MOMMAERTS MAHANEY
FINANCIAL SERVICES, INC
ACHIEVE MORE.

989 W Washington St., Suite # 101
Marquette, MI 49855
(906) 226-8711
www.mommaerts-mahaney.com

April 25, 2022

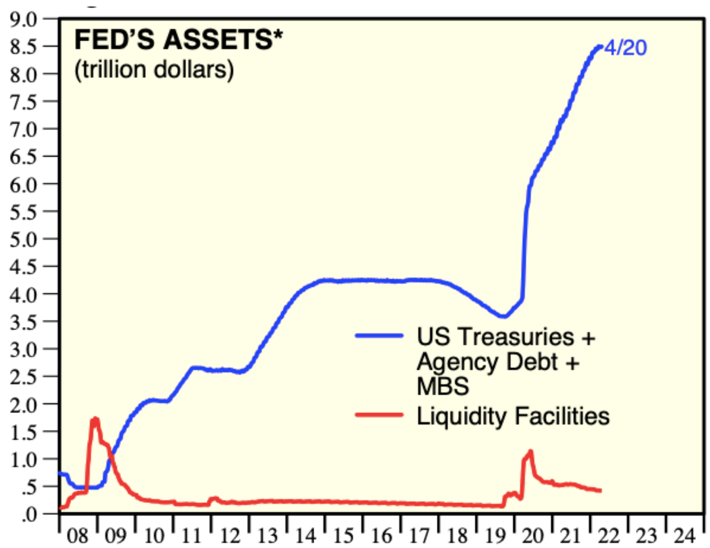
A Peek at Peak Inflation

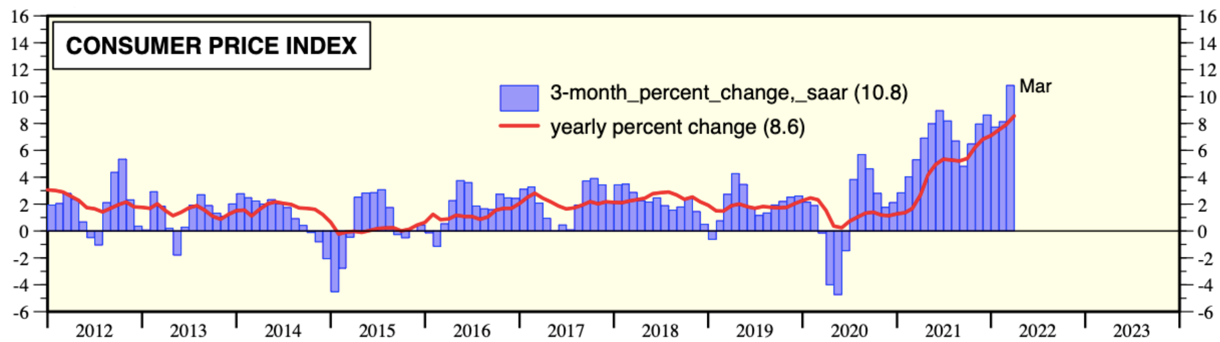
Jon C. Mommaerts Certified Financial Planner®
Robert Kea Chartered Financial Analyst
J. Matthew Tuccini Certified Financial Planner®
Jason J. Rolling Financial Advisor

Recent Volatility - It's rare when market volatility is disruptive enough that we reach out and address the volatility of daily market movements. Last week saw a violent reversal in what had been a steadily recovering equity market.

The S&P 500 made a record high on January 3rd of this year. It then dropped 13.0% from its record high, bottoming on March 8th. It subsequently rebounded 11% through March 29th. It then dropped 8%, with much of this drop occurring over the last couple of days, including a 4% reversal following Fed Chair Powell's speech on Wednesday.

Powell stated, "The labor market is very strong, and inflation is much too high...we will take the necessary steps to ensure a return to price stability, in particular, if we conclude that it is appropriate to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings, we will do so. And if we determine that we need to tighten beyond common measures of neutral and into a more restrictive stance, we will do that as well." Before assuring us he will heroically save us from inflation, we would have appreciated it if the Fed Chair first acknowledged they created the inflation they will now save us from.

