Ep78: America's Economic Imbalance and Rising Inflation

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PATTI BRENNAN: Hi, everybody. Welcome to the "Patti Brennan Show." Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives.

Joining me today is Eric Fuhrman. He is known by many of you who have been subscribing to the show as the Professor. The Professor and I are going to unpack a topic that...geez, it just seems like everybody is talking about today. Right, Eric?

ERIC FUHRMAN: I would say so. The only suggestion we might have, we should play some kind of dramatic music when we make the introduction. The Professor, you need some kind of drama to really...

PATTI: We probably should get your Alma Mater, your school song, playing in the background, something like that.

ERIC: Yes. Maybe a clip from "Gladiator" or something like that.

PATTI: Absolutely. I'll believe with this...

ERIC: Russell Crowe movie.

PATTI: With this topic we need the Gladiator. Today, we're going to be talking about inflation, an important topic for everybody who's watching and listening to the show.

Eric, it's funny, I have to share with you something that someone told me about the podcast. They said that when they listen to you and Brad, they always feel like they get the facts and nothing but the facts. It's unbiased and very clear, and they always walk away feeling better. I just wanted to say that to you. I really appreciate the time and effort that you put into this podcast.

I also want to let everybody know that in preparation for these shows, we put together whitepapers. Up until today, we haven't put them on the website. It occurred to me that, "Geez, we're doing all of this work. We've got charts, and graphs, and a lot of really good content." In addition to listening to podcasts, you can go to the website, and you'll also see the whitepaper addressing the topic that we've discussed.

With that in mind, we're going to talk about, geez, what is the big deal with inflation? Is it something that we all need to be worried about? By the way, what are we going to do about it?

ERIC: I just want to follow up on that comment there. Appreciate that. I think that we owe it to our clients but also anybody who listens to the podcast to really come with hard-hitting facts, not just facts but things that are supported by evidence that can be demonstrated by observing the world and what we see and weaving together a compelling narrative.

Hopefully, that creates a podcast that's going to cause somebody to take the scenic route to work so that they can get all the facts and figures and listen to it from start to finish. That's what we want. It's not just for you to tune in but to tune in to the very end.

PATTI: Oh, absolutely, and I know I would do it, especially knowing what we've put together for today's show. It's really good stuff. Again, to your point, it's just facts. We're hearing the headlines, and we're hearing what the Fed thinks and what other people think. Where is all this information coming from? How are they backing it up?

ERIC: What's neat about you and me is we're both nerds because we're talking about inflation here, but I think what's important is that the enthusiasm comes through and is infectious and that hopefully benefits anybody listening to the podcast that they come away with an understanding of something that maybe is not the most exciting topic but certainly affects your pocketbook and your finances.

PATTI: It also affects how you sleep at night because, geez, you look at the headlines right now, and people are reading 5.4 percent inflation. This is scary. Are we going back to the '70s? Eric, this is probably dating myself. It's well before your time, but I find there is a generational difference between people's perceptions of inflation.

I grew up in the '70s. Geez, we had to wait two and a half hours in gas lines just to fill up our tank. In fact, I will never forget this, Eric. I don't remember. It might have been 1980. The EPA came out with the most fuel-efficient car in America. It happened to be the Volkswagen Rabbit diesel engine. My father, Gene Clark, the father of seven children went out...

ERIC: God bless him.

PATTI: God bless him. He's right. He went out and bought a Volkswagen Rabbit that fits for people if you're lucky, but you know what? Hey, it gets 50 miles per gallon. The only problem that he discovered was that the tank itself was only 10 gallons. We were still waiting in line as often as the rest of us.

That's the way we grew up with inflation and the long gas lines, and it's never going to end if the world was going to run out of oil. It is a fear that's out there. We remember Germany in the black and white pictures of the bread lines and something that you brought up about China which we'll get to later.

It's a very real thing because of these rising prices. If the incomes are not rising along with it, how are people going to afford to live?

ERIC: What I think is so interesting is that what you really highlight on here, which is important, because I was born in the '70s, at the end of the '70s, I didn't live through it. Our experiences really shaped our expectations of how we view inflation.

For me, I didn't have an income back then. I wasn't buying things. My parents were, but I just remember them complaining a lot when gas was more than the dollar a gallon.

The baskets of goods that I purchase throughout my lifetime are more things like electronics and other things. The basket I purchased might be different than the basket of goods that somebody who's older that purchase, so we see it through different lenses really shape our AR experience in the time period that we grew up.

PATTI: Let's unpack this a little bit. Let's give everybody a primer on inflation. What exactly is it, Professor?

ERIC: Inflation can arise for different reasons. Usually economy at any given time is able to produce a relatively fixed quantity of goods and services, but the prices to produce those goods and services can drive inflation higher if this idea of too many dollars chasing too few goods.

