Seeking Alpha α

Today's Market

Inflation & The Great Supply Lie

Jan. 06, 2022 8:10 AM ET | 95 Comments | 73 Likes

Summary

- The Fed turns into a 'Paper Hawk'. It remains very dovish in the face of mounting inflation.
- "Supply disruptions" continue to be blamed as a major contributing factor for inflation. However data suggest otherwise.
- We are seeing "explosive demand growth" that supply chains and a tight labor market cannot keep up with.
- Inflation is here to stay. The Government is unable and unwilling to do much about it.
- How well are you prepared for a multi-year inflation cycle?
- Looking for a portfolio of ideas like this one? Members of High Dividend Opportunities get exclusive access to our model portfolio. Learn More »

Thomas Faull/iStock via Getty Images

Inflation is high. How high? Well I probably don't need to tell you, but for the benefit of the elites who don't do their own shopping:

That's the highest it has been since the early '80s. The Government will tell you that this inflation is caused by "temporary" supply chain problems. They are fooling you! Inflation isn't being caused by problems in the supply chain, it isn't going to go away on its own, and nobody in Washington D.C. is doing anything that will have a material impact on it.

Don't believe the Government's deceitful claims. Investors need to take adequate steps to protect their retirement from sustained high inflation today and going forward.

After all, this is not the first time that the Fed and Government have tried to fool investors as I wrote in a recent report entitled "The Great Inflation Lie", where I highlighted that they have knowingly misled the public by downplaying inflation.

It Is Not A Supply Problem!

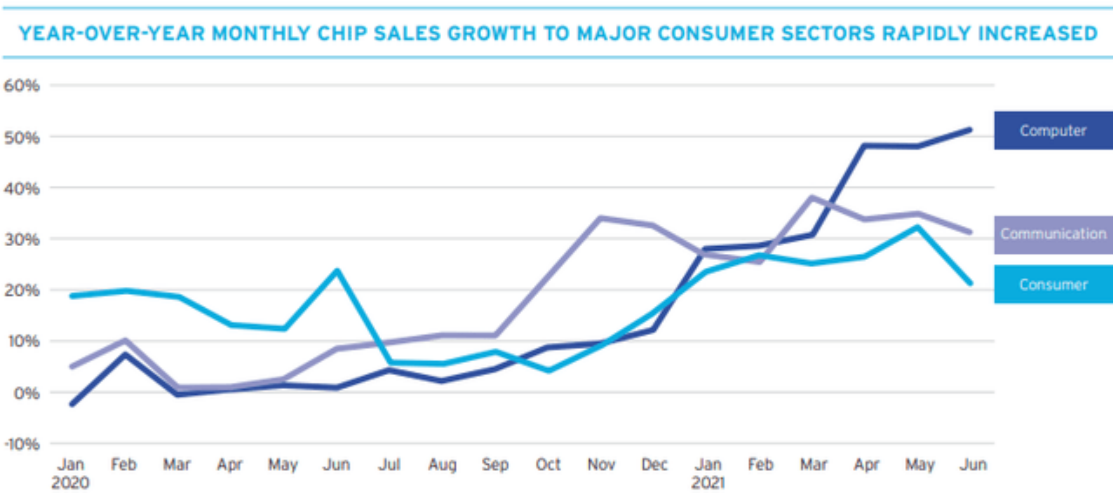
The world continues to face a severe shortage of everything ranging from semiconductors to construction materials. Industry experts and government officials continue to tell you that the shortage is caused by a supply crunch due to the pandemic. But the reality is far from that.

Let's look at a sector that gets a ton of press for its "shortage": Semiconductors. With electronics getting more sophisticated and "smarter", these chips are essential to making a lot of the products that consumers love. From cell phones, computers, cars, and more.

Record Level Semiconductor Production

The COVID-19 pandemic caused a sudden and sharp drop in automotive sales in spring 2020. Automakers extended the weak forecast out and responded by cutting their orders for parts, materials, and, yes, semiconductor chips necessary for the modern vehicle's critical functions. When the U.S. government stepped up to support the markets through quantitative easing by releasing an unprecedented volume of stimulus packages, demand for passenger vehicles rebounded among several other goods. By then, chip manufacturers were already fully committed to supplying large customers whose businesses were thriving from day one of the pandemic – consumer electronics, data centers, SaaS providers, and other work from home technology providers.

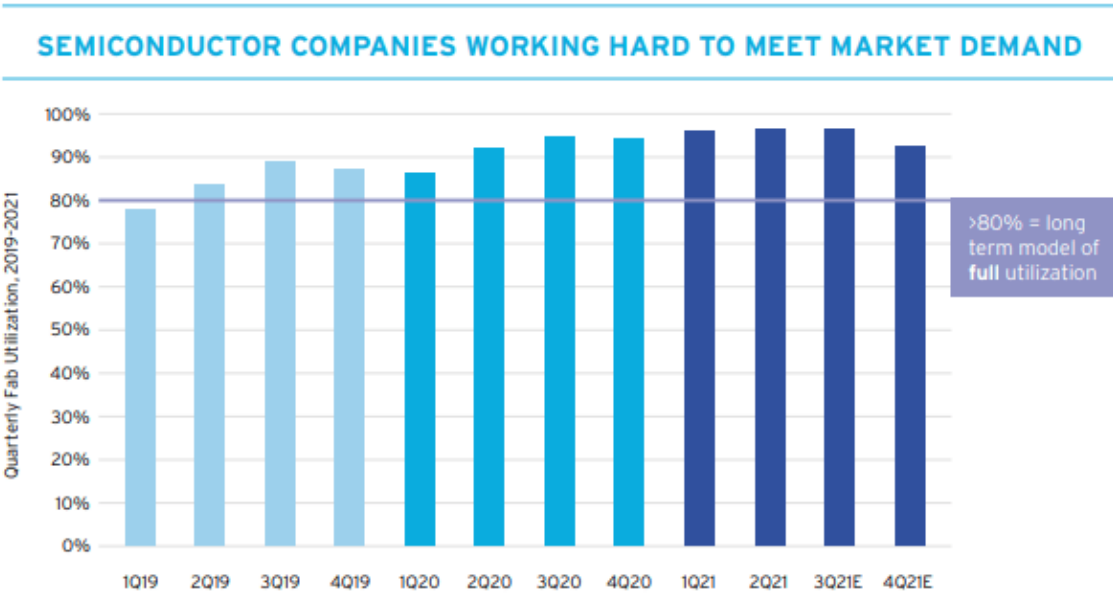
In effect, there wasn't a reduction of overall supply, just that the supply was unable to meet the unexpected explosion of demand. In fact, *more semiconductors were made in 2021 than in any year in history,* more semiconductors were built in 2020 than in 2019. What changed was a massive increase in demand for chips to be used in computers, phones, and other products that a typical consumer that was handed $1,000 from the government and quarantined at home might want to buy.