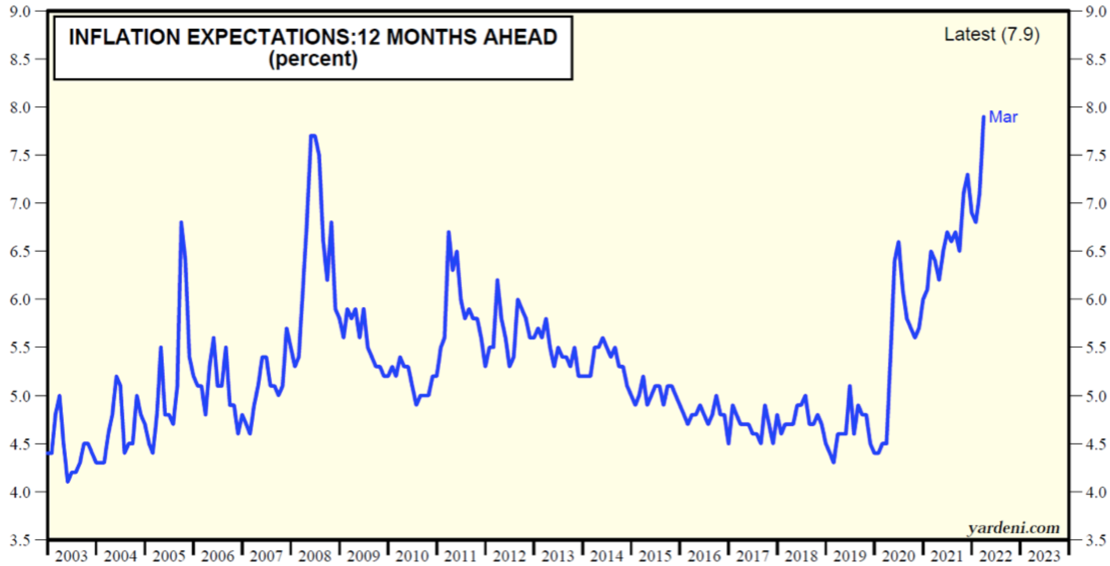




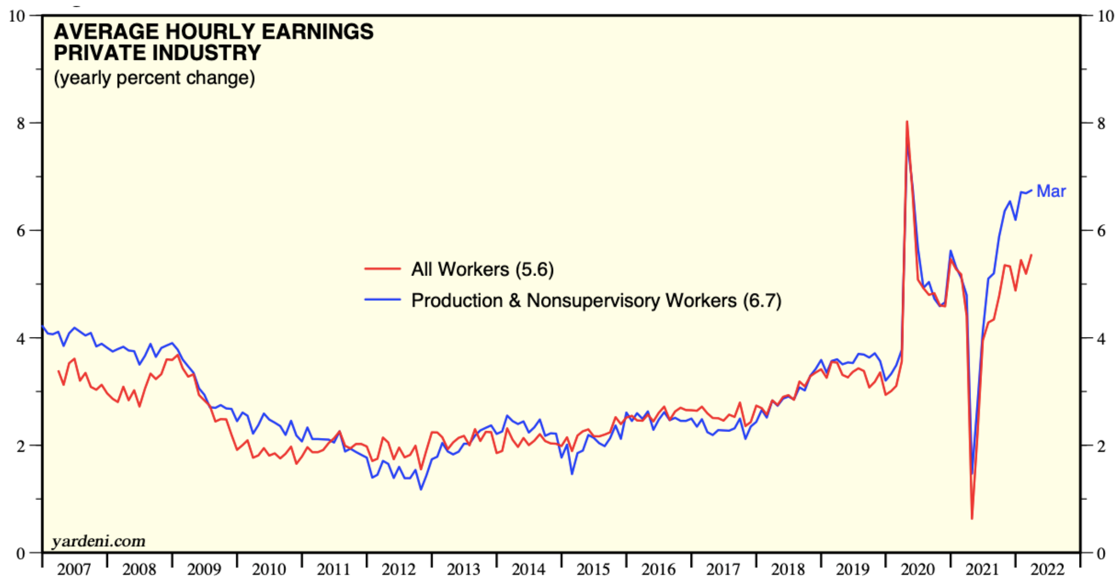
Needless to say, this is why we remain skeptical of Keynesian Economics. We will resist a further rant on that subject, at least for the moment. Rather, we will take a look at when we expect peak inflation and what that means for financial markets.

The Federal Reserve is currently in a very rare situation. All 12 voting members of the Federal Reserve agree that tighter monetary policy is necessary to control inflation. A consensus view within the Fed almost never occurs. As background, each voting member is generally referred to as a Hawk or a Dove. The Hawks generally push for tighter monetary policy while the Doves generally favor an easing monetary policy. The Fed has a dual mandate to create full employment along with price stability, aka controlling inflation. There has been a truly remarkable transformation within the Fed's animal kingdom, Doves have transformed into Hawks. A clear consensus has developed within the Fed, which is about as rare as a consensus between political parties. Higher inflation is now universally viewed as a real issue and tighter monetary policy is a necessity to bring inflation back into check. In the most recent Fed minutes, the Fed acknowledged inflation is no longer *transitory* and they will no longer use this word to describe the current inflation environment.

