basically outlawed. In 2015, after many years of intense lobbying by U.S. oil companies, they were allowed to export their domestic oil production.

Foreign oil prices can be \$5 to \$10 higher than domestic prices. Below are the current prices from the WSJ:

	LAST	CHANGE	%CHG
Brent Crude Futures	79.50	-0.20	-0.25
Crude Oil Futures	76.52	-0.23	-0.30

Brent crude (oil from the North Sea) is considered international oil, and the crude oil futures listed is WTI (West Texas Intermediate) domestic oil. Domestic oil companies can sell their oil overseas where prices are higher.

We do import more expensive foreign oil. Below are the top oil countries we import oil from:

## Weekly Preliminary Crude Imports by Top 10 Countries of Origin (ranking based on 2020 Petroleum Supply Monthly data)

(Thousand Barrels per Day)

Period: Weekly ▼

<a href="#">Download Series History</a> <span style="margin-left: 10px;"><a href="#">Definitions, Sources &amp; Notes</a></span>									
Country	<input type="checkbox"/> Graph <input type="checkbox"/> Clear	10/08/21	10/15/21	10/22/21	10/29/21	11/05/21	11/12/21	View History	
		1- Canada	<input type="checkbox"/>	3,441	3,254	3,472	3,685		3,550
2- Mexico	<input type="checkbox"/>	316	462	631	439	365	499	<a href="#">2010-2021</a>	
3- Saudi Arabia	<input type="checkbox"/>	304	319	336	397	598	453	<a href="#">2010-2021</a>	
4- Colombia	<input type="checkbox"/>	382	211	141	71	121	302	<a href="#">2010-2021</a>	
5- Iraq	<input type="checkbox"/>	188	239	155	187	51	42	<a href="#">2010-2021</a>	
6- Ecuador	<input type="checkbox"/>	208	0	222	92	117	103	<a href="#">2010-2021</a>	
7- Brazil	<input type="checkbox"/>	0	208	286	178	142	133	<a href="#">2010-2021</a>	
8- Russia	<input type="checkbox"/>	354	0	205	206	95	408	<a href="#">2010-2021</a>	

Source: U.S. Energy Information Admin.

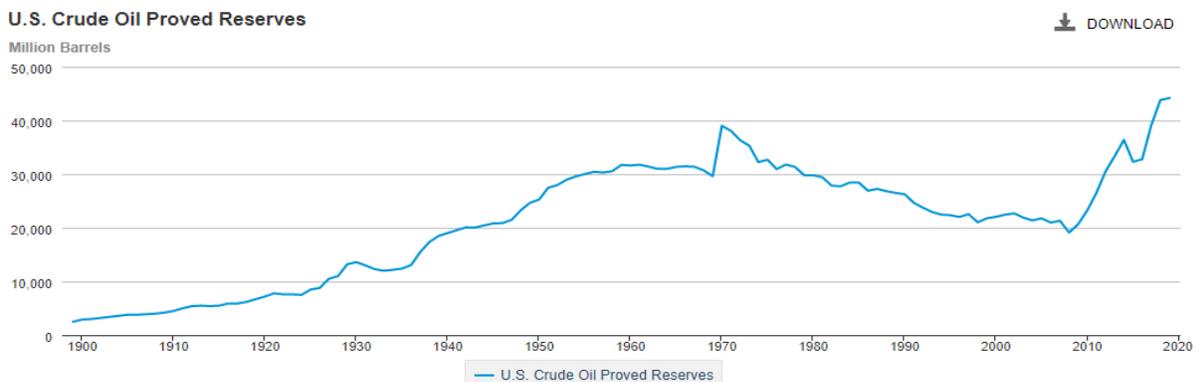
Because our reserves will probably last about ten years at current supply/demand levels and our costs are higher, we should consider importing more of our oil needs.

The administration should consider:

- Temporarily suspend oil companies' ability to sell domestic oil production.
- Sell oil from the strategic oil reserves until we are closer to supply, demand equilibrium and the pandemic is under control
- Buy more oil from oil producers that have the most oil reserves and lowest prices.

Some investors, politicians, would say “let the free markets work.” There is no free market in global oil markets. OPEC can influence supplies and, therefore prices. It is essentially a cartel.

Below is a chart that shows the historical trend of U.S. proved reserves. Currently, the U.S. has about 43 billion barrels of oil.