There's more demand than there is supply. We believe there is right now that can drive prices higher. It's a human phenomenon that has been around for centuries, so it's nothing new.

PATTI: If I hear you right, it's caused by an imbalance of some sort. Too much money, too few supplies. It's an imbalance, right?

ERIC: Right.

PATTI: Now, we've got that. Right now, we're talking about this 5.4 percent inflation. That is significantly higher than the Fed target of two percent. Are we on the weight of runaway inflation? By the way, is all inflation created equal as everything going up?

ERIC: That's a great point that people need to understand, is they tend to focus on that headline number. That's a dramatic increase. Again, the number is measuring June from this year to June of last year. We were in a much different place last year where prices were not rising because we were going through COVID.

PATTI: Boy, that's a good point. Guys, really lock and load that point. It's year over year. Remember where we are. Just as Eric just said, in June of last year, we were in lockdown. People were not buying anything.

ERIC: Also, here, for those that are watching online, we are putting up charts of these graphs, so you can see it, but figure one that we're going to present that the human brain needs to fill a void.

When you look at this number, you see a chart where it's just going straight up. The brain has to fill that in, and the brain is likely going to say, "Well, it's just going to keep moving in the same direction. We're just going to extrapolate the past into the present."

The reality is, when you look over a much broader timeframe, inflation has a lot of oscillation. It moves up dramatically. It falls dramatically. We just want to take a step back and realize that, yes, it is a big number, but I think we just need a deeper understanding and recognition that trees don't grow to the sky. It just doesn't go on forever.

PATTI: I love this part in your whitepaper that referred to certain self-correcting mechanisms because what happens is when there is a lack of supply, prices go up, and then capitalism is what capitalism is. Other entities say, "Wow, they're really making a lot of money. This profit-driven society that we have," and more people get into that particular areas, so the supply increases.

As the prices are also going up, and then consumers, people like you and I are saying, "I'm not paying that much money for that house," which is something that we're experiencing right now.

How many people have we receive calls from who were looking at buying a second home or maybe getting a larger home and they're saying, "You know what, we're waiting this one out. The prices have gotten ridiculous"? That becomes a self-correcting mechanism also.

Sooner or later, more supply people are not going to be buying and having this feverish, pitch of overbidding for these homes, that's number one.

Number two, as the prices begin to level out and even go down as lumber has, builders are now saying, "OK, I was pausing on building that development. We weren't going forward with it, but now I can do so, I can build a home, and have a profit." It does begin to dissipate over time in normal times. Let's just say that, right?

ERIC: Yeah. You highlight. This is Economics 101. We all have to figure out how to allocate scarce resources. You and I, as consumers, freely engage in cooperative exchange if it's to our benefit. It is the buyers and sellers that set the price.

Transactions are occurring, prices are rising, but people are still coming together and finding value in that transaction. That transaction is ultimately what creates output and economic prosperity, which defines our standard of living.

If prices get too far out of whack, just like you're saying, we hear people that are now saying, "I'm going to delay or defer the purchase," you and I can make a decision whether we exchange or whether we opt out and say, "I'm just going to wait."

Just like you're saying, as more people are exchanging, if prices are rising, that will bring sooner or later more supply to the market because that means profit margins are going up or people decide it's too high, it's not worth it, and they wait. Now, eventually, the price will slow down or...

PATTI: As inventories rise, it all comes down to that.

ERIC: Or at least, that's how all those charts go that when you were an economics class, you had to fill out on your test.

PATTI: It's interesting because it's getting back to that 5.4 percent. I was fascinated with figure number two here in terms of, "Gee, what really is inflating and what really isn't inflating?" Take it away, Eric. I thought this was terrific.

ERIC: I think the point here is that the headline number is an aggregate basket of thousands of different products and services that are being valued. Inflation is most certainly not evenly distributed, and it affects some people in some industries more than others.

When you look at headline number 5.4, more than a third of that increase is just related to rises in used car and truck prices. That's one element

PATTI: That blows me away, I'm sorry. That is amazing of all of the metrics and all of the things that were are being measured. It's not even new cars. I could understand the new car prices increasing faster because manufacturers can't get ahold of the chips, right?

ERIC: Right.

PATTI: But it's the used cars, which I just think is fascinating. It's a third of the increase, which is not everybody is buying a new, used car. I don't think that's a word yet.

Not everyone's buying a new, used car every single year. Not everybody is going to be affected by that part of the CPI U.

ERIC: What's so interesting, you have three categories that increased 44 percent year over year – fuel oil, motor oil, used cars, and trucks – but other things too like transportation services, airlines. You've had double-digit increases and these areas, but we have to think and put that in context of what has basically transpired over the last 18 months.