- Source: Semi-Conductor Industry Association

Given the complexity of building semiconductors, the businesses that make them simply haven't been able to expand quickly enough to meet the supply surge. The bottom line, the "shortage" is caused by new demand, not because supply declined.

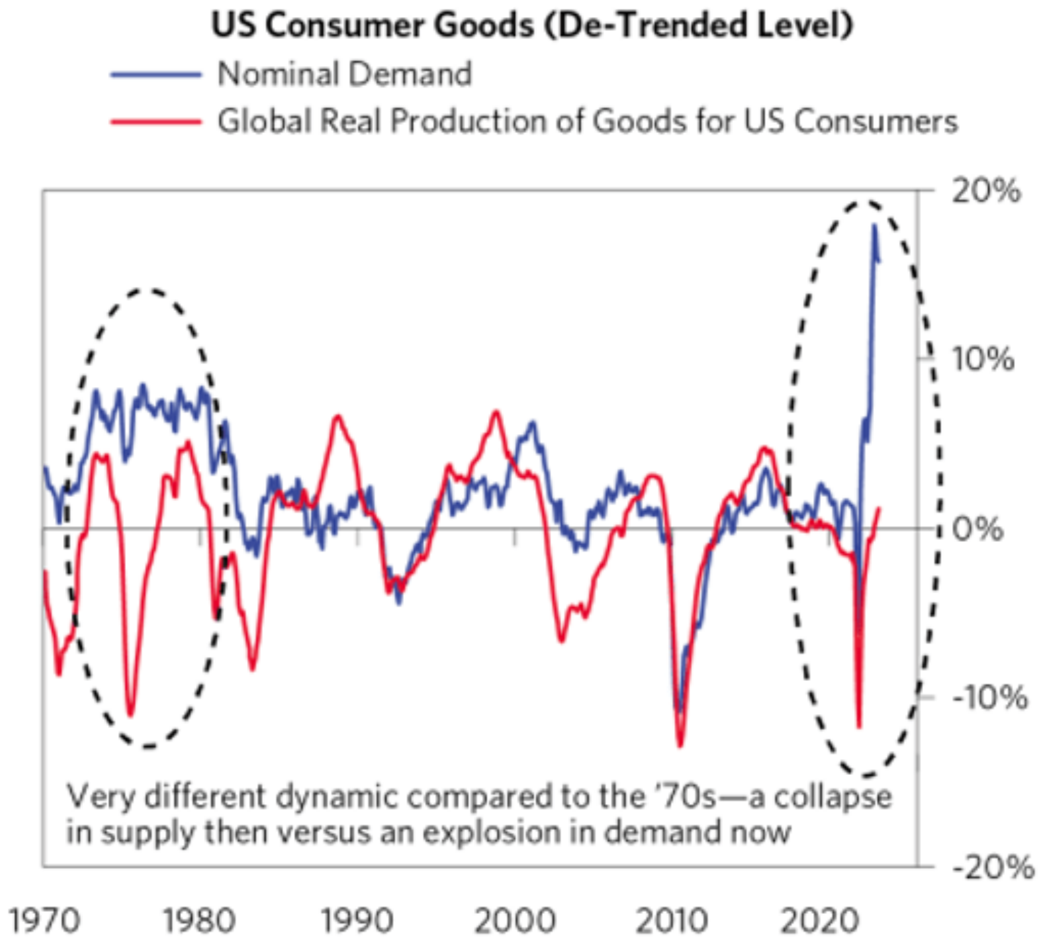
In fact, semiconductor factories are operating above "full utilization" trying to keep up.



- Source: Semi-Conductor Industry Association

The Story Is Similar For Most Other Products

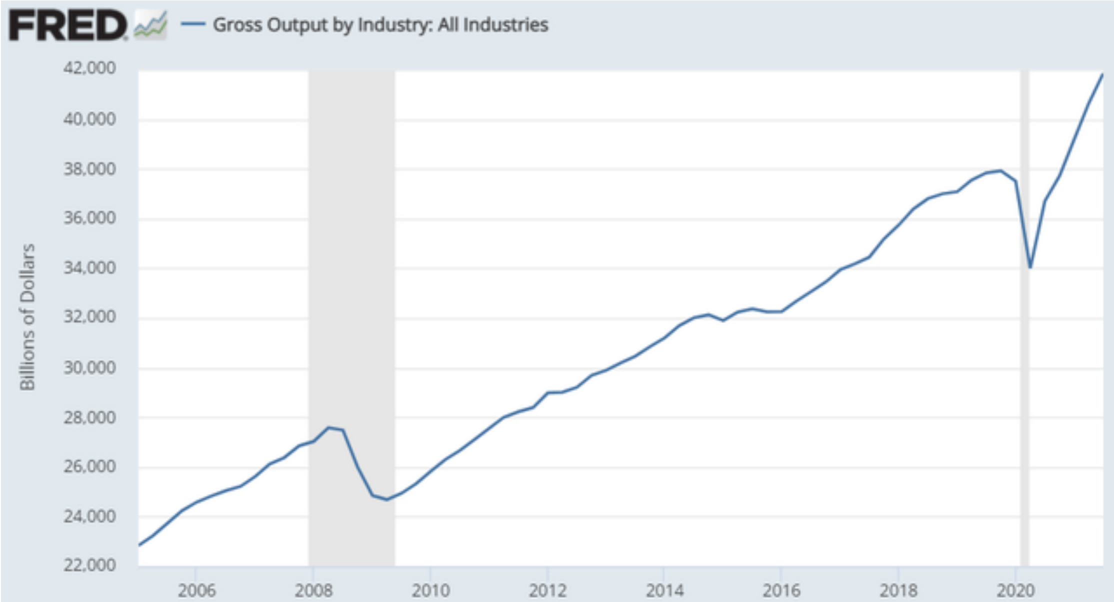
Bridgewater Associates recently published a paper that’s well worth reading, whose argument is summarized by the title: “It’s Mostly a Demand Shock, Not a Supply Shock, and It’s Everywhere.” By the hedge fund’s estimates, global real production is back in line with the trend of the last half-century after last year's shock — *while demand has gone to the moon!*



Demand for essential goods and services is significantly above pre-pandemic days, and suppliers are simply trying to catch up.

