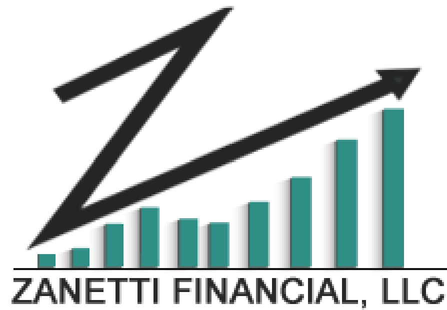

Zanetti Monday Missive 2022.01.03 Deflation, Inflation, Stagflation... Who Will Win?

“Economics is the only field in which two people can win the Nobel Prize for saying the exact opposite thing.”
~ Roberto Alazar

Hello Everyone,

There is an old joke in financial circles. Get three economists together and you’ll get four opinions.

And nowhere does this seem truer than in the deflation vs. inflation vs. stagflation debate.

So, who will be right?

For investors, the answer to that question will matter a lot.

The deflation camp says, “*The Fed will raise rates. Real estate sales will crumble under the weight of higher rates. The stock and bond markets will fall as well. This is the Great Depression all over again. The massive edifice of accumulated debt will topple. Cash will be king!!*”

OK.

The inflation camp says, "*Yes, debt is the problem. But the government cannot afford a cascade of debt default. Besides it's in the government's best interest to pay off their trillions in debt with inflated dollars. Thus, the "printing press" will run full speed ahead. Prices will rise. The dollar will be devalued. Cash is trash!!*"

OK.

Then, there is the stagflation camp. "*Both sides are right…and wrong. We will simultaneously (!) have inflation and deflation. Yes, bubbles will deflate. The stock and real estate markets will come back to earth---but not crash. Food & energy prices will rise (inflation) but it will be manageable. Wages will rise, but not fast enough to keep pace with consumer inflation. In short, standards of living will fall, but we will "muddle through.*"

OK.

The temptation is to take the middle road: stagflation. Afterall, usually extremes are wrong. The problem with this argument is that it does not consider two things…scale and margin.

Let's start with scale.

Let's say that over a three-year period, the cost of a high-definition TV falls 20%. And let's say we also see prices drop on computers, cell phones, jeans, and a host of other consumer products. Oh, and the quality also improves. In this scenario, we would see lower prices plus higher quality. That is deflationary--- and the best of both worlds.

But let's also say that over this same period of time, the cost of health insurance, education, and childcare goes up 20%. And the quality degrades. That is inflationary--- and the worst of both worlds.

Now statisticians do not care about best or worst. They just tabulate. Some things are up 20%. Some are down 20%. So, inflation must be flat.

This is where scale matters. And why statistics often don't reflect real life.

Consumers don't have to buy flat screen TVs. But most need health insurance. It's the same dynamic with jeans, computers, and cell phones. It's nice to replace or upgrade, but not necessary. That is not true of food, gas, childcare, and education costs.

Thus, "real life" inflation "scales" at an accelerated rate. And this is why people laugh when the Government says the inflation rate is 5%.

So, understanding this, let's move on to the concept of margin. Then we can decide whether the deflation, inflation, or stagflation camp has the stronger argument.

So, what does it mean when someone says," Prices are set at the margins"?

Let's say you have a neighborhood with 100 similar homes. And they all cost around $400,000. But suddenly things change. Five houses sell for $450,000. Appraisers will then revalue all the homes up to $450,000…even though 95 homes didn't sell. Those five "sales on the margin" made everyone feel richer.

And now the un-sold neighborhood's "equity" has popped $4,750,000 (95 X $50,000). And no on one had to work harder, put in overtime, or remodel the kitchen.

Of course, the same thing can happen in reverse. If five marginal sales go for $350,000, you'll have a lot of depressed homeowners.

With respect to Wall Street, the largest cost for most publicly traded companies is labor. This is where "margin" and "scale" come together.

If companies must pay an extra $2.00/hour for entry-level workers, the additional labor cost doesn't end there. Those costs will scale up the wage food-chain. Mid and higher-level employees will want pay raises, too.

And don't forget the "extras" that come with increased pay. Think

benefits like health insurance, 401K's, worker's compensation costs, etc. Labor "overhead" can easily add 35%-40% of labor costs.

Thus, the initial $2.00/hour pay increase occurred "on the margin" but scaled up rapidly. And this is what we are seeing now. Companies are seeing labor costs skyrocketing. And those costs are passed on to consumers.

All of these changes are signs of inflation.

By the way, this is also true for government labor costs as well. Government costs are rising. And since government doesn't have a product to sell, tax increases are the typical answer.

And when you add in supply chain disruptions, Covid costs/restrictions, and a declining dollar, it is easy to see how a self-reinforcing inflation loop can occur.

Higher wages leading to higher prices & higher taxes. That, in turn, leads to demands for higher wages to compensate for the higher cost of living.

The answer is to achieve higher productivity. But that is the subject for another missive. And besides in an era where government is substituting "free money" for "earned money" it is hard to make the case for increased productivity coming anytime soon.

Thus, we at Zanetti Financial consider ourselves charter members in the inflation camp. Stagflation and deflation may make sense in the classroom, but not in real life.

Signed, Your Let's-Hope-2022-Doesn't-Mean-2020-Too Financial Advisor,

Greg

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