Source: U.S. Energy Information Admin.

The U.S. uses about 7 billion barrels a year. At current consumption, the U.S. could run out of oil in less than ten years. It would make sense to import cheaper, more abundant global oil.

The world has about 1.6 trillion barrels of oil. OPEC nations have the most oil reserves. At current consumption, global energy proved reserves could last about 47 years. Eventually, we will have to find alternatives to hydrocarbons and combustion engines.

**Shift to Electric Vehicles, EVs**

Energy supply issues and rising oil prices started in the early 2000s. Many energy experts thought we were close to peak oil (oil production and reserves would peak). There was lots of speculation on what was next for global energy. After almost 20 years, the answer will probably be EVs. Climate change is causing many weather disasters. EVs could also help with climate change.

Every car company globally (Ford, GM, Toyota, Nissan, Volkswagen, BMW, Mercedes, China car manufacturers....) will offer EVs at different price points. Some have them available now. Most will have EVs available by 2025 to 2030.

Will car companies: solve range anxiety (especially with women), will consumers buy these EVs, and will there be enough charging stations? EV enthusiasts and environmentalists are probably getting ahead of themselves. The shift to EVs and the infrastructure needed will take time and trillions of dollars of spending, just as it did for the combustion engine.

**Energy Conclusion**

Energy prices may stay elevated due to:

- A refocus on shareholder needs, not exploration and production
- ESG
- The transitions to EVs
- We will probably see less capital devoted to energy exploration and production.

Thanks to fracking, there is plenty of U.S. natural gas. Supply and demand equilibrium should be reached after winter.

**Inflation and Interest Rate Forecasts**

Below is a survey from the WSJ that polls about 70 economists from around the world. The economists come from different industries and academia.

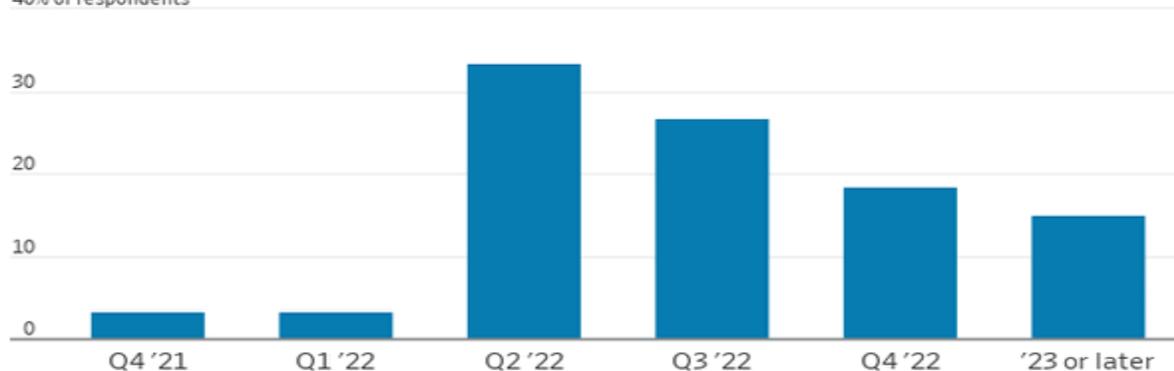
<b>WSJ Economic Survey October</b>		<b>CPI (Year-over-Year Percent Change)</b>			
<b>Name:</b>	<b>Organization:</b>	<b>Dec 2021</b>	<b>Dec 2022</b>	<b>Dec 2023</b>	<b>Dec 2024</b>
	<b>October 2021</b>	<b>5.25</b>	<b>2.63</b>	<b>2.46</b>	<b>2.33</b>
	<b>April 2021</b>	<b>2.58</b>	<b>2.27</b>	<b>2.34</b>	

The above table shows CPI, inflation forecasts from April and October. These economists are generally wrong in the short run, but it's essential to follow their changing forecasts. Is the trend in the forecasts rising, falling, or stable? We can see the inflation forecasts have gone up. The good news is they see inflation falling below 3% over the next three years. The subsequent forecasts will be in January. I will issue a report if I see significant changes in the inflation forecast trends.

Supply-chain bottlenecks are a source of shortages and inflation. Ports, cargo ships are more than at capacity. Factories are closed or slow to open. There are labor shortages, especially truck drivers. Below is a survey of economists asking them when they think the bottlenecks will get better:

**When do you expect supply-chain disruptions to largely have receded?**

40% of respondents



Source: Wall Street Journal Economic Forecasting Survey of 67 economists, Oct. 8-12, 2021

Most see the supply-chain getting better by mid-year/fall of next year.

