The Advisor

A quarterly publication from Ables, Iannone, Moore & Associates, Inc.

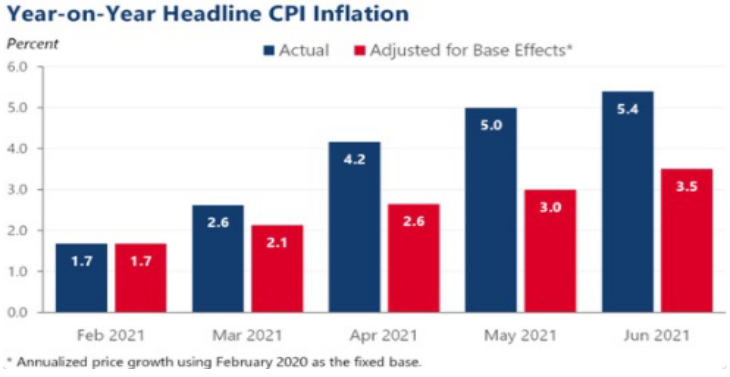
# Market Update -Third Quarter, 2021

**THE MORE THINGS CHANGE**, the more they stay the same. Welcome to The Advisor and a discussion on the hottest topic in the financial world – inflation. So, what has changed? The data. What has stayed the same? Inflationary fears. We'll devote this newsletter to showing you the dichotomous relationship between the front-and-center narrative of what we're being told each day (inflation is here to stay and it's scary) and the behind-the-scenes data of what the market is saying (this, likely, will surprise you).

Our last newsletter laid out the arguments for the great inflation debate that began taking shape during the first quarter and continued to dominate the headlines in the second quarter. To recap, one side argues we are facing a secular shift towards inflation and without countermeasures the stability of financial markets and the economic recovery are at serious risk. The other side argues that inflationary pressures are to be expected coming out of Covid and they will moderate as the global recovery proceeds. Which side is right? Well, that depends on who you ask. We do know the media is clearly in the inflation fear camp. Everywhere you turn there is a headline about inflation. We also know the Fed and chair Jerome Powell fit squarely into the transitory inflation camp by maintaining commitment to low rates and accommodative monetary policy. It's probably too early to make a definitive call considering we're in the middle innings of a tie ballgame; but in our opinion, as the third quarter gets underway, the majority of data does not lead us down the pathway to a world of debilitating inflation.

To start, we go to the June CPI report that showed Headline CPI jumped 5.4% year-over-year, the highest level since 2008. Meanwhile, Core CPI, which strips out food and energy, came in at 4.5%, a 30-year high. These are eye-popping numbers and as the basis for media headlines and pundit commentary – we agree, these are super-hot inflation numbers! Granted, it feels a bit sophomoric to leave the analysis at the Headline CPI number so let's see the adjusted CPI number when factoring in the base effects from the Covid comparisons.

To the right you will find a chart from the Council of Economic Advisors that adjusts the year-over-year Headline CPI number for base effects – or the mathematical fact that comparisons of data over time periods can become highly distorted when prior year periods were abnormally depressed or elevated. The June number clocked in at 3.5%. Although this is certainly a more manageable number compared to the 5.4% headline - the trend is clearly still rising.