Yes, the numbers are high relative to history, but we're also talking about a historical event that has not occurred in the modern age with just-in-time supply chains where people don't build massive inventories. They order things when they need them.

Something like this has never occurred or unfolded in this way. I don't know that you can say this situation is just like the 1970s. This situation is unique, and we have to understand that.

PATTI: It is so interesting because again on that chart, figure number two, the second and third categories are motor fuel and fuel oil, which by the way, just to bring you back a year ago, do you guys remember that oil prices went negative. Negative. Now, that's never happened before. That's your starting measurement, and then you're comparing it today.

Again, when you hear these figures, understand what they're measuring, year over year versus annual things of that nature, and make sure that you are…At least, I'm going to speak from our perspective. We're always evaluating these things in their proper context.

ERIC: Context is everything. Some people who have been locked down in their homes will be happy to hear that alcoholic beverages have only increased by 1.9 percent, so far less than the CPI. Clearly, some people are benefiting from the inflationary trend.

PATTI: Which is interesting, because I think that comes down to…I mean, everybody was drinking a lot more. Hey, you know what? It was out there, so I might as well go for it.

ERIC: Moving on. What you tapped into earlier was this generational difference in terms of expectations, but it is interesting. Surveys are done on inflationary expectations, and there is a pretty distinct difference based on when you were born.

Some people would say certain cohorts of the population have a sampling bias to how they view inflations. Most of our clients tend to be on the older end of the age spectrum. We hear a certain perspective, and that perspective is really formed by experiences over 30, 40, 50 years.

PATTI: You bet. At the same point, our younger clients who don't seem to be as concerned about it, also need a little bit more education, that never says never, right?

ERIC: Yeah.

PATTI: We do have some of the signs of inflation that it could get to be an issue that needs to be dealt with in a more forthright manner. Let's talk about the drivers of it.

Let's talk about the drivers of inflation and then maybe break it down, Eric so that the listeners can get a better understanding of why the Federal Reserve and Jerome Powell, in particular, seem to believe that this is all going to be temporary. This is transitory. How come?

ERIC: Inflation is a general rise in the price level, but it can occur for different reasons. Economics has given us a way to delineate between two forces that might cause inflation. The 1970s style would be what's called cost-push inflation where you have some kind of shock or something that happens.

Basically, the natural resources that make the products that we consume or the cost of labor, these things are rising and that's increasing production costs, and supply ends up shrinking because of that. If you and I still want the same kind of stuff, but there's not as much of it to go around, that's called cost-push inflation.

We think and believe when we look at what's going on in different indicators that this is actually the other form of inflation, which is called demand-pull. That's more of a situation where demand is growing, and there's just supply is not growing fast enough to meet everyone's demand.

If you want to tease apart COVID and decisions that were made, I think we have a framework that supports the demand-pull inflation theory more than the 1970s style cost-push.

PATTI: All of the things that were done in 2020, during COVID, whether it'd be fiscal or from the Federal Reserve, fiscal in terms of checks to every American, rich or unemployment benefits, the evictions.

The fact that people couldn't be evicted from their homes and their apartments, and then the Federal Reserve stepping in, lowering interest rates, and doing the bond-buying programs to increase the supply of money in the economy, making it so that banks didn't have to have the reserves that they did before that loosened up the lending requirements, and so the banks could lend more.

There's a lot more money in the economy, just pure cold cash. On top of it, we were in lockdown, and we couldn't spend it. Savings rates went up, and that was wonderful, but eventually, that will catch up with us.

ERIC: It's interesting. For us, we have our client base to take a sampling, but how many phone calls that we get our client said, "Well, we're just not spending money. You don't have to send us the same amount, or you can stop the distribution. We're fine on cash"?

These are people that are not doing this discretionary spending, and cash is just piling up, is not being spent. As you pointed out, you have a government stimulus that is injecting money into the economy and directly into people's pockets.

PATTI: It's really interesting. I just thought about this. Even the suspension of the requirement for people to take their required minimum distributions, most of our clients, they said, "Hey, I don't need it. Don't send us our required minimum distribution this year if we don't have to take it. Just leave there."

As a result, their taxes went way down. I just think the domino effect of all of the decisions, it's fascinating. The unintended consequence could be some inflation.

ERIC: When you put the pieces together into this mosaic of this demand-pull theory, what you come away with is what you're describing, is that there's pent-up demand. There are people that have cash. There's stimulus, but guess what? They can't spend it because of lockdowns and social distancing.

Those things are now melting away or have been removed over the last couple of months, so you've got all this money and all these people that are itching to get out and spend. You've got a huge burst of demand.

Think about producers. Think about businesses. If you're a business and you go through something like COVID, what do you need to survive? You need cash. You need lines of credit. If you have inventory, inventory is cash tied up in the balance sheet, so what do you do? You liquidate.

