



Gleanings

Which inflation?

While we all are paying \$7 now for butter and maybe 25% more for our car insurance, economists are debating whether those price increases are behind us or not.

There are a lot of ways to measure inflation, with the Consumer Price Index being the public favorite and the Personal Consumption Expenditures price index, the Fed's. My theory, based on past Federal Reserve behavior, is that wage inflation is the one that they actually worry about. While the other measures were increasing in the months before they raised rates in the past, the peaks in wage inflation best coincided with the peaks in the Fed policy rate. The table to the left shows each measure of inflation at the month when the Fed Funds rate hit its high (for that cycle). While the relatively smaller increases in consumer inflation provided good political cover for a government agency that was increasing the cost of debt for everyone; generally speaking, persistent wage inflation (in this case measured by the year on year change in salaries and wages from the Commerce Department's GDP report) triggers an immediate and substantial increase in rates. The campaigns were so successful, that from the first cycle in 1985 to the peak of the job market in 2019, the economy was able to grow at almost 6% per year while the number of people employed only grew by 1% per year. Every time that they raised rates, the economy slowed, job growth was either halved or in the case of the 2000 and 2006 recessions, we lost 1.5 and 3 million jobs respectively. In the current cycle, we have seen wage inflation slow from double-digit highs to 5.8% currently. That rate however, is still high enough that unless employment growth slows, there will be no rate cuts anytime soon.

We do see some evidence that there could be some progress this summer. The chart on the reverse side of this page shows the trend in retail sales growth. The line represents the most recent annual growth rate compared to that of the previous five years. A value of 105 (on the left scale) is when the rate is the 5% higher (for example) than the five-year average and vice versa. The price of the S&P index is tracked in the same way on the right-hand scale. You can take away three ideas from this chart. One is that retail sales growth has slowed substantially to a degree matching or exceeding the last three recessions. Two, the stock market and the economy (as measured by retail sales) typically move in the same direction. Three, that currently the market is up while sales growth is down. That worries me.

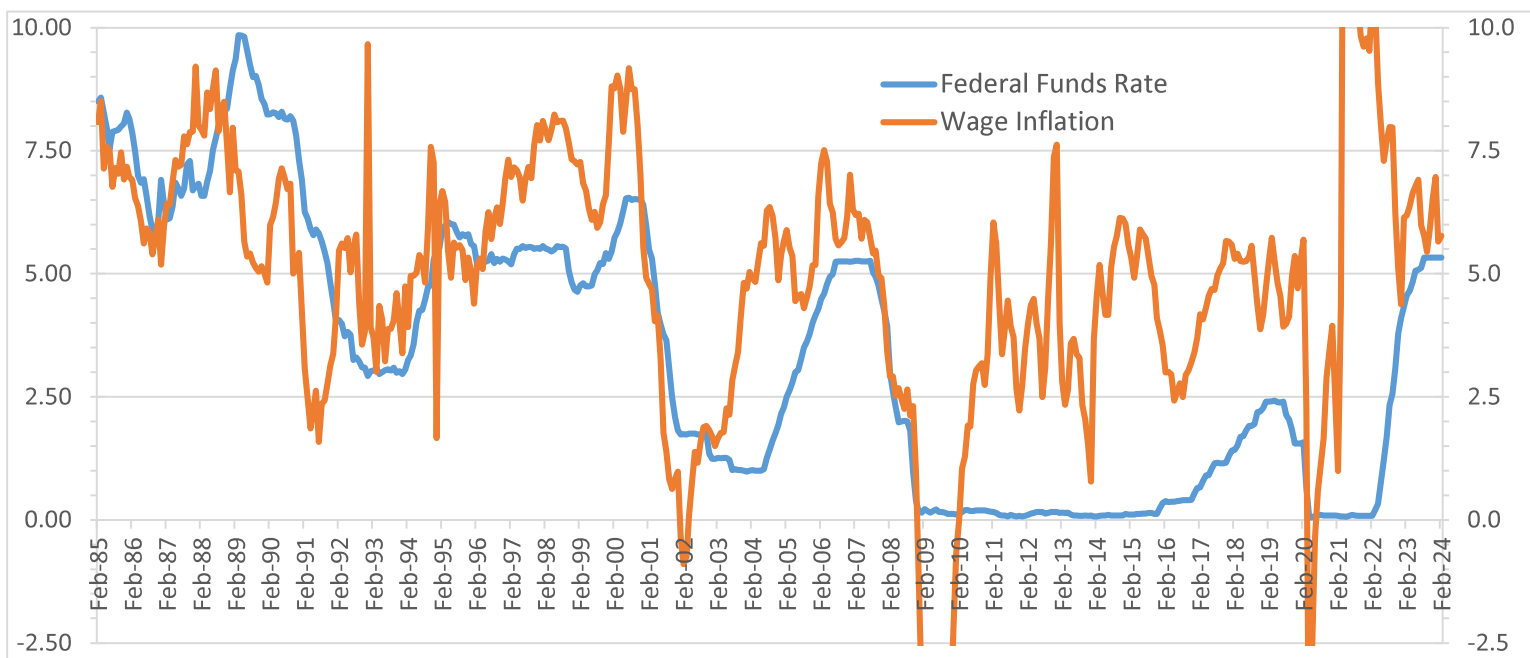
Index Returns	2021	2022	2023	2024
S&P 500	28.7	-18.3	26.3	10.6%
ML 1-5 yr Gov't/Corp	-9	-5.5	5.2	0.2%
EAFE (Dev Fgn Mkts)	11.3	-14.4	18.2	5.7%
Emerging Markets	-2.5	-20.9	10.1	2.1%