Again, most economists see inflation falling next year and then staying below 3%. Again, the trend of the forecasts is what is important.

### **The Federal Reserve**

The Federal Reserve has many tools to tame inflation: increasing reserve requirements for banks and brokerage firms, increasing margin requirements for the commodities and futures markets, open market operations. The best tool they have and use to bring down inflation is raising interest rates.

Congress passed legislation giving the Fed two mandates: 1. Price stability 2. Create conditions for full employment. Last year Fed Chair Powell announced that he is more concerned with unemployment, especially for low-income workers, and he would let inflation overheat to make sure anyone who wants a job can find one.

The Fed has stated they will slow their buying of government securities. They should also begin raising interest rates.

## United States Fed Funds Rate



Starting in 2016, the Fed tried to normalize (adjust interest rates to inflation) rates by raising them. The Fed got undeserved criticism, especially from the President, and started dropping them again in 2019. The pandemic occurred, and the economy went into recession; the Fed lowered rates to .25%.

The labor section above suggests that labor shortages will continue, and keeping interest rates ultra-low in hopes of increasing employment does not make sense. Inflation is now more critical. Besides, full employment is considered 5% unemployment by many economists. Unemployment is currently below 5%.

Again inflation can destroy one's standard of living.

## Solutions

### High prices and shortages can self-correct

High prices, shortages can lead to the following:

- High prices usually lead to less demand, then demand and supply can reach equilibrium
- Consumers can switch to lower-cost alternatives. E.g., instead of coffee, instant coffee, tea, hot chocolate can be substitutes
- High prices can lead to more production, supply. The example given in the energy section illustrates how this happens. It's not unusual for shortages to turn into gluts and lower costs
- Companies are always trying to bring down costs and to be more efficient

### Covid

Certain countries, especially China, will lockdown cities, ports. They even locked down Disney World because of one infection. They believe lockdowns will minimize the spread of the virus. Because China is an important global manufacturer and exporter, they are one of the many causes of inflation.

We know how to get to herd immunity without more deaths and infections: wear a mask, avoid large outdoor crowds, socially distance at least 6 feet, wash your hands when you need to (that means often), get vaccinated, and get your booster shot. Because not enough people are doing this, it will take longer to get to herd immunity.

The world is doing much worse than the U.S., so the virus can continue to mutate and spread.

Eventually, covid will not be an inflationary problem. We will have to learn to live with covid, and experts believe the pandemic will turn into an endemic. When does this happen? No one knows.

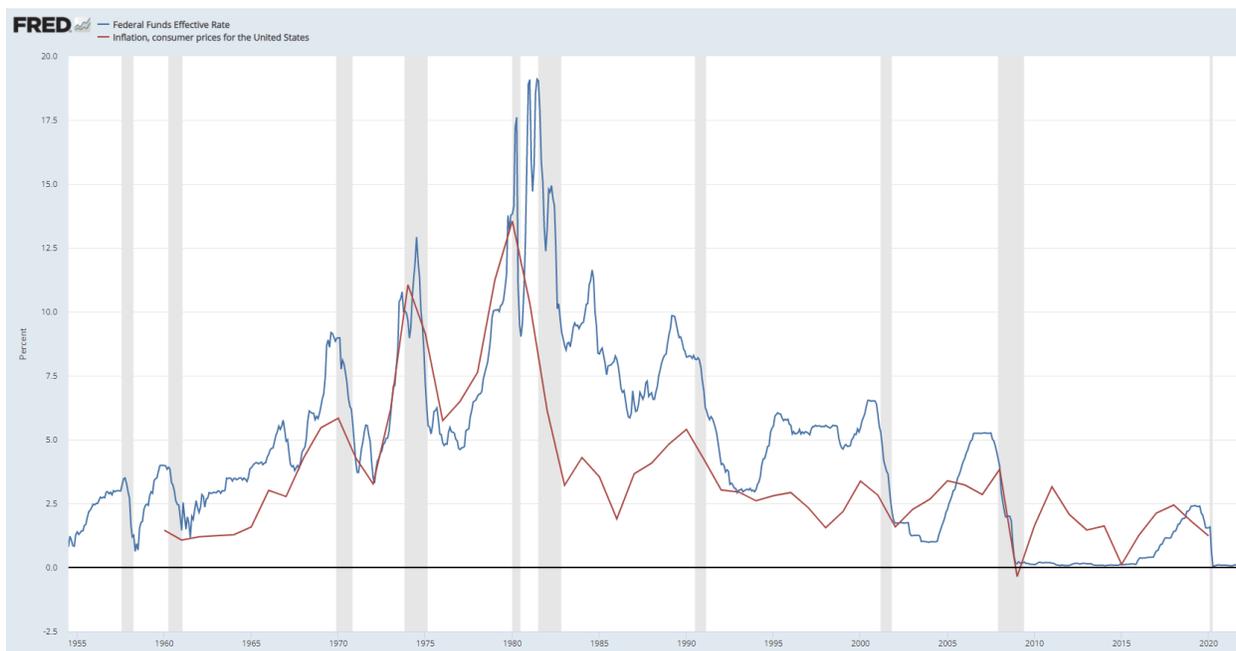
Covid and the pandemic is the key to returning to normalcy. If covid doesn't get better, we can expect slower economic growth with shortages, inflation, and struggling equity markets.