As we're piecing together this theory, you have a lot of cash, a lot of pent up demand that is basically being released all at once, not over time, at the same time that you have suppliers that are dealing with record-low inventories and cannot rebuild them because they needed cash to survive. Inventory's been liquidated. You've got these two really incredible forces coming together at the same time.

PATTI: Eric, it's so interesting because as we were preparing this podcast, you told me about the story of taking your family out to a restaurant this weekend. I will have you tell that story, but I think that along with inventory…

Remember, we are a nation, an economy, of goods and services. Geez, as part of this whole issue, many people let their employees go or put them on furlough, never to see them again. Why don't you tell our listeners what happened this weekend?

ERIC: My mind was in tune with this because this is something that's been in the works for a while. I took my family out to a restaurant that was on the water, a beautiful place. It was so interesting. We went to check-in, two and a half hour wait, people, sitting everywhere. In my mind, I'm thinking, "Wow, a lot of demand. People want to get out."

As we wandered around while we were waiting, trying to pass the time, the interesting thing that I noticed is there's a two and a half hour wait, there are people everywhere, but there are empty tables all over the place. Why are there empty tables?

PATTI: There were no servers.

ERIC: Right.

PATTI: Right, they...

ERIC: Not enough people to wait on it, so there is a true economic cross. That kind of thing can play out in terms of rising prices, but there is also an opportunity cost because those are sales that those businesses are not able to realize because they can't service the customer.

PATTI: Exactly, and they don't have the people putting in the orders, therefore, they're not having that sale. In this example, it might be a meal, but sales occur at all levels of the economy. Therefore, they don't have the profits. That goes on too long. Guess what? They're out of business.

ERIC: That's an example of the service business, but we can look at evidence of inventory ratios, and this is common sense. You can observe this with your own eyes when you go around – inventory of housing, inventory of autos, inventory at retail stores.

There is a metric called the inventory to sales ratio that you can look at. Normally, what you want to see is a low inventory number, right? You don't want too much cash tied up in inventory because that's money that's inefficient.

You want to try to keep balance, but what we see now is you have inventory to sales ratios that are rock bottom. They've never been so low. That's not a sign that businesses suddenly became magically efficient in the last 12 months. It's a sign that they don't have a product.

If you don't have a product or there's very little of it, what happens? The price goes up, or you can't record sales because you don't have the stuff to sell. To me, that's an interesting way to see another thing that feeds into that demand-pull inflation story that there's not enough supply to satiate demand.

PATTI: That's a metric that the Federal Reserve looks at. That's an important thing for everybody listening and watching today. They're not making this stuff up. That's a ratio easily obtained when you go on the Federal Reserve's website. Another important statistic that delves even...

ERIC: If you're like us, it's easy because we're on there all the time. We know what to look for.

PATTI: That's true. We're nerding out again. Sorry about that. Good point.

ERIC: It's not as easy you think.

PATTI: OK, guys. Do you think that one was bad? Wait till you hear this next one.

It's called the Baltic Dry Index. Don't I know you want to turn off your phone and run to your computer to look this up because it's so fascinating. However, it does give us a very good idea of what might come in the future. Eric, why don't you explain to everybody what it's really measuring?

ERIC: Gosh, it's a term that I don't know ever gets worked into very many meetings, but it seems relevant today.

PATTI: Fire away.

ERIC: I tried this one on my family. "Baltic Dry Index, what are you talking about, Dad?" Basically, what the Baltic Dry Index is, when you think about this supply and demand story, if retailers don't have inventories, keep working your way back to the origin of the supply chain.

Where is the genesis of the supply chain? It starts with raw materials like copper, iron ore, grains, whatever it is, that's the beginning. All those goods, those raw materials that eventually are turned into intermediate to finished goods that we end up buying, have to be sourced and shipped from all different parts of the globe.

The Baltic Dry Index looks at 20 different major global shipping routes and four different classes of shipping containers from ones that can go through the Panama Canal to ones that can't. It is a very clear leading indicator of the global demand picture, which will eventually unfold because if there's a great demand for shipping containers, the price of those containers will go up.

What you've seen is an almost eightfold increase in the cost of shipping containers since probably May of last year. The price of the ship things has skyrocketed. That is a sign of this unfolding conspicuous demand story that people don't order raw materials unless they have orders to fill.

Again, retracing the supply chain back to the original point of origin continues to paint that interesting picture that, again, supports this notion of more of a demand type inflation than a cost type inflation.

PATTI: Let me play devil's advocate here because what I'm hearing from you is this is probably not going to be another 1970s. I'm going to reveal my generational difference here, but wait a minute, Eric.

The '70s rampant inflation was really fueled by – no pun intended – the oil crisis and the rising prices of oil. Why is this different? Isn't it true that it's the same thing all over again, we can't get a hold of the raw materials quickly enough, and so, therefore, prices are going up?