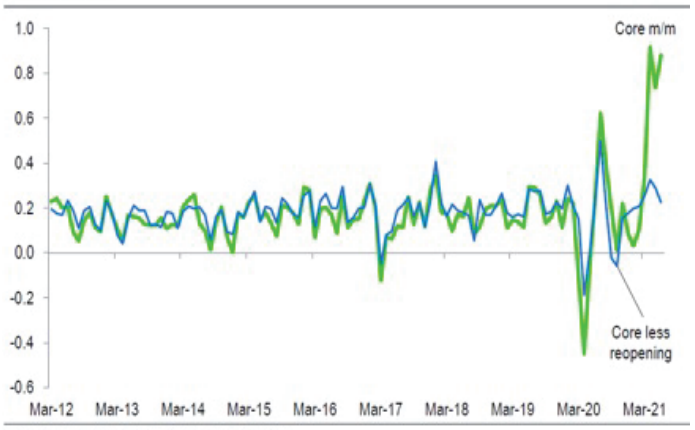



Let's keep digging into the June report and look at the internals where we do find some outliers, namely used-car pricing. In fact, the Bureau of Labor Statistics (BLS) stated, "more than one third" of the June CPI figure can be attributed to the increase in the vehicle-related pricing component. We're not dismissing the rise in costs to the used-car consumer but we do notate the outsized impact this particular cohort has on the inflation report. We'll leave the debate to our readers of whether used-car pricing should even be included in a report the BLS says is designed to measure the cost of a basket of goods and services that consumers purchase for everyday living.

Next, we turn to a chart (right) compiled by Steve Englander, a strategist from Standard Chartered, who adjusted the inflation numbers by removing the reopening centric components. The takeaway is clear, reopening the economy after the pandemic induced shutdown is pushing the limits of historical inflation comparisons. Critics may dismiss this chart out of hand as re-working the data to fit a point of view; however, we find the correlation of the data to be very compelling and although not gospel, a strong testimony to the fact that the reopening of the economy has distorted the numbers.

**Figure 1: Removing reopening removes most of the inflation surge**

*CPI, % m/m*




Source: Macrobond, Standard Chartered Research

Wage growth is a key component of any serious inflation analysis. Without an increase in consumer income it is nearly impossible to maintain higher consumer prices. Lacking a sustained upward trajectory on wage growth the consumer limits their timing and choices of consumption along with borrowing levels. Simply stated, persistent wage inflation is needed to produce sustained inflation. Taking a peek into the most recent survey from the National Federation of Independent Business, a widely respected leading indicator, shows more firms are planning to raise prices instead of wages. Moreover, the Wage Growth Tracker, from the Federal Reserve Bank of Atlanta, measures the three-month moving average of median wage growth. It has been range-bound and stagnant since 2015.

The bond market has an inflation opinion as well. Currently, the U.S. 10Y has fallen below 1.2% and the spread between the 2Y and 10Y has tightened to 106 basis points. Keep in mind that bond yields and prices work inverse to each other. If yields are falling, prices are going up which means buyers are in control. We can also look to the FRED's 5-Yr, 5-Yr Forward Inflation Expectation Rate – it has fallen to 2.14%. Knowing that inflation erodes the value of future cash flows – yields would not be falling (bond prices rising) if, in fact, the bond market believed inflation was the greatest threat.

So, there you have it – inflation has taken root for the time being as evidenced in various pockets of the supply chain and in our daily lives. However, the headline data and media narrative conflicts with several pieces of recent economic data as it relates to not only the current level of inflation but the long-term forecast as well. Inflation expectations are a real thing and can become a self-fulfilling prophecy. Investors would be wise to maintain perspective when evaluating macroeconomic trends and be vigilant in distinguishing headlines and truth; they are not always one and the same. Markets are a complicated force and technology has amplified the speed, altered the rules and increased the number of participants. This can create breathtaking moves in asset prices, up and down, as competing traders, investors and speculators try to accomplish their respective goals. This is normal, or at least the new normal, but history remains steadfast in showing the great opportunities that come to the patient investor.

To our clients, thank you for the opportunity to serve your investment needs and please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, if you would like a second perspective on your investment accounts, please feel free to contact us. As fiduciaries, we will happily provide you with an unbiased opinion.

AIM Associates
Insight. Perspective. Results.
Ables, Iannone, Moore & Associates, Inc.
*An Independent Registered Investment Advisory Firm*
419 Montgomery Street
Savannah, Georgia 31401
Phone: 912-777-4128 • Fax: 912-777-5943
Toll Free: 866-815-6004, www.aimainc.com