### **Federal Reserve**

Raising interest rates is a tried and true tool the Fed has to slow the economy and inflationary pressures. Now that inflation is a problem, the Fed will have to shift from achieving full employment (we are essentially at full employment) to fighting inflation.

The Fed has been buying \$120 billion of government paper, government agencies and some corporate bonds. They recently announced they will cut their buying by \$15 billion. This needs to increase gradually. They know if they cut their buying too fast or too much, it could upset the debt and equity markets.

The Fed should raise interest rates. There is risk to the economy when the Fed raises rates, as the chart below shows.



I really like this chart. It basically explains a lot about our economy: it's cyclical; higher inflation (red trendline) leads to higher rates (blue trendline) and usually a recession (grey shaded areas).

When the Fed started raising rates in 2016, we did not go into recession. Covid pushed us into a recession.

There is probably enough momentum in the economy from the pent-up demand due to the pandemic. Also, the financial system, workers, many businesses, and organizations have plenty of liquidity and support/stimulus provided to workers and many businesses.

They should also raise margin requirements for oil to lower the speculation and volatility in the oil futures market. If prices continue to reverse, short selling could occur, putting more downward pressure on oil prices.

## **Labor**

### **Education and job training**

The U.S. must stop looking at education and training as an expense. It is an INVESTMENT. A more educated workforce can lead to: a better educated, trained workforce that could be more productive (high productivity can lead to lower inflation), better pay and higher income taxes to U.S. coffers, and even happy employees and employers.

### **Coordinate labor needs between the government, labor, and employers**

We also need to follow other countries that coordinate labor needs with the government (federal and local), employers, and workers. As a country, we do not do a good job of preparing, training young people for the future. Education and job training also needs to be ongoing.

### **Immigration Reform**

Most wealthy nations use immigration to help do the jobs that nationals won't do. Since the beginning of this nation, we have relied on cheap (sometimes free), abundant, productive immigrants to help us with our labor needs. For example, the Bracero program, a U.S. agreement with Mexico in 1942 to provide labor during WWII.

Corporate America complains that there is a skills gap in their talent pool. They will probably ask for immigration reform for skilled foreign workers.

We need immigration reform. According to the media, nearly 2 million immigrants have crossed the border this year. Many of these immigrants want to work. Let them have temporary visas and work at the low-paying jobs that go unfilled and help unclog the ports, especially in Los Angeles. Most U.S. citizens, especially families, can't live on \$15 an hour. Immigrants can be resourceful in lowering their living costs. Low-paid and skilled employees are the ones that employers need desperately. A pathway to citizenship could be offered to some as an incentive. The incentive for citizenship could ensure low-paying jobs are filled if they comply with our laws.

I can hear “build that wall” when it comes to immigration reform. There is a reluctance by some Americans to allow these “illegals” in the country. Many Mexican people in the U.S. aren’t immigrants as they have been here for centuries. Mexicans are essentially North American natives. Mexicans lost the Mexican-American War (1846 to 1848) and a lot of their land in the Southwest to the U.S. They have proved to be abundant, cheap, productive, willing workers, especially at farms, restaurants, hotels, landscaping businesses....