ERIC: Nothing is ever clear cut in the world. There is no you can point to this and say, "It is exactly this and this is the cause." We're talking about decisions that are made by billions of people and businesses all across the world.

We're just trying to think of a framework to understand it. There's no doubt that resource prices are rising, oil's going up. Months ago, lumber was skyrocketing and hitting all-time highs.

There is some of that there that supports this other notion, but what we're trying to define and boil it down into its most basic components, what are the real primary drivers? Are those costs of raw materials, copper, and things like that going up?

Yes. You can look at a chart, and you can clearly see that those things are going up. What are the reasons? What are the main drivers?

PATTI: How permanent is that going to be?

ERIC: Exactly. It's more of a situation where the entire globe shut down in unison and it is opening up in unison. A lot of people have money to spend. They want to spend it. Supply is nowhere to be found because people weren't producing for so long.

PATTI: It's a perfect storm.

ERIC: It's just going to take time to catch up.

PATTI: I got it. What I think is interesting is, look at what's happened to lumber. It skyrocketed, and now it's come back down again. It does support that theory, certainly in that example.

Let's go forward. Let's focus now on what's going to solve this problem? We talk about the government and the Federal Reserve and their role as we've spoken in prior podcasts, is really to issue policies that are countercyclical.

When things are really bad, they both step in to save the day, if you will. We've seen that in terms of the money supply, and lowering interest rates, and issuing checks, and it really did work.

Let's go back a little bit in history, OK? That's fine and dandy now, but we still have inflation. We're still worried about this. Why don't we just slay this dragon once and for all? For example, can we go back to the gold standard? Won't that solve it? Because there's only so much gold in the world.

ERIC: I think its interesting people would say, "We've got to go back to sound money, hard money, and that will solve the problem." If you look at history, all types of things have served as a store of value.

Gold just happens to be the one that human beings, for one reason or another, just – I'm trying to think of the right word here – fascinated by its golden luster. It's got visual appeal and so forth.

PATTI: That, too, is also cultural because as you brought up last night, China, their gold standard was actually not gold. It was the rice standard because that's what was so important to the people of China.

ERIC: I think at some point it was back in the 16th century or something like that, but yeah.

PATTI: I'm dating myself again, guys, OK?

ERIC: Oh my goodness, yeah.

I think there's a notion that you could return to that, but the history there, the United States had a binding metallic standard of gold and silver. Then about 1871, gold basically supplanted silver. We were on a hard gold standard from 1871 to 1914, somewhere around when World War I broke out.

I think the founding of our country and most democratic governments, people have this natural distrust of government-controlled money.

When you think about the history of monarchs and so forth, how did monarchs attain wealth? It was by ex appropriation and transfers, devaluation when they spent too much money. Just the monetary affairs were usually completely mismanaged at the expense of the population.

I think the gold standard is really a way where the government cannot intervene and engage in some of these things that essentially rob the population of wealth.

The issue that you have with the gold standard is that – we use this example of Rip van Winkle – if you fell asleep in 1871 when we adopted the gold standard and woke up in 1914, the price level was virtually unchanged. The gold standard was successful in keeping inflation contained, but that doesn't mean there wasn't inflation or deflation during that period.

What you have is if you're trying to maintain the value of the currency, the price level now swings fairly wildly up and down because it's reacting because there's a difference between how much money there is and how much we're producing at any given time, and that causes a change in price.

That oscillation creates dramatic swings in the business cycle. When you look back historically on a gold standard, you had some very deep but very, very frequent recessions. There was basically an even distribution of recession and expansion, recession and expansion all over again.

That's part of the problem of the gold standard is it makes the business cycle unpredictable and unstable. Again, if you look at it during that period of time, it was a period of a lot of oscillations in the underlying economy.

Another problem with the gold standard is there's not enough of it in the world to basically support today's level of transaction. A lot of the reserves are lying in the ground of people that we would consider our enemies, places like Russia and China, for example. In effect, we'd be conceding control of the money supply to them if you went to a hard gold standard, so probably not ideal.

PATTI: With this fiat system, which is basically a paper-based monetary system, it allows the government to do many of the things they did last year, to act and issue policies that will serve as a shock absorber, right?

It's not going to slay the dragon of the business cycle. We're still going to have ups and downs. We're still going to have recessions.

The goal here – and what I think has occurred over time through experience and learning what works, what doesn't work – is that it actually seems to be they're issuing policies that are making these recessions less frequent, not as deep, and helping us to recover quicker.

In fact, just this morning, there was a report that basically said this has been the fastest recovery in the history of our country. The fastest.

ERIC: That observation is spot on. This notion of government activism and counter-cyclical economic policies really came as a result of the Great Depression where basically policymakers acknowledged that the market is not always self-correcting.