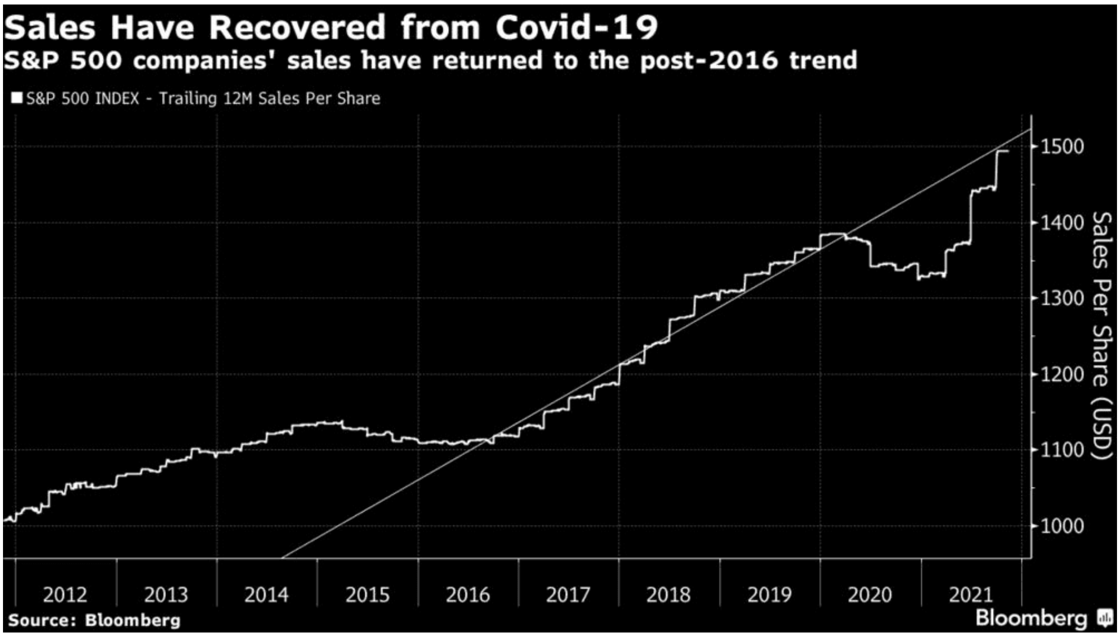
We can confirm that supply remains high through a variety of widely available economic measures. Let's look at just a few.

Gross outputs for U.S. Industries are well above pre-COVID levels:

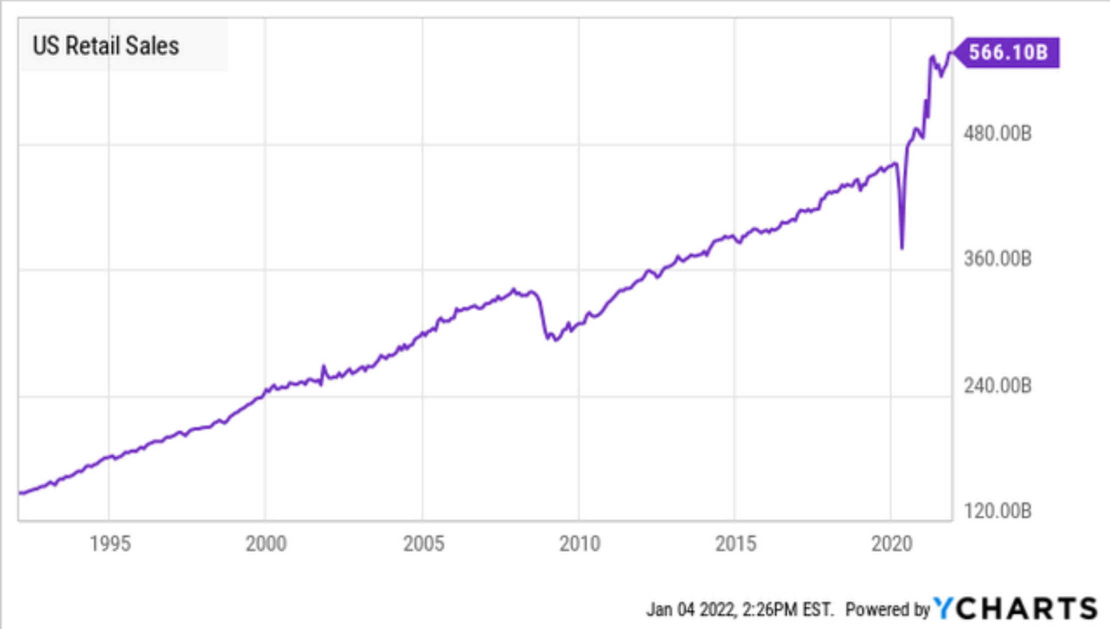


- Source: St. Louis Fed (updated Dec. 22, 2021)

Look at sales for S&P 500 companies.

