Inflation: Is This Time Different?

By Joseph Caplan

- Economic dislocation stemming from the global pandemic, and the unconventional measures to counter it (lockdowns, monetary and fiscal stimulus), has created unfamiliar dynamics in the post-COVID economy.
- The fallout from these unconventional measures has resulted in increasingly disturbing phenomena including: deglobalization, inflationary pressures across the spectrum (goods, services, labor), as well as rising geopolitical risks.
- With the confluence of unfamiliar risks emerging, traditional portfolio management strategies require novel approaches.

The COVID-19 Economy

At the onset of the COVID-19 pandemic and the subsequent global rollout of lockdown restrictions, adherence to traditional economic theory had become futile. On the supply side, production of goods came to a near complete halt with the global supply chain facing multiple headwinds. As manufacturers anticipated a slowdown in end-market demand, producers halted orders on crucial components. This resulted in spot shortages across the economy, from automobiles to houses.

On the demand side, quite unexpectedly, many people began rethinking their lifestyle needs due to the mandated lockdowns. Many families abruptly modified their spending priorities, particularly with regard to shelter, transportation, entertainment, food and technology. At the same time, unprecedented government fiscal stimulus generated a swift and powerful increase in overall consumer demand. Consequently, as demand vastly outweighed supply in many categories, prices of many goods began accelerating higher.

In reaction to the economic unknowns of a global pandemic, the federal government and central bank executed a swift response. Congress passed the CARES act to help the newly unemployed, support struggling small businesses, aid state and local government, and throw a lifeline to certain severely impacted industries. The Federal Reserve rapidly cut interest rates to near-zero and resumed the post-financial crisis policy of quantitative easing. These actions combined created an abundance of liquidity into the economy, rapidly sending financial assets back to pre-pandemic highs in just a matter of months.

Around the Globe

One of the most instrumental economic forces of the 20th century was the evolution from a relatively insular, country-specific economic model to a fully integrated global economy. Technology, transportation efficiencies and post-World War II infrastructure improvements laid the groundwork for countries to trade more efficiently and safely. The many benefits of globalization were felt almost universally. The growing global middle class now enjoys stable prices, higher standards of living and better access to goods and services that would otherwise have been inaccessible or relatively unaffordable.

But as globalization succeeded, the reliability of the global supply chain became more precarious. And this has been the Achilles heel of the current economic headwinds.

At the end of 2020, the United States commenced its mass-vaccination efforts. By most measures, the U.S economy has been one of the first to recover sharply. On a global scale, however, things are not as rosy. Many countries have dramatically lagged on the vaccination front, particularly in certain key emerging markets. Since the global supply chain is so interconnected, while demand has been accelerating, demand for goods is far outstripping supply.

Even as vaccinations have increased across the globe, manufacturing firms continue to scramble for parts and labor. The stability of global manufacturing continues to be constrained due to waves of COVID-19 infection and labor shortages in countries that are key suppliers to the global supply chain. Supply shortages, coupled with rising prices for commodities and energy, have put added pressure on the supply chain. And as demand continues to rise, some of the shortages have been exacerbated. As a net importer, the U.S. is quite reliant on many other countries for supplies of key components, and hampered by the supply chain challenges. Consequently, prices of many goods and services have been rising at a pace that we have not seen in decades.

Pressure Points

Today, inflationary pressures are being felt across the spectrum. Let us just look at some examples and why the challenges may be more than transitory:

Energy: Energy shortages have been spreading globally. Countries that are net importers of energy, including India and China, are particularly vulnerable. (Note that in April 2020, the price of a barrel of oil briefly traded below zero, meaning that a seller would be required to take

CONTINUED ON NEXT PAGE

Inflation: Is This Time Different?

CONTINUED FROM PREVIOUS PAGE

delivery of oil.) Recent energy shortages, including oil, natural gas and even coal, are negatively impacting the global economy. Moreover, a number of countries are on the brink of a power crisis (which could worsen if winter weather patterns prove more dire than expected). There are increasing reports of manufacturers having to slow production or close down due to challenges in energy supply as well as the rising prices. Global leaders are now being pressured to rethink their decarbonization strategies and how to adapt their long-term energy transition strategies.

Deglobalization and Trade Issues: Given the widespread impacts of the interdependent global supply chain, corporations and even governments are compelled to rethink how to adapt to the newfound weaknesses in the model. Supply chains have become too conditioned to the dependability of other global manufacturers and countries. A stark reminder of that dependence can be seen in the semiconductor industry. Taiwan Semiconductor Manufacturing Company manufactures over 50% of global semiconductor chips. These chips are at the forefront of nearly every electronic gadget and device. Our reliance on one company, particularly in a country that has longer-term geopolitical vulnerability, is problematic. The U.S. federal government is now considering the onshoring of semiconductor manufacturing to ensure that America will no longer be exposed to shortages of such an important engine of growth.

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Final Thoughts

What should be apparent to nearly everyone is that inflation is currently a dominant challenge to Americans and to the vibrancy of our economy going forward. In the next column, we will address how investors should be thinking about the longer-term risks of inflation to their portfolios and how to protect one's portfolio if inflation proves persistent.

*Jonathan Caplan contributed to this article.

Joseph Caplan is a vice president of investment strategy at Caplan Capital Management. He received his BA in economics from Rutgers University. The views presented are those of the authors and should not be construed as personal investment advice or a solicitation to purchase or sell securities referenced in this market commentary. The authors or clients may own stock or sectors discussed. All economic and performance information is historical and not indicative of future results. Any investment involves risk. You should not assume that any discussion or information provided here serves as the receipt of, or as a substitute for, personalized investment advice. All information is obtained from sources believed to be reliable. However, we do not guarantee the accuracy, adequacy or completeness of any information and are not responsible for any errors or omissions or from the results obtained from the use of such information.