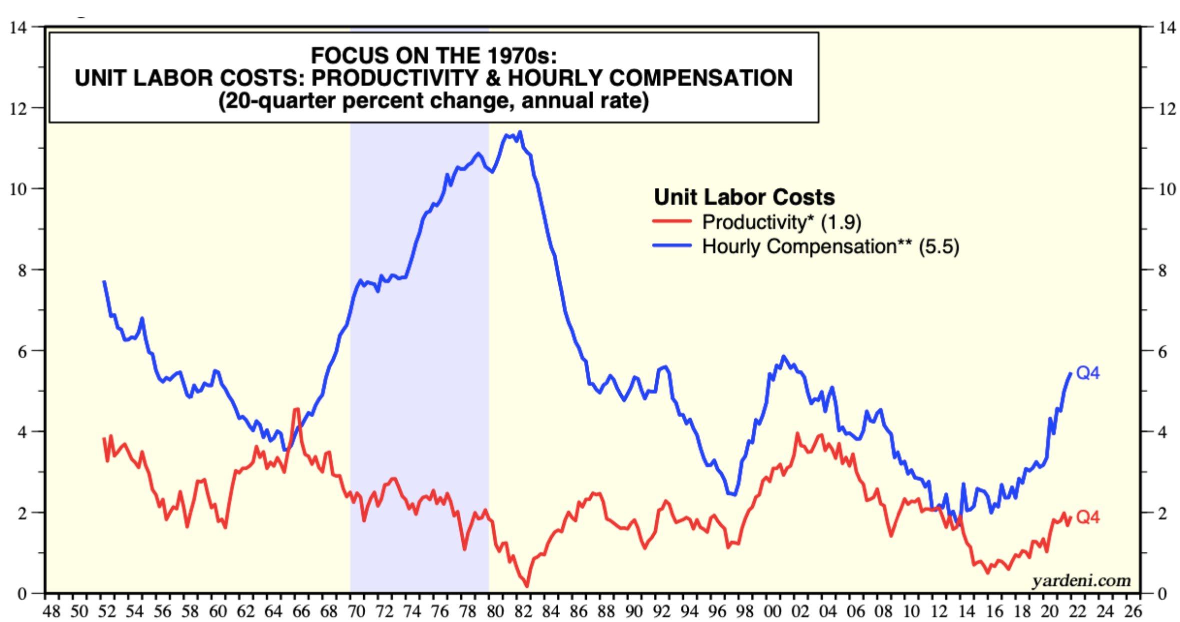
We suppose the good news is that the Fed is really bad at forecasting inflation. Although it is rare for the Fed to have a consensus view on the need for tighter monetary policy, it is not rare for the Fed to consistently overestimate the future rate of inflation. Over the last two decades, the inflation rate has remained materially below the Fed's forecasts of inflation. Over the last decade, inflation forecasts have consistently called for rates at or above 4%. Until recently, the actual rate has consistently remained below the Fed's 2% target rate.



We have and continue to argue that the *Fed Model* of forecasting inflation is flawed. More specifically, the Fed is not properly measuring the labor supply. Even without immigration, technology has allowed most industries to tap into the global labor supply. Of course, certain industries, such as the restaurant industry, are more limited to the domestic labor supply. However, average hourly earnings have remained well in check since the onset of the technology boom. (There is no useful information to be harnessed from the nuttiness of the last few years.)



Technology advancements have and continue to help employers increase productivity. The 70s' were a period of rapidly rising wages and plummeting productivity. That is not the current situation. Unlike the manufacturing economy of prior decades, employment is not tied to COLA (cost of living adjustments). This has helped to avoid a wage-price spiral. This is why unlike in the 70s', corporate earnings continue to grow to new record highs.