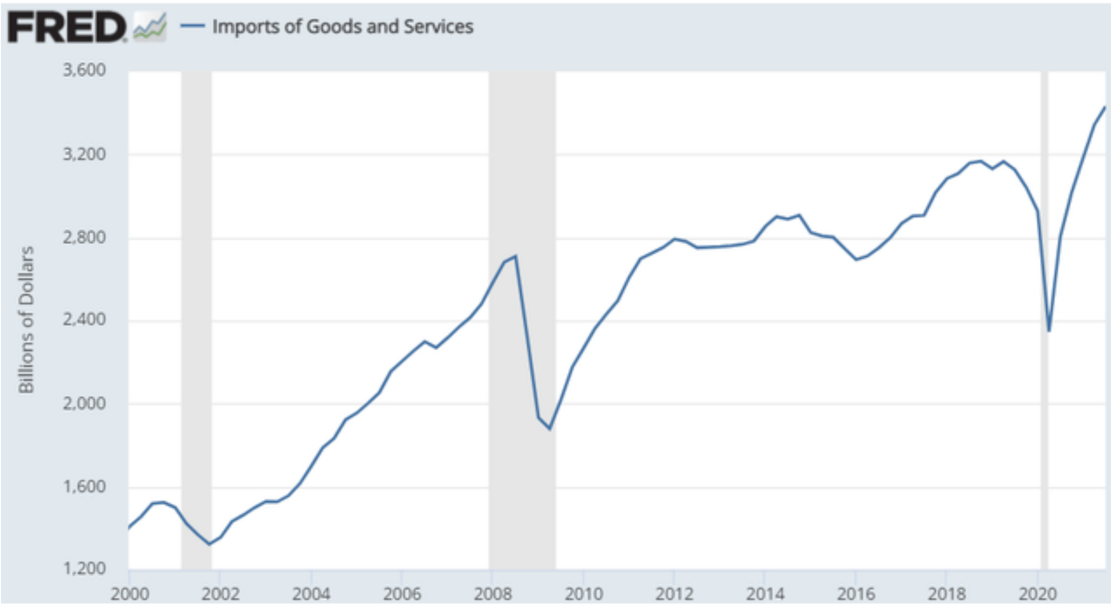


Retail sales have surged:



1. From 2010-2020, retail sales grew at about 5% per year.
2. From January 2020 to today, retail sales have surged 23.5%! 4.5 years of growth in less than two years! No wonder manufacturers are struggling to keep up!

Finally, U.S. imports are up 17% since Q1 2020:



- Source: St. Louis Fed (updated Dec. 22, 2021)

According to the charts above:

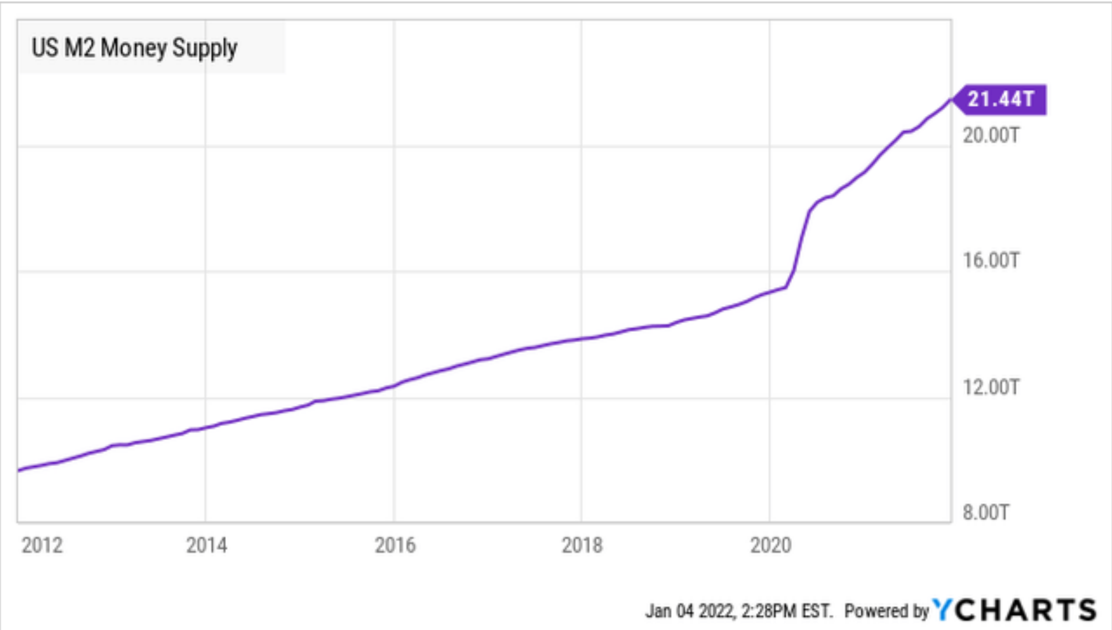
1. Production is *well over* pre-COVID levels.
2. U.S. industrial output is also *above* pre-COVID levels.
3. Sales of S&P 500 companies are *above* pre-COVID levels.
4. Retail sales are 23.5% *above* pre-COVID levels.
5. U.S. imports are *over* pre-COVID levels.

The only variable that has changed is that *demand has surged* and none of the supply chains are able to cope with it.

So yes, we do have a "supply" problem, *but only because demand has surged so much higher than it was before COVID.*

Demand Is Fueled By Money

Fundamentally, this inflation is being caused by the Bubble of Liquidity. The economy is flooded with cash. *After COVID, the M2 money supply spiked, bank liquidity spiked, consumer checking accounts spiked, corporate cash spiked, and corporate cap-ex spiked. This isn't a coincidence, they are all related!*



There is more money in consumers' pockets, more money in corporate pockets, and more money in banks' pockets. When there is more money, people spend it. I would think those in Washington D.C. would be familiar with that phenomenon since they are so good at spending!