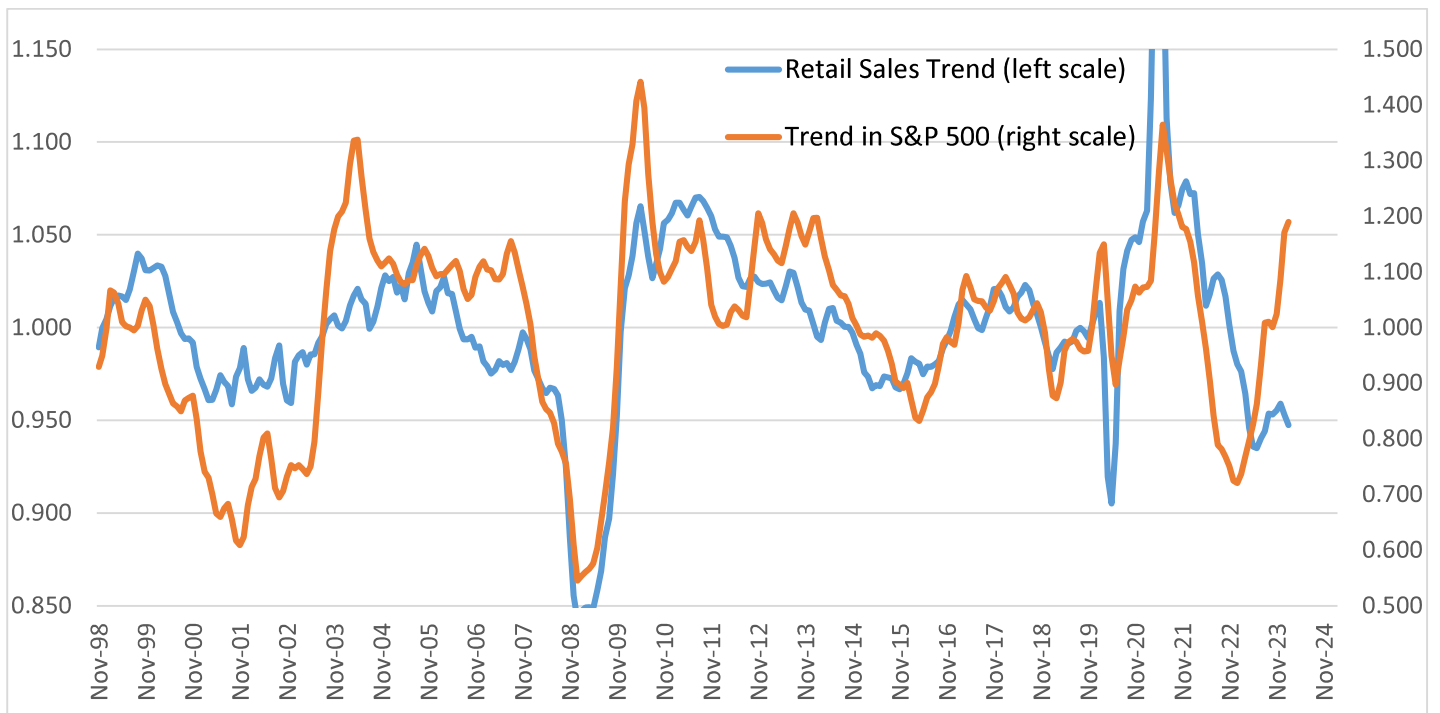
999 Waterside Dr #2600
Norfolk, VA 23510
(757) 679-9781

www.sandpiper-capital.com

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Fed Funds Peak	Wage Inflation	PCE	CPI
03/85	8.5	3.6	3.8
07/00	9.2	2.7	3.6
03/06	7.5	2.9	3.4
03/19	5.7	1.5	1.9
06/23	6.9	3.2	3.1





In past cycles, the stock market wasn't the only thing that dropped when the central bank slowed the economy. In the chart below, you can see a graphic representation of what people mean when they say that the yield curve is inverted. The rate on thirty-year Treasuries is a reflection of what the market thinks that the Federal Funds rate will be over the next thirty years. The federal funds rate theoretically would be set at a level that will neither spur the economy nor slow it, (the "neutral rate"). Normally that would mean that if the economy is growing at a steady 4%, then a neutral rate would be 4%. However, as we've seen, the economy rarely grows at a steady rate. Since slowing wage growth over the last thirty years has meant slowing sales growth, a Fed Funds rate substantially below neutral has often been required to encourage (debt financed) spending. If you picture a line that goes from 10% on the left side of the chart and connects with 3% on the right-hand side, that would coincide with a) where a restrictive rate would begin each year and b) the top of the range for long Treasury bond rates. Not coincidentally, it would also track the path of GDP growth.

Each time the bank wanted to slow the economy, they raised the blue line until it went above the orange line. When the cost of money is greater than the rate at which you can reasonably expect your business (income) to grow, you reduce your debt (spending) and that all feeds on itself to bring down inflation. Once that process starts however, it often takes on a life of its own and it takes dramatic action (low, low rates and deficit spending) to get the economy growing again.

If, because wage inflation is still high, the Fed keeps rates high for too much longer, there is a good possibility that the slowing sales growth will snowball and we will need to see short rates under 1% again. If so, the thirty-year Treasury rate will fall to reflect the possibility that they will be that low for a long time. I think it's important to note that a 2% drop in long Treasury rates brings a 40% increase in their market value. I think that possibility warrants some optimistic patience.

