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