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Reality-TV

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Our society has an unhealthy fascination with inflation. The US population also has an unhealthy fascination with the Kardashians, but that's neither here nor there. When Kim and Kourtney have a fight, stock markets don't sell off 5%. When a Federal Reserve Governor references inflation, the stock market goes crazy. This has been happening once or twice a year over the last couple of decades.

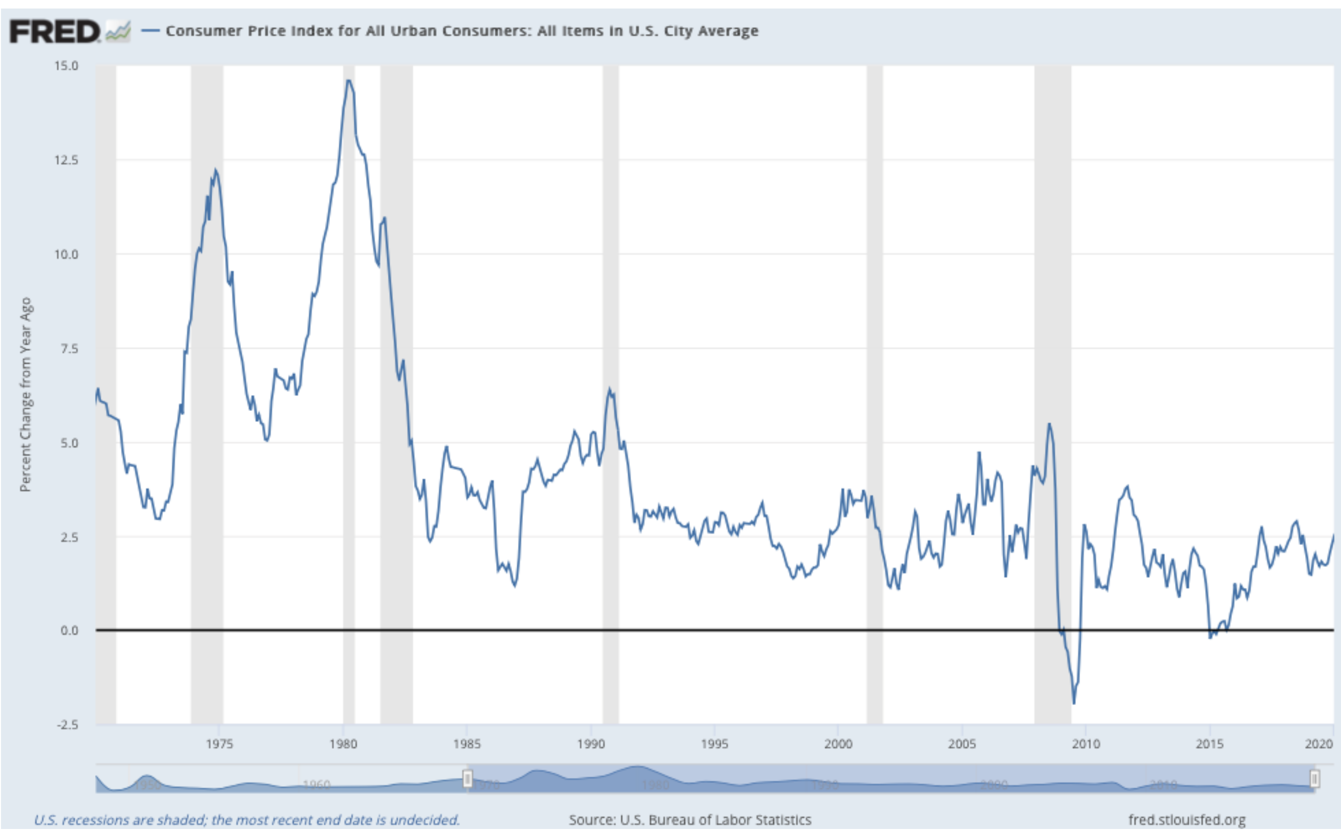
Reality television achieves higher ratings by creating drama from otherwise insignificant events. The most successful reality shows develop strong viewer emotion around characters and storylines. The networks hope their creation of superficial drama generates a love or hate relationship between the viewers and the characters, then they have you hooked. They achieve this dynamic by creating heroes and villains. We (meaning Audrey and Bob) are still infuriated with ABC's Bachelor Jason Mesnick initially choosing kindhearted Melissa (our choice) but then dumping her for that conniving back-stabber Molly, but we digress.