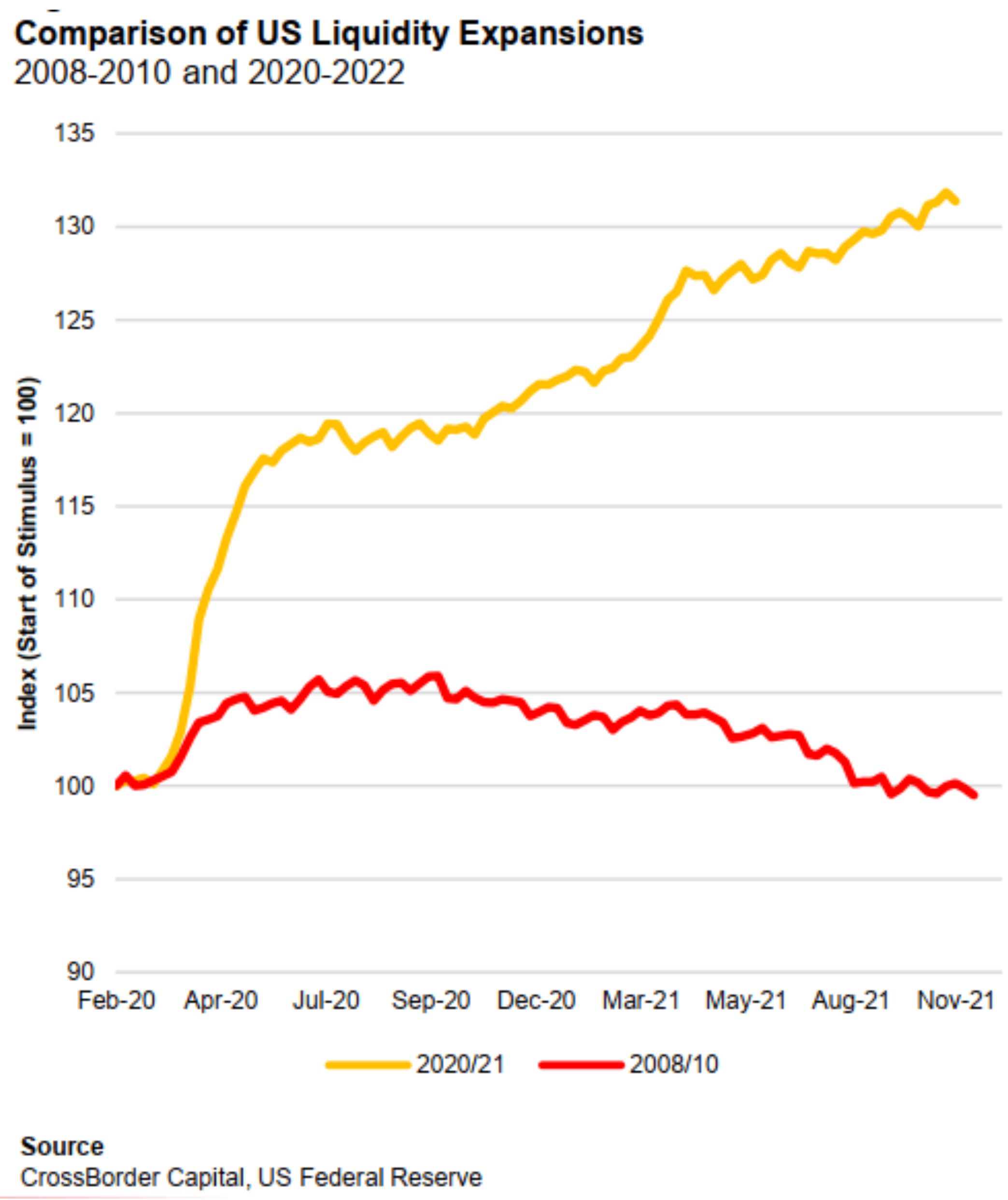
What has materially changed today is that consumer demand is much higher than before, making corporate demand higher and supply is only low relative to the new, much higher, demand. *It is all tied back to the massive increase of liquidity at all levels of the economy; both the Fed and Government have only themselves to blame.*

The massive increase in money supply in the system is the defining characteristic of this economy. With such a massive glut of demand, supply will have to grow to meet it. What does that mean? Higher prices (inflation) and economic expansion.

So no, J. Powell, stop fooling us and blaming supply disruptions!

We do not have a "supply problem" but rather a "Demand Explosion" because you pumped so much liquidity into the system.

Just compare the difference in how much liquidity was pumped for the Great Financial Crisis (housing bubble) of 2008-2010 and the COVID crisis!



The figures are mind-blowing!

And what is the government doing about it? It is trying to provide more government spending in an attempt to ease the impacts on voters, including direct payments in the form of an extension of the "child tax credit". *The government's response to excess liquidity driving inflation? Inject even more liquidity!*

One of the safest bets investors can make is that the U.S. Government will continue spending. Significant austerity measures are not in the playbook of anyone in Washington D.C. in the foreseeable future.

The Fed Is Not Trying To Stop Inflation

For over a year now I have been saying that the Fed has been fooling investors. It is a position that is somewhat controversial. Yet, the only alternative is utter incompetence, which leads to the same result.

How else do you explain how the Fed is suddenly incapable of projecting inflation two months in advance when historically they have been reasonably accurate projecting 2-3 years in advance?

The Fed is now projecting inflation at 2.7% for 2022, and I will go on record right now as saying that is very low and will be exceeded early in the year.

Additionally, the Fed projected that the target interest rate might be raised to 0.9% in 2022, a significant increase from its prior projection of 0.3% in September.

Percent

Variable	Median[1]				
	2021	2022	2023	2024	Longer run
Change in real GDP	5.5	4.0	2.2	2.0	1.8
September projection	5.9	3.8	2.5	2.0	1.8
Unemployment rate	4.3	3.5	3.5	3.5	4.0
September projection	4.8	3.8	3.5	3.5	4.0
PCE inflation	5.3	2.6	2.3	2.1	2.0
September projection	4.2	2.2	2.2	2.1	2.0
Core PCE inflation[4]	4.4	2.7	2.3	2.1	
September projection	3.7	2.3	2.2	2.1	
Memo: Projected appropriate policy path					
Federal funds rate	0.1	0.9	1.6	2.1	2.5
September projection	0.1	0.3	1.0	1.8	2.5

*- Source: Federal Reserve December **2021** Projection Materials*

Put that together, and you have a story of a Fed that is "more hawkish". But is it really "hawkish"? Let's look back at the Fed before Powell. Here is a look at the same slide from March 2016's projection materials, when the Fed was starting its first round of rate hikes since before the Great Financial Crisis.

Percent

Variable	Median[1] 2016	2017	2018	Longer run
Change in real GDP	2.2	2.1	2.0	2.0
December projection	2.4	2.2	2.0	2.0
Unemployment rate	4.7	4.6	4.5	4.8
December projection	4.7	4.7	4.7	4.9
PCE inflation	1.2	1.9	2.0	2.0
December projection	1.6	1.9	2.0	2.0
Core PCE inflation[4]	1.6	1.8	2.0	
December projection	1.6	1.9	2.0	
Memo: Projected appropriate policy path				
Federal funds rate	0.9	1.9	3.0	3.3
December projection	1.4	2.4	3.3	3.5

*- Source: Federal Reserve March **2016** Projection Materials*

The Fed was actually very accurate on inflation projections.