We can solve many of our labor problems and rising labor costs with immigration reform.

### **China and Supply Chains**

There are still tariffs on Chinese exports. Dropping these tariffs could help inflation from goods coming from China.

For decades, just-in-time (JIT) inventories (companies limit inventories, so they don’t tie up capital) have been around. This could change as companies now see the downside of JIT. Some manufacturing could come back to the U.S. The manufacturing will probably be automated as U.S. labor costs and regulations are too high. Better inventory management and some domestic manufacturing for essential goods could reduce shortages and inflation in future economic cycles. Changes would take too long and be costly to make a difference now.

## **Summary and Conclusion**

### **Causes**

There are many causes of the inflation the world is experiencing. Below is a summary of the main reasons for current inflation trends.

### **Covid**

Covid is the leading cause of inflation. The global economy basically shut down because of covid. In the U.S., the Fed created tons of liquidity to avoid a deep recession. Lawmakers provided cash to workers, businesses, and other organizations to help them get to the other side of the pandemic. The global economy was unprepared for the strong pent-up demand backed by liquidity and lots of cash in consumers’ pockets.

We avoided a deep recession, but now we have an inflation problem that the Fed can usually handle.

### **Supply Chain Bottlenecks and Shortages**

Covid is also responsible for the many global supply chain bottlenecks. It is also causing shortages from food to semiconductors.

### **Labor**

Labor shortages were a problem before the pandemic and will probably be a problem going forward. Low-wage jobs are the hardest to fill. Also, certain skilled positions aren’t being filled because of a skills gap.

The baby boomer retirement trend accelerated during the pandemic. Retired baby boomers are probably not coming back to the labor force.

## **Energy**

Lowering energy costs could be a longer-term problem.

A shift toward EVs, shareholders focus on their return of capital, and ESG will probably mean less capital for energy. We will probably also see less drilling.

## **Potential Solutions**

### **Now**

- Because the pandemic is a global problem, stronger coordination should occur between nations, health organizations, and vaccine providers. Beating covid is the key to the global economy and inflation.

With our resources, the U.S. should be at the top of the list of the countries that are controlling covid.

- The Fed has always been critical to controlling inflation and keeping the momentum in the economy going.

They need to start raising rates.

They need to decrease more their buying of bonds.

Raise margin requirements for natural gas and oil futures

It's a tricky balancing act.

- Disallow the exporting of domestic oil production during the pandemic
- Eliminate tariffs from goods coming from China
- Import more oil from countries that have cheap and abundant oil
- Immigration reform – Employers are looking for millions of low-wage, low-skilled workers. The solution is at the border and immigration reform.

Many workers and retirees will be or are receiving increased paychecks from 4 to 6%. Inflation is net about 2%. For the past few decades, we have had rising inflation but stagnant wages.

### **Longer-term**

The U.S. must invest more in education and training. We have let our young people down with sky-high educational costs and uncertain long-term job/career outlooks. There needs to be better coordination between governments, education/training, employers, and employees. Some U.S. communities and countries are doing this coordination successfully.

JIT inventories will be rethought. Some essential goods could come back to the U.S. to be made. Labor and energy could be longer-term inflation problems. The shift from combustion engines to EVs could be a rocky road.

### **Conclusion**

Most economists believe that supply chain issues should improve by the middle of next year. They also see inflation falling below 3% starting next year. These forecasts will change. If the forecasts have significant adjustments, I will include the forecasts in future Updates. The low inflation of about 2% that we have had for the last dozen years will probably end and may be closer to 3%, the historical inflation average.

Covid continues to cloud the economic and market outlook. Inflation is now another concern. Interest rates will have to rise to slow inflationary pressures.

With higher interest rates and a cloudy investment outlook, investors will have to bring down their expectations for next year. Also, stock picking with a focus on valuations and catalysts for upside momentum will be essential. Indexes could struggle because of their high valuations and the real possibility that we will see higher interest rates.

Covid could worsen, and the Fed could make mistakes (raising interest rates to slow or fast, tapering too fast or slow) in taming inflation. There is a small probability of having a double-dip recession, similar to the early 1980s. I doubt prices would fall back to last year's prices, so we will sit tight if this happens.

There is probably enough momentum in the economy to avoid a double-dip recession.

If you have cash left, you should consider investing as some bargains have appeared during this selling period.

I will provide my stock market outlook toward the end of December and my economic outlook in January.