Sometimes, you need policies to help arrest the deflation and help the economy recover faster. This is really based on the teachings of John Maynard Keynes. If you want to know more about that, you can go back to our podcast on the output gap from back in April, right?

PATTI: There you go.

ERIC: If you want a more expansive discussion, refer to that one. This idea is that you engage in countercyclical policies. Just like you said, the government can increase the money supply not to create inflation but to act as a shock absorber.

If you say, "Well, what is the record of that compared to the gold standard?" what you've seen is that the duration of the recessions has been cut in half, expansions have increased substantially from what they used to be. You've got shorter recessions, longer expansions, and far fewer recessions compared to what you had historically.

PATTI: Eric, I'm just going to layout these statistics in figure nine, because it is really dramatic. Under the gold standard, the average length of contractions was 22 months. Since that time, it's now 10 months.

To your point, we've cut the length of these contractions or these recessions in half. What I think is actually even more inspiring is that the length of the expansions has increased from 25 months to 64 months. That's dramatic.

They are shorter in duration in terms of the contractions, and the expansions are far longer. Combined, that delta is really creating a powerful and has created a really powerful economy, a prosperous economy. I think that's the whole point of all this.

Again, what's the side effect? This is like medicine. There are side effects. A potential side effect could be inflation, and that's something that the Federal Reserve and everybody are very, very conscious of.

ERIC: I think what's important maybe for the listeners to understand are, what are the trade-offs? There are trade-offs to both systems. Something like a gold standard, yes, it is very effective at maintaining the price level and arresting inflation. The trade-off is more volatility in the economic cycle.

What policymakers have figured out, and part of this is an experiment they continue to learn. If you have a gradual but predictable increase in inflation, what that creates is an environment where people are more likely to maximize consumption because it's predictable, and they're likely to consume more.

Think of it this way. Consumption is current prosperity. Future prosperity is dictated by investment. When you have predictable but low levels of inflation, that encourages more investments. What you're really trying to maximize are those two things that drive current and long-term prosperity, consumption and investment.

Yes, the price level does rise, but as long as it is controlled in a gradual fashion, you get those. That ultimately, I think, is what has driven the shorter recessions and also the longer, more prosperous expansions.

PATTI: The data proves it. Looking back as you did over 200 years, making the comparison to what it was versus what it is, I think it's fascinating to go back to the 1700s, the 1800s. Granted, there wasn't any inflation, but the abject poverty throughout the world was incredible. I mean, the quality of life, standards of living never got better.

Fast forward to the 20th century, and to see the difference on a chart, it's remarkable the increase in prosperity throughout the world. Yes, inflation has definitely been significantly higher, but the level of prosperity and the reduction in worldwide poverty, it's just immeasurable in terms of being able to articulate the benefit of some of this learning.

We keep on focusing on learning because it is a great human experiment. That's what economics is. Many universities have taken the study of economics out of the business school, and they've put it in the Schools of Arts and Sciences because it is an art. It's something that over time we learn and get better at.

Again, we understand the side effects of some of the policies, inflation being one of them. We understand that a third of it is the increase in used cars. That's significant. How much are we going to thwart this thing called inflation through government policies if it is really temporary? Let's talk about what happens if things get out of control? What does the government do to control inflation?

ERIC: Inflation, if it's modest, is a good thing. But it can certainly get out of control, and a lot of that has to do with the credibility of governments and institutions to make the tough choices to rebalance the economy when these things are getting out of line.

Back to the historical record, yes, we've had inflation. Compared to the hundreds of years prior to, say, the 20th century, we've had massive inflation from 1900 to 2000. The price level is increased 23 fold.

By the same token, we've also enjoyed unbelievable economic prosperity during that time. An interesting way is to say, "Well, how does our government manage inflation relative to other global partners?”

PATTI: That’s a really good question.

ERIC: Have they done a good job, or haven’t they? There’s no doubting there’s inflation, but how do we measure if they did a good job or not?

PATTI: Different nations experience more or less inflation and how did they deal with it compared to the way that we’re dealing with it because the policies have been different.

ERIC: Exactly. There was an interesting study that we came across for this podcast as a really unique way of looking at things that I never considered, but one way to measure inflation is to look at exchange rates. What is the exchange rate between, say, the dollar and the British pound, or the Japanese yen, or the Swiss franc?

PATTI: There you go.

ERIC: But looking at them over time, because ultimately, there’s a theory. Again, this is all about economics today. Sorry, folks, if you didn’t know that getting into this one.

There’s a concept known as purchasing power parity, and the idea is that the United States and let’s say Switzerland, they enact policies, economic and monetary, to support and maximize the benefit of the citizens in their country. Those inflation levels may be different. Eventually, those differences will show up in the exchange rate between the two countries.