1. Actual inflation was 1.6%, 1.7% and 2.0%. The Fed actually raised to 0.75%, 1.5%, and 2.5%. It wasn't quite as hawkish as the Fed projected, but in the ballpark.
2. Also note, that the Fed was acting to nip inflation in the bud, *increasing rates before inflation hit 2%, and increasing the Federal Funds Rate to be higher than inflation.*

Even if you take the Fed's December projections at face value, the indication is that the Fed does not intend on reining in inflation through rate hikes. *The Fed intends to raise rates more slowly than the prior Fed did, even though forward inflation projections are higher.*

In 2016, the Fed was Hawkish. Today's Fed is only Hawkish relative to its own historically loose monetary policy. If the Fed were serious about tackling inflation, it would be looking at raising the target rate above the inflation rate. Instead, the Fed is maintaining a monetary easing policy since the overnight rate will be held at negative real yields after inflation, even using the Fed's low inflation projections.

- Source: Alamy

The Government Isn't Serious About Tackling Inflation

Jerome Powell, President Biden, and many others keep trying to find a scapegoat to blame inflation on while trying to look like they are taking measures to curb it. We see laughably ineffective measures being suggested.

The Biden administration attempted to lower oil prices by releasing 50 million barrels from the Strategic Petroleum Reserve and is tackling "Big Meat" by throwing government money at independently owned processors. To put it in perspective, the US consumes 7.5+ billion barrels of oil a year, 50 million over a few months is a rounding error. Throwing $1 billion in government money at smaller, less efficient meat producers in an industry that does nearly $1 trillion in annual revenue is not going to make a difference.

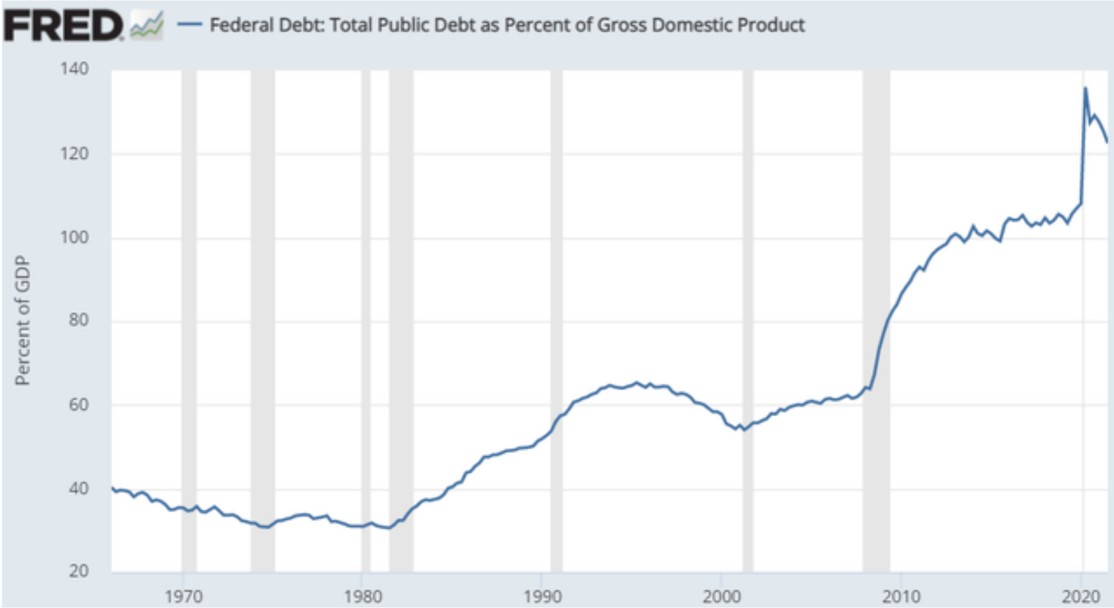
It's a bit like trying to travel to Mars in a hang-glider. If the government were serious about tackling inflation, we would see much more aggressive measures.

Why The Government Is 'Happy' With high Inflation

The reality is that both the Fed and the Government *need inflation*. The Federal Government has trillions in debt and the only practical way to deal with it is to deplete it through inflation.

The Government is very comfortable letting inflation run at 3-6%. Why?

The U.S. Government has run up a ton of debt. As a percentage of GDP, the Federal debt *is now over 120%*. The cost of COVID alone was several times higher than the cost of WWII in today's dollar terms.

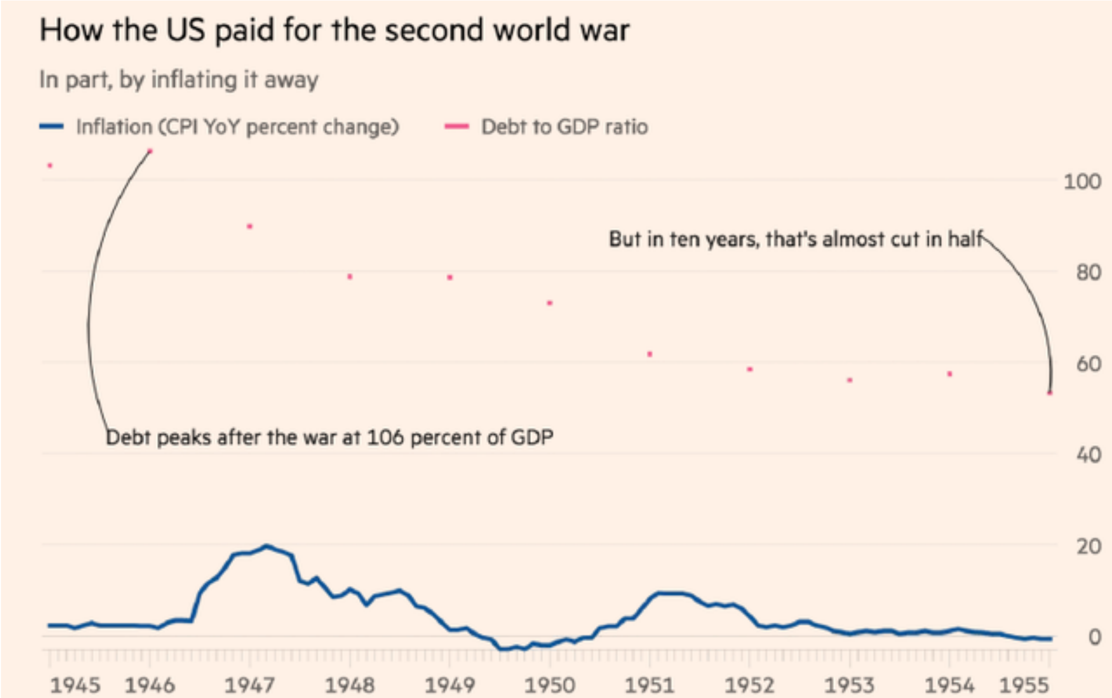


- Source: St. Louis Fed (updated Dec. 22, 2021)

Dealing with debt is always politically unpopular. Raising taxes in a meaningful way and cutting spending are political hot-buttons that are sure to upset a large number of constituents.

