INVESTMENT STRATEGY UPDATE

June 30, 2021

VIEWING THE WORLD FROM A NEW LENS … INFLATION

As the United States recovers from the COVID-19 pandemic, we are increasingly hearing a word that some had thought was practically extinct: inflation. After the Great Inflation of the 1970s and early 1980s, the country saw over 30 years where inflation had not been a problem. Suddenly, rising prices are a significant concern for many. And this is monumentally important because our behavior and decisions are much different if we think prices will continue to increase into the future. Inflating prices cause us to want to buy more now to stock up and maybe even hoard. The opposite is true with falling prices.

It is worth taking a moment to define inflation. Inflation is not when the price of a single item increases; it is when the general level of prices increases across the board. During the low inflation era of the 1990s and 2000s, for example, the prices of health care and post-secondary education continued to climb quite aggressively, yet inflation overall was not a major problem. At that same time, electronics and technology, following Moore's law, drastically declined in price while the general level of prices was more or less stable.

Consumer inflation is currently running at a 5% annual rate. A lot of goods are also difficult to find, with long wait times to be back in stock. The great debate is whether this is a temporary phenomenon lasting a few months or something more concerning, à la the 1970s.

The Price of Goods and Services

Consider the following:

- Polysilicon crystal, used in solar panels, has seen its price jump by a factor of four, resulting in higher prices for finished product (panels) and delayed projects.
- Used car prices jumped by 10% over the course of just one month (from April to May 2021).
- Lumber prices jumped from $400 to $1600 per thousand board feet, increasing the cost of a newly built single-family home by an average of $36,000, according to the NAHB.
- Uber/Lyft rides are up 35% - 40%.
- Corn prices rose 50%.
- Polyvinylchloride (PVC) and polypropylene, common plastics, have jumped 300%.
- Stocks and real estate have gone up considerably as well.

Spiraling Wages?

The inflation of the 1970s and '80s actually got its start back in the 1960s due to the combined expenditures of the Vietnam War and President Johnson's War on Poverty ("guns and butter"). Inflation picked up at the time but, more importantly, inflation *expectations* also picked up.

The public began to believe that inflation was here to stay. Cost of Living Adjustments (COLA) were written into labor contracts with unions, and they still remain with Social Security payments. Unfortunately, this process fed upon itself with no significant effort to change things from the Federal government, and inflation accelerated. By the end of the 1970s inflation was over 10%.

Currently, the cost of labor is again going up, both from a purported shortage of available, willing workers and from new minimum-wage laws passed by various states in recent years which are now beginning to kick in. Some are calling the current labor situation the "great reshuffling," with many workers looking to switch jobs in search of higher pay and better working conditions now that the economy is reopening. These higher pay scales will likely show up more in the cost of services relative to the cost of goods since labor is a bigger part of a restaurant's costs than those of an automobile transmission plant.

Don't Forget the Government's Part

All of this is taking place in the context of unprecedented monetary and fiscal stimulus. Interest rates are well below five percent on almost any kind of loan. Government spending has expanded to almost a quarter of the entire U.S. economy. Certainly, an argument can be made that we may be in the initial stage of repeating the steps seen back in the 1960s. The Fed has only begun to talk about talking about hiking rates. But the situation is also significantly different now than in the 1970s. This latest episode of shortages and rising prices can pretty clearly be traced to the COVID-related economic shutdown last year and the subsequent efforts to restart the economy. There was no comparable single event during the 1970s.

The Case for Inflation Being Transitory

So, it looks bad right now, but the larger question is whether this is a temporary phenomenon or whether these are just the first few steps of a return to the bad old days of the 1970s and stagflation (inflation with stagnant economic growth). A case can be made for either outcome.

It may be that COVID was simply the first and by far the biggest of a series of one-off events that are temporarily pumping up prices. In many cases, rising prices for a given item can be associated with odd events:

- Lumber prices have jumped in part due to wildfires in the Pacific Northwest followed by mills operating at limited capacity due to concerns about COVID.
- A ship got stuck sidewise, temporarily closing the Suez Canal which led to delays in shipping, and the industry still has not recovered.
- Corn prices surged due to drought in South America. There was also greatly increased demand from China, rebuilding its hog population which had been earlier culled to stop swine flu.
- Uber and Lyft prices have risen as there continues to be a shortage of drivers, possibly due to fears of COVID contamination. Also contributing is Wall Street's increasing insistence that the companies actually begin to turn a profit.
- The major freeze last winter in Texas and other parts of the oil patch led to damaged equipment and disrupted production, which turned into higher prices for a number of petroleum related chemicals and plastics, etc.

- Auto makers cut way back on orders for computer chips during the early days of the pandemic in anticipation of a drop in automobile demand that did not really materialize. Then a fire in March 2021 at a key automotive semiconductor plant near Tokyo further disrupted production.