If a country has a higher level of inflation, over time, you would expect their currency to depreciate relative to the other country.

When you think about, how is our government managed, how do we give them a grade for managing inflation, what you would have to look over, say, the last 50 or 100 years and say, “What country’s currency appreciated against the US dollar?” because that would say that their inflation has been lower on a relative basis, assuming the theory is correct.

The reality is you only find four global trading partners that actually experienced an appreciation, and really only two of them that had a significant appreciation in their currency relative to the United States.

That would be another way to say, “Well, what’s our grade, relative to other people?” We’ve done pretty darn good considering that these countries that have actually seen a better outcome are a fraction of the size of the United States.

PATTI: I think it’s also interesting to take a look at the countries that experienced that hyper, hyperinflation, like Germany and some of the other countries. I found it fascinating to learn that the ones that had the real issues, the primary catalyst was that they lost a war.

As a result of losing the war, their governments chose to print a lot of money – for lack of a better word – increase the money supply, and as a result, rampant inflation occurred.

ERIC: Yeah. You just have to think about the realities there. If you've lost a war, your infrastructure and productive capacity have been destroyed, so how do you provide? You can't tax people, because they…

PATTI: They don't have any money, yeah.

ERIC: …on incomes, so what do you do? You print money like crazy. Yes, there are very few instances of hyperinflation, but the catalyst or the common denominator is usually being on the losing side of a major conflict more often than not. Interesting through-line between those things.

In any event, I think maybe to wrap this up is, what are the policy tools available? Again, governments have to be credible that they will make the hard choices necessary because inflation is about expectations.

PATTI: Before we go there, I would imagine that everybody listening, they want to know what those four countries are, so…

ERIC: Oh yeah, no problem. Go ahead.

PATTI: …let's tell them. The Netherlands, Netherlands Antilles, Singapore, and Switzerland. Those are the four countries where the value of their currency actually appreciated against the dollar.

Now let's get to the bottom line. Inflation goes from 5.4 percent to 7 percent to 10 percent. What is the government going to do? What can they do?

ERIC: There's fiscal policy and monetary policy. Monetary policy, thank goodness, is independent of political influence, so they can act quickly.

Fiscal policy, not so much unless they're faced with a crisis like COVID or something like that. Fiscal policy is through taxation, and government spending will affect inflation. If there's too much money floating around, the government can raise taxes to drain the system of that excess money.

They can stop spending when the government runs a deficit. They're spending in addition to the private sector, so that's more money chasing after fewer goods if they can manage deficits.

The problem is we're coming out of an economic crisis. The government is still in countercyclical policy mode. This would be the antithesis of what you would normally do in a situation like this where we're just trying to get back online again. I don't see that as being viable, at least in the near future, but the monetary policy would be. Those are the traditional toolbox.

PATTI: Increasing interest rates, increasing the requirement for banks in terms of how much they keep in reserves, paying interest on bank reserves instead of…

If I were the president of a bank, and if the Federal Reserve was going to pay me three percent on my reserves – when right now they don't get anything – gee, why would I lend it out to somebody and take the risk that I may not get that money back? This is a no-brainer. I'll just get the interest from the Federal Reserve.

ERIC: I think that's a critical distinction for our listeners is that when people see the Fed's balance sheet as seven trillion or whatever it is, people automatically make this assumption that the money supply has drastically increased, and now you're going to have all this inflation.

The Fed is conducting these policies in the interbank market, so they are taking bonds off the balance sheet of banks and replacing them with cash. That's not money that is now in the economy to spend. What creates inflation is that now the banks have cash, there's the incentive to then lend it out to create loans. It is the loan origination process that injects more money into the system.

The Fed's policy is meant to provide liquidity and incentivize banks to lend, but it can go both ways. They can pull the cash out and swap it with bonds if they want to go in the reverse.

Money can be, in effect, created or destroyed in the same manner very quickly by the Federal Reserve, but it's not necessarily inflationary, and so banks start lending. That's really looking at debt growth and loan origination.

PATTI: If anybody listening has applied for a mortgage lately, you will also understand and you already know that it's not an easy process. The lending standards may have relaxed a little bit but not that much. In fact, they got really bad last year during COVID. In fact, many of the major lenders were not even offering jumbo loans. They were out of that business.

ERIC: I was going to say, I don't know if that's a subtle suggestion of a preview into the next podcast. I don't know, maybe.

PATTI: That could be a really good one. Eric, as you were talking about the banking sector, and the lending standards, and things of that nature, I was reminded immediately of today's "Philadelphia Inquirer" article that directly talks about this point.

The headline reads, "More mortgages mean more debt. Talk about clickbait." I was like, "Oh, no, are we getting into another financial crisis?" Yet, when you dig…

ERIC: The original conclusion.