The last time debt was even in this ballpark was in 1946. The U.S. Government had a massive debt of $269 billion. Just by reading that number, you know what happened. What is $269 billion to the U.S. Government today? That is only half of what the government spends on interest payments alone! $269 billion just isn't what it used to be, *and that was intentional.*

As a reminder, the U.S. never "paid" for WWII – it refinanced the debt, and through inflation, the significance of the debt dissipated quickly, even as the total debt grew.



- *Source:* *Financial Times*

A significant amount of inflation is the only solution that the U.S. Government has to manage its debts and obligations. The Government knows it and the Fed knows it too.

Focusing on "temporary" supply problems is a good way to redirect the media away from the reality of inflation and attempt to reassure the market that the Fed and the Government have inflation under control.

The Government wants to manage inflation expectations to avoid "hyper" inflation – to do that they are:

1. Providing low-ball projections.
2. Appearing hawkish to reassure investors that inflation will be controlled.
3. Trying to convince the public that inflation is caused by "temporary" supply issues.
4. Making grand displays of "doing something" to control

inflation.

With these actions, they hope to keep inflation in the low single digits and limit public anger.

Conclusion

We are living through a unique time that we have not seen in many decades:

1. The combination of high inflation and low Treasury rates hasn't been seen in 70 years!
2. We have a Federal Reserve that has gone well off the script that has been followed for the past 40 years. This Fed is very dovish, even when talking like a hawk.
3. We have a U.S. Government with the highest levels of debt/GDP ever and no sign of slowing down.
4. There is a "Bubble of Liquidity" in the economy that is substantially larger than it has ever been before.
5. Demand has outpaced supply at an unprecedented level. If you add to this the lack of workers, scarcity of basic materials, and tons of cash in consumers' pockets, this is the perfect storm for continued inflation pressures.

Inflation is here to stay. The Fed cannot hike interest rates by much without running the risk of derailing the economy and causing a full-blown credit crisis. Importantly, neither the Fed nor the Government intends on making a serious effort to rein in inflation.

The ultimate objective is deflating the mounting government debt. Printing money and keeping interest rates low is the only way the Fed and Government can deal with the huge national debt. It is also the only viable option to deplete the bubble of bank "junk" loans, and that of the private sector, without avoiding a new "financial crisis".

At HDO, we've taken significant steps to prepare for a multi-year cycle of inflation caused by loose monetary policy, and the Fed's unwillingness and inability to control it.

Now is NOT the time to be holding a lot of cash, because its value will continue to evaporate, as we have seen in the year 2021. But it is time to take action to preserve the "purchasing power" of your savings, and that of your income stream, if you have not done so yet. How well are you prepared?

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This article was written by

Author of

I am a former Investment and Commercial Banker with over 35 years experience in the field. I have been advising both individuals and institutional client

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73 Likes

95 Comments

Comments (95)

Tama Harbor

Yesterday, 5:52 PM

Comments (7)

Clearly the result of all the 'free' Biden money.

Reply Like (1)

Spitfire MK V

Yesterday, 5:49 PM

Comments (524)

This inflation hysteria is but a relative flash in the pan . High prices will cure high prices to the point of all fiat being worthless with the Fed asleep at the wheel pedal to the metal . Put some Gold in your back yard and relax. . .

Reply Like

ofirm

Yesterday, 5:41 PM

Premium Marketplace Comments (3.37K)

here is how the inflation looks like removing the adjustments made to the CPI calculation since 1980:

www.shadowstats.com/...

Reply Like

Fischel

Premium Comments (1.39K)

Yesterday, 5:37 PM

@Rida Morwa as you present a non-trustworthy Fed (or government?), would you say there is a vulnerability to a black swan such as a revolt (somehow) of other countries rejecting the US Dollar as world reserve currency ? or to ask maybe a different question, do you see any black swans which could come about "politically" in the international arena due to the US Fed and/or political/government macro-economic games? and if so, what would an example or some examples of those black swans be ?

Reply Like

RUBYRUBY3

Comments (6.08K)

Yesterday, 5:36 PM

The biggest complaint I hear is my pockets are too full of money.

Press like if you " don't " hear that

Reply Like

M Plaut

Contributor Comments (1.24K)

Yesterday, 5:34 PM

A wonderfully argued presentation. It reminds me of some of Lincoln's speeches.
IMO the key point is that the Fed does not plan to raise interest rates above the rate of inflation.
You just have to wonder if maybe they are fooling themselves along with everyone else!

Reply Like

Entreri Yesterday, 5:23 PM

Comments (7.93K)

Computers. What happened due to the pandemic? Employees and students worked from home = many cases upgrading electronics. Demand increased.

Stocking up on various goods. Demand increased. Most services were shut down. People were going to spend $ stuck at home.

Bond market pricing in low inflation. Velocity of money continues to decrease.

USD has climbed against the Euro. It was near .60 during the GR. Past 2 years it has risen, .89. Going back to values before March 2020 crash.

Reply Like

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graysonlargman Yesterday, 5:13 PM

Premium Comments (1)

Fantastic analysis. Thanks for sharing.

Reply Like (1)

Soto1 Yesterday, 5:10 PM

Comments (1.01K)

Does it really matter if the issue is with the demand side or the supply side? As long as the demand / supply imbalance exist, prices will continue to be elevated. How long will this 'pumped' liquidity really last? These demand levels do not seem sustainable.

Reply Like

Gulabdang

Yesterday, 4:53 PM

Comments (343)

So, expose yourself to crowded trades, volatility, buy the top at historic p.e.s or engage some advanced weird options strategy, become a land Barron, or go in on dividend stocks nobody has ever heard of. Is there a simple man's strategy here? What would Ron Swanson do?

Reply Like (1)

Well meaning

Yesterday, 4:26 PM

Comments (1.53K)

Rida, I just LOVE your articles. You have a way of explaining complicated subjects in a way that makes them understandable to lay persons many of whom have never had an education in economics and finance. And you do it in such a unique and relatable way. You are a real asset to this website. I wish you all the best and wish you a long and happy life so you can continue doing what you do so well!