CNBC, and the other financial news networks, seem to be taking a page out of the reality television playbook. A recurring character on their reality show is inflation. A couple of times a year they reintroduce this evil character and whip their audience into a frenzy. Experts keep warning us that inflation is lurking just around the next corner. They assure us this villain is even more evil than Molly, and will quickly ruin the economy. Stock markets go down and ratings go up. Understandably, we receive many emails from concerned investors about this inflation character.

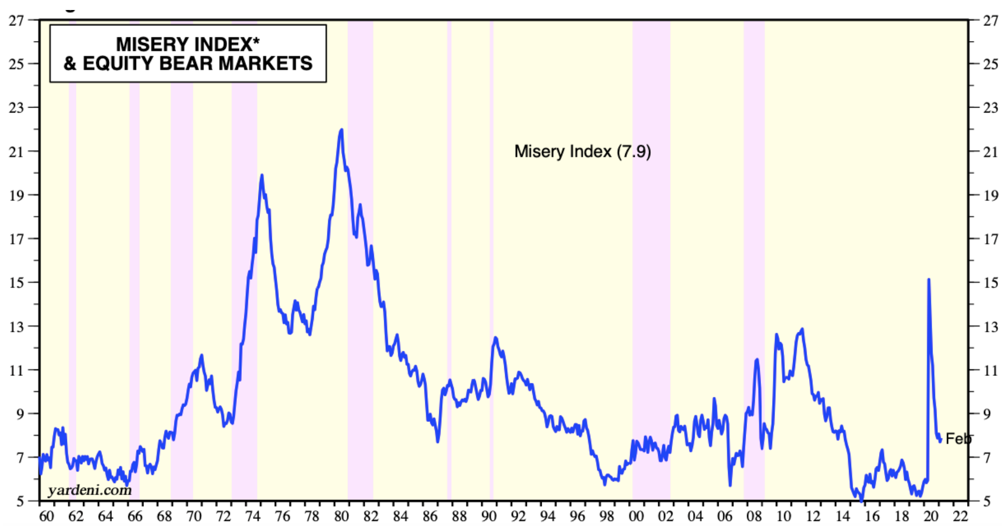
We’ve been consistent about our thoughts on inflation. We don’t think inflation is evil (unlike Molly). Inflation is simply misunderstood. When presented with multiple options, there are two ways to come to a decision. Choose the option you prefer or eliminate the options you dislike. Both will lead you to a final choice. The Bachelor does the latter at the conclusion of each week’s episode. His limited number of roses gradually eliminates contestants until he ends up with his most appealing option.

The Consumer Price Index (CPI) measures the change in prices paid by the average consumer. It is how we define inflation in the United States. There are three options for price movement; up (inflation), down (deflation), or flat (noflation). If we had only one rose to hand out, deflation and noflation would be sent home. We would get weepy and give our rose to inflation before honeymooning on the island of Economic Prosperity.

Inflation has both an inner and outer beauty. Here’s a picture from our wedding day.