PATTI: Exactly. Guys, here we go again with the headlines. Just got to read the article and get the facts. "With increased home sales, originations rose." That's not surprising, but loan levels are far behind those before the 2008 crisis. In the last 12 months, 44 percent of the country's entire $10.4 trillion worth of mortgages that were approved were approved in the last 12 months.

These were refinanced so that the debt service levels, which you and I both know because we see the data, is actually significantly lower. The monthly payments have decreased. What I also think is fascinating and really go to this point of, "We're probably not headed for another financial crisis," 71 percent of mortgage originations were with people who had a credit score of 760 or above.

Wow, that is a huge FICO score. These are not people who are going to be in a position where they can't make their monthly payments. That is a very, very high standard for a loan.

I think that that, yes, there are more people that are refinancing. They may be buying homes, but the people who are doing it can afford to do so, and/or they're making sound financial decisions by refinancing existing mortgages and lowering their monthly debt service.

ERIC: Which in an interesting way, inflation above the cost of your mortgage would actually make it easier to repay over time.

PATTI: There you go.

ERIC: It all depends on whether you're a lender or creditor. Inflation can be a good thing, or…

PATTI: Absolutely. The other thing is that the mortgages that were approved – I think it was 30 percent or more of the mortgages were adjustable-rate mortgages before the financial crisis – it's two percent. People are getting fixed mortgages.

Again, to that point, as long as we understand what the rules of the game are, that inflation is going to remain relatively level and that the cost of doing business or providing for our families, yes, it might increase, but it's not going to increase out of sight that we can manage that.

Then on top of that, you have a family that refinances their mortgage, and now there is no increase. I will tell you that Economics 101, 10 years from now, that family is going to be in a much better place.

ERIC: Amen. I took your advice from one of the podcasts I refinance.

PATTI: Attaboy, so glad to hear that.

ERIC: You're right. We're practicing what we preach.

PATTI: By the way, guys, if you haven't refinanced, it is not too late. Do you know that this morning, the 10 year Treasury was 1.16? It peaked this year at 1.7, so interest rates upon... The 10-year Treasury is what people look at when we're talking about mortgages.

You just have to look at the 10 year Treasury to get a feel for what mortgage rates are doing. They've actually come down again. For those of you who are listening, it's not too late to refinance by all means. If you plan on being in your home for – pick a number – four years, five years or longer, it's probably a very good idea to do so.

Speaking of which, let's close this with some ideas. The podcast today is about inflation. What, if anything, should we be doing for our clients, with our clients to really hedge against this thing called inflation?

ERIC: I would say the first thing coming out of the pandemic is that cash is no good.

PATTI: That's right.

ERIC: Inflation is probably the worst thing you can have, so cash isn't going to go down, but its real value after inflation is going to be significantly diminished. Cash is probably among the worst things you can do unless outside of just needing money for short-term liquidity.

I think it also depends on your thesis, is inflation transitory. Is this part of a longer-term thing? Ultimately, no one knows the future, but we have to make educated guesses. If it is transitory, usually, short-term inflation is not good for really any kind of asset, maybe Treasury inflation-protected bonds, but generally, stocks and bonds don't perform well with inflation.

But long term, if this is a long term problem, stocks are...If you believe Jeremy Siegel, he read stocks for the long run. Stocks are claims on real assets, which have the ability to adjust as the price level rises.

It might not happen in the short run but over long periods of time because stocks are claims on future production. They're really the best mechanism to have an inflation hedge when we're thinking in periods of 10 years or longer.

PATTI: I liked the way that you framed that in terms of it depends on your perspective, in terms of is this transitory or longer-term, because if it's transitory, not a lot should be done. Let's just put it out there. Don't make major changes in your portfolio just because some headline says, "More mortgages mean more debt," and scaring us into doing things that are probably not in your best interest.

ERIC: The potential tax consequences would probably be more expensive than the actual inflation itself if it's, say...

PATTI: Absolutely. Over time, markets will take into consideration that everything is inflating and the market tends to follow. Folks, that does it for today. I so appreciate you, Eric. Thank you so much for all the research, the data, your perspective, your young thing, who's never experienced inflation.

Thanks to all of you. We really, really appreciate you being here with us today. We value your time. That's why we put as much work into these podcasts as we do. Go to our website, the whitepaper will be there. It probably won't be as funny as Eric was today, but it certainly will be an education.

If you have any questions, please go to our website at keyfinancialinc.com. Let us know what you think. More importantly or equally as important, let us know if there's something that you'd like us to talk about. We can do basically an "Ask Patti Brennan" type of series which is 10, 15 minutes on a particular question, or we can do another deep dive on a topic like the one we've talked about today.

Thank you so much for joining us. I hope you have a terrific day. I'm Patti Brennan, and we will see you again very soon take care.

ERIC: They can get out of their car now and go into work.