Reply Like (2)

Krek

Yesterday, 4:17 PM

Comments (358)

The author is NUTS if he thinks the FED won't get a lot more hawkish if 6%+ monthly inflation readings keep coming in. Pure nonsense.

Plus, if inflation continues and oil keeps blasting higher, that itself will cause a recession.

Seems like there's not much of a path to healthy stock markets for a while. Prepare for impact. *(edited)*

Reply Like (1)

KevjustBrowsing

Yesterday, 5:04 PM

Comments (404)

@Krek you completely missed his point that "hawkishness" is relative. He is saying that this Fed will not raise rates ABOVE inflation but that they will continue to be behind the curve. Other governments are raising rates yet ours has not....

Reply Like

Random Logic

Yesterday, 4:05 PM

Premium Comments (5.29K)

Cogent and refreshingly honest article. I sometimes read from bond investors that they feel comfortable with U.S. treasuries because the U.S government has never defaulted. They are ignoring 1971 when Nixon closed the “gold window” and converted the U.S currency to a fiat currency.

Reply Like (2)

Shareholders Unite

Yesterday, 3:37 PM

Marketplace Contributor Premium Comments (11.21K)

It's really rather simple, some stylized facts:

1) There was Fed QE for most of the past decade without this producing any uptick in inflation whatsoever, this isn't the driving force.

2) Pandemic caused supply disruptions and a shift from services to goods

3) Governments started to financially support average people as a result of the pandemic, which has shown to be one of the most successful policy interventions of all time as almost 100% gets spent while almost all QE money simply sits idle, goes into assets, and foreign bank accounts and actually does very little for the real economy.

There is nothing more to it. Possible inflation has hit escape velocity as labor bargaining position is stronger than at any time in the past couple of decades, but policy support is already disappearing (BBB isn't large enough to move the needle all that much and might not even become law anyway and if it does, there is stuff in there that could very well dampen inflation, rather than fuel it, like childcare and pre-school raising labor supply).

Reply Like (1)

Rida Morwa Yesterday, 4:23 PM

Marketplace Contributor Premium Comments (22.26K)

Author's Reply @Shareholders Unite Thanks for the points.

1) The sheer volume of QE isn't even comparable. Prior QE was needed because of a shortage of liquidity. In this case, the volume far exceeded the needed liquidity. The most stark example is the massive uptick in reverse repurchases being done by the Fed, while the Fed continues to buy more treasuries. I'd suggest that prior QE did have an inflationary impact, but it was an inflationary impact on inherently deflationary times (IOW, without Fed action there would have been deflation). Now we have continued QE during inflationary times. To say that prior QE didn't have an impact on inflation to me is a bit like saying that because stepping on the gas pedal on a car stuck in mud doesn't cause you to go forward, stepping on the gas pedal when the care is back on asphalt isn't the cause of the car moving forward.

2) Yet demand for services is higher as well. The services PMI has been higher than manufacturing PMI for most of the past year, and today's report suggests that services companies will be increasing prices substantially as their costs are rising. Goods led the way in inflation last year, but with labor prices rising, inflation in services will be coming sooner rather than later: www.ismworld.org/...

3) Agreed. Direct stimulus payments to individuals and businesses was a very effective means of injecting liquidity into the system and is a big part of why we are seeing inflation across the board.

Reply Like (5)

Eighthman

Comments (659)

Yesterday, 2:48 PM

It's very confusing. I check the DXY chart every day and the dollar is pretty strong. Maybe other currencies are just inflated a bit more. Gold goes nowhere but that might be because crypto is diverting investment away from gold.
OTOH, wait for a possible black swan after the Olympics from digital yuan. Huawei phones in Africa are being supplied with digital wallets and lots of nations want to escape US dollar sanctions. It could shift quickly, at least in transactions use, if not reserves.

Reply Like

Rida Morwa

Marketplace Contributor Premium Comments (22.26K)

Yesterday, 4:25 PM

Author's Reply @Eighthman Gold isn't the best inflation hedge, in large part because investors ran into it right away, long before inflation started. It is more of a "safe-haven" type investment and right now that is a crowded trade.

Reply Like

turnip123

Comments (15)

Yesterday, 2:47 PM

thanks you for putting into objective terms what most Americans experience everyday.
I can't help to wonder if another reason for expanding money supply is to punish Chinese as they are largest holders of US DEBT and we'd be paying them back in depreciated dollars thereby 'cheating' them out of profit.

Reply Like

Rida Morwa Yesterday, 4:25 PM

Marketplace Contributor Premium Comments (22.26K)

Author's Reply @turnip123 The largest holder of US debt is the Federal Reserve.

Reply Like (1)

Roger field Yesterday, 12:41 PM

Marketplace Comments (1.04K)

“The Fed is now projecting inflation at 2.7% for 2022, and I will go on record right now as saying that is very low and will be exceeded early in the year.”

And when inflation DOES turn out to be higher the Fed and the regime will try and dance their way out of the incongruency by claiming changed, “transitory” circumstances.

Reply Like (2)

Jacopo Barban Yesterday, 12:11 PM

Comments (195)

@Rida Morwa thank you very much for these macro-economic articles which, personally, I find extremely useful.
Little by little, they are helping me more and more to fully understand all these very important aspects which (as you perfectly express), are absolutely not revealed in an transparent and impartial manner.
Happy to be yours avid reader!
Greetings from Italy

Reply Like (3)

Cornfab Yesterday, 11:51 AM

Comments (15)

Sounds like a defacto currency devaluation

Reply Like (1)

No way Jose

Yesterday, 1:53 PM

Premium Comments (7)

@Cornfab

USD is cooked.

The problem is everything is manipulated so hard to hide somewhere else.

Reply Like (1)

---

jgrever621

Yesterday, 11:45 AM

Premium Comments (4.13K)

Oh the answer is easy, doing so is very hard: stop spending, take the hit, and lo !!!! inflation falls flat. Or take the excess money out of the economy; and puff, the bubble collapses.

But very hard on people, mostly the ones that have no floor under them. And will also increase the number on wellfare.

So, no that won't work.

BUT the darned FED can slow inflation and just won't. What good are they?

Reply Like (3)