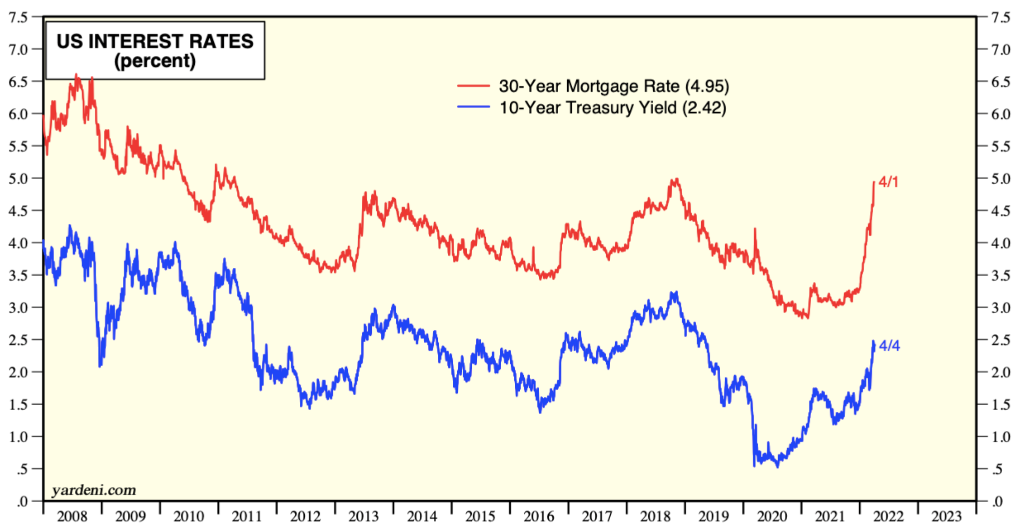


Wage price spirals cause the type of systematic inflation we saw in the 70s'. During the inflationary periods of the 70s' and post WWII, corporations needed to consistently increase salaries to attract employees. This increased disposable income lead to more demand. More demand leads to a need for more supply. The need for more supply lead to even higher wages. This is referred to as a wage-price spiral. As wages spike, corporate profit margins shrink. This leads to high inflation and low growth, aka stagflation. The unprofitable corporations then start laying off workers, which shrinks disposable income and eventually leads to a recession.

This is not the scenario we see as most likely. It's become clear that too much stimulus (free money) was injected into the economy. This money needs to be burned off. Once this money is absorbed into the economy, inflation should moderate, although remain elevated above previous levels. **Our expectation is for inflation rates to peak this summer.** After a shockingly high 7.9% inflation rate in February, the March CPI report was even more shockingly high at 8.5%. Looking at the components of CPI offers valuable insight into these shocking numbers. Energy increased by 32% and food increased by 8.8%. Meanwhile, most other components of the CPI were down from their recent peaks. There is also evidence that housing is slowing as rates increase. (More on that below.)

We continue to forecast inflation will trend between 3%-4% for the next several years. We also predict that the Fed will adjust its inflation target from 2% to 3%. It's so much easier than admitting they were woefully behind the inflation curve. We actually encourage them to do so. A consistent 3% inflation rate is not overly troublesome and far less harmful to the economy than pushing inflation back down to 2%.

Median home prices have risen more than 30% over the last year. Although prices are still rising, there has been a slowing in the rate of price appreciation. This makes sense. 30-year mortgage rates have risen to 5%, matching their highest levels over the last decade.



Most home buyers are still reliant on making the cash flow work, a few percentage points turn would-be buyers into fans of remodeling their current dwelling. Redfin recently noted a decrease in online searches, home tours, and mortgage applications.

The volatility range for stocks right now is ridiculous. Day to day stock prices continue to be highly dependent on the Talking Fed Heads and daily news flow. We believe we are once again near the low end of a wide price range and expect higher levels by year-end. There continues to be good news on the earnings front. So far 17% of S&P 500 companies have reported Q1 earnings with 81% beating analyst estimates. Broadly speaking, the earnings beats are attributable to insatiable consumer demand and the ability of corporations to push prices increases through to consumers.

We will communicate again later this week. Do your best to stomach this volatility storm, and give us a call if the antacids aren't getting the job done.

The Mommaerts Mahaney Team

Jon C Mommaerts, CFP®: Jon is a Principal of Mommaerts Mahaney Financial Services, Inc. He has over 30 years of experience working with professionals and those about to retire. He is a member of the Financial Planning Association, as well as a member of the Preferred Financial Advisors.

J. Matthew Tuccini, CFP®: Matt has over 17 years of experience working in the financial services industry with vast experience in retirement planning, tax strategies, and financial planning.

Robert Kea, CFA: Bob has over 30 years of experience in portfolio management. He was a founding member and Co-Head on Putnam's Asset Allocation Group, which managed $12Bn in both retail and institutional assets.

Jason Rolling, Financial Advisor: Jason has been in the financial services industry for the past 15 years. His financial experience includes retail banking, consumer & commercial lending, bank management at the local, regional and SVP level, wealth management, and financial planning.

FPA FINANCIAL PLANNING ASSOCIATION | PROUD MEMBER

989 W. Washington Street, Suite 101 Marquette, MI 49855
(906) 226-8711