There are other factors which have contributed to rising prices. U.S. tariffs placed on many imported goods by the previous administration have been maintained by the current one. Globalization, where corporations develop supply chains around the world to search for the absolute cheapest manufacturer of goods, may have reached a wall. The past trend to focus on lean inventories (also known as Just-In-Time) is being reassessed (with a new term of Just-In-Case) and, adding to inflationary problems, some firms are double ordering or hoarding what supplies are available.

Another prior instance of inflation in the U.S. may have some relevance to the current situation. During World War II, the domestic economy was massively state controlled. Price and wage controls were very common. Resulting shortages were managed through rationing. Basically, everything went toward the goal of winning the war. When that victory came, many folks had lots of savings simply because there was so little to buy. As price controls were lifted, inflation roared, averaging 12% between 1945-47. However, by 1949 the readjustment was over, and the stage was set for the solid economic growth of the 1950s and ’60s. Inflationary expectations never really took hold. While there was a period of adjustment as factories retooled for civilian rather than wartime needs, it only lasted relatively briefly.

For now, there are some initial signs that inflation might possibly be turning over. Those lumber prices that quadrupled have peaked. Wholesalers are refusing to pay the higher prices and are drawing down inventories from 45 - 60 days’ worth of sales to 30 - 35. University of Michigan surveys show that consumers are saying that now is the worst time to buy a house in the last 30 years and the worst time to buy a vehicle (new or used) since the Global Financial Crisis of 2008. General Motors noted that it has now been able to rework software for its cars to use what computer chips it does have available, and it has also been able to pull some deliveries of semiconductors ahead from later this year into the second quarter, giving suppliers breathing room to catch up.

This coming September may end up being a significant inflection point. Supplemental Federal unemployment benefits will expire nationwide. Most schools will reopen on an in-person basis. Less cash coming in and the end of a need to stay home to watch the kids means the labor force will expand and possibly lead to some wage cost moderation. While this fall is probably too early for the Fed to act, there is no question they are extremely well aware of the inflation threat and will act to try to keep it under control.

One of the biggest problems facing the Fed is the fact that while prices for goods can go up and down easily, wage costs are “sticky” and tend not to fall. In a full-fledged inflation, higher prices cause workers to demand higher wages which forces firms to raise prices (the wage – price spiral). Labor costs fall in aggregate only when the Fed raises rates and causes a recession and layoffs. Clearly the Fed wants to avoid that, at least for now.

Investment Implications

So, where does BTR come down on all this? Are we in for a decade of stagflation and a repeat of the 1970s? Or will we be chuckling to ourselves twelve months from now that it was so weird how everyone got so worked up about a few production hiccups that resulted in some short-lived price hikes? We believe most of the current price spikes will work themselves out in relatively short order, either through increased supply or decreased demand. However, we also believe there will be structurally higher inflation, perhaps 3 to 3.5% going forward rather than the 2 to 2.5% we have been used to. This shift will not necessarily be all bad. Stocks can continue to do well in this environment. We need to view our investment decisions through this new lens. The winners will be those who can either keep their input costs under control and/or pass along those costs to their customers. Of course, how BTR reacts to the actual outcomes will be much more important than our forecasting skills.

Historically healthcare companies have been able to pass along higher prices, and we believe that will continue. We are interested in precious metals stocks, as a hedge against the very loose monetary policies and the continued deficit spending in the U.S. Beyond that, we are looking toward beneficiaries of the world reopening — those companies who saw demand decline from the pandemic but will rebound as we get back to normal. However, the stock prices of many have already moved up. Vacancies in retail and office space will be reabsorbed. The world will need more energy which will be met both from conventional and from emerging green technologies. Ongoing growth in innovative technologies are interesting regardless of inflation. Lastly, if it turns out inflation becomes a serious problem, interest rates will eventually climb and there will be opportunities to invest in bonds with those higher yields.

Market Outlook

Major stock market indexes have moved up even further over the last few months to new record highs, with few pullbacks along the way. Strong fiscal and monetary stimulus are providing ongoing liquidity and, with few profitable alternatives available, stocks have continued to attract more investment. The debate over whether inflation is a big worry yet will likely continue to drive market volatility. Instead of undergoing any significant correction, the stock market has churned daily in back-and-forth trading. Perhaps corrections this year will be ones of time rather than price, although we would not be surprised to see more substantial selling on any bad news.

Investors have also recently alternated back and forth between cyclical re-opening trades and higher-growth technology and internet companies. While stocks of companies that benefit from economic recovery have now priced in at least some of that outcome, the high-growth pandemic beneficiaries still sell at significant premium valuations. Thus, we continue to tilt toward investments that will grow with the economy in a rising interest rate environment.

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