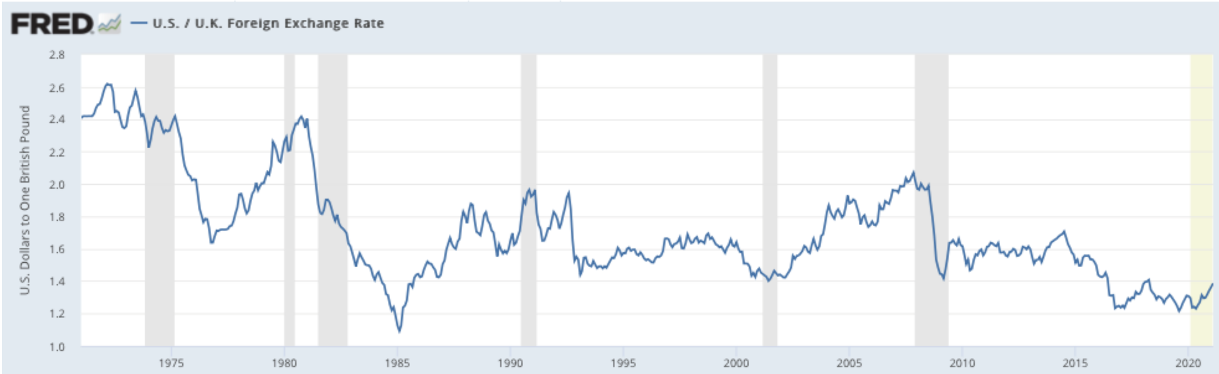


The inflation rate has been steadily dropping since 1980. During the ’70s, inflation developed a bad reputation and hasn’t been able to shake it since. After many years of reasonably stable inflation rates, in 1971, inflation started to spike higher. It earned the nicknames hyperinflation and later stagflation (high inflation combined with low economic growth). Stagflation gave birth to an economic indicator known as the misery index, the unemployment rate plus the inflation rate.

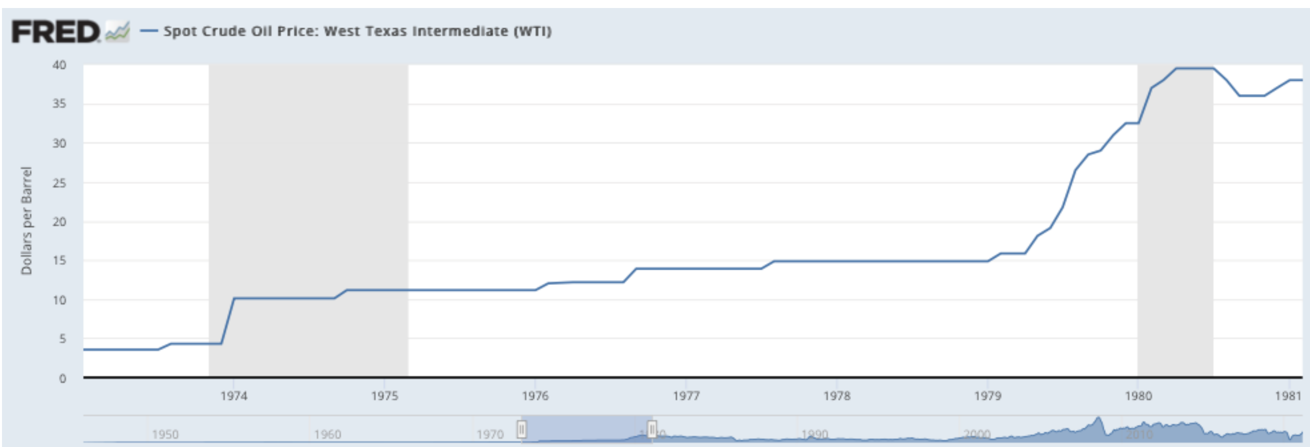


The ’70s were a miserable economic experience as the Misery Index confirms. Those of us that grew up in the '70s still remember it well and want to be certain we never have to relive that experience. Much like our grandparents never trusted banks after the Great Depression, we don’t trust inflation. Learning to trust inflation again has not been easy for most. Understanding what caused the inflation spike in the ’70s may help.

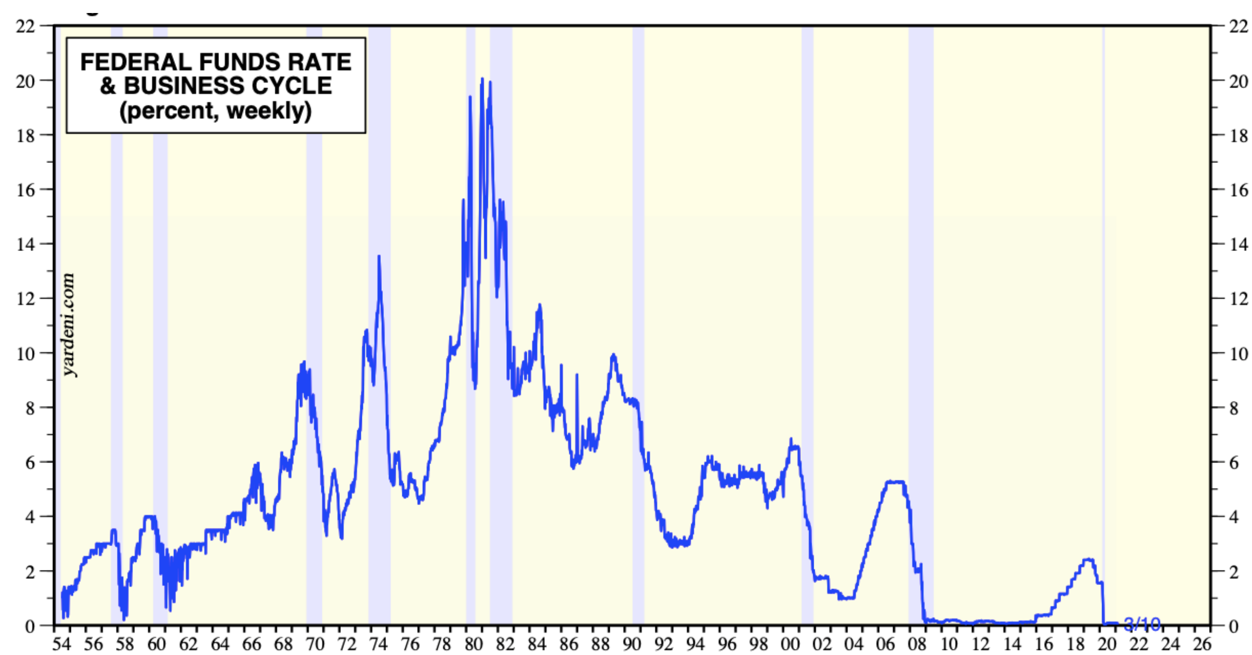
On August 15, 1971, President Richard Nixon ended our monetary system known as the Gold Standard. This meant the convertibility of gold into U.S. Dollars was no longer pegged. The value of U.S. Dollars in foreign exchange markets fell sharply. (Note - We are using the UK Pound as a proxy exchange rate since Francs, Marks, Liras, etc. became the Euro.)



This caused import prices to move dramatically higher. Global commodity prices also shot higher since they are priced in U.S. Dollars. This in turn drove consumer prices higher. Basic necessities like food and shelter became intolerably expensive. OPEC then decided to limit the supply of oil being shipped to America and this created an 800% increase in oil prices during the decade.



CPI went from 2.7% during June 1972 to 14.8% during March 1980. Wages, in particular union wages, were tied to the inflation rate. This created an upward spiral of inflation that kept feeding on itself. Finally, in 1980 Fed Chair Paul Volcker ended this insanity by purposely collapsing the economy. He severely tightened monetary policy by raising the Fed Funds Rate dramatically, causing a severe recession.



Since 1980 we have been experiencing a consistent decrease in the inflation rate. Our belief is what happened in the '70s was unique and likely not repeatable. We also believe that supply has greatly expanded due to globalization and technology. This is fundamentally disinflationary since prices are the equilibrium between supply and demand. Our greatest concern is not inflation, it is deflation.

Capitalism relies on prices being higher in the future. If prices are going to be lower in the future, consumers have no incentive to spend their money today. They will wait until tomorrow when the price is lower. When this happens across an entire economy it is known as a deflationary death spiral. It is what happened during the Great Depression. Why buy something today that is going to cost less tomorrow? Nondiscretionary spending is less affected since consumers still have to eat and provide themselves with the basic necessities of life. However, discretionary spending disappears. That new washing machine is getting cheaper every day, let's keep waiting before we buy a new one. A zero-inflation rate (noflation) creates the same dynamic albeit to a lesser extent.

The Fed has been targeting a 2% inflation rate for many years and has been unable to achieve even that modest goal on a consistent basis. We welcome a little more inflation. Our greater concern continues to be deflation and we keep dancing dangerously close to a 0% inflation rate. Expect many more stock market tantrums over inflation fears. Inflation will likely move higher over the next several months. Sending 250,000,000 Americans $1,400 tends to have that effect. However, we don't expect a structural increase in the inflation rate. Once the stimulus checks are spent, inflation rates will likely drop again.

We will always save a rose for you,
The Mommaerts Mahaney Financial Team

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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.

Mommaerts Mahaney Financial Services, Inc. provides advisory services through ERTS Wealth Advisors, LLC, a registered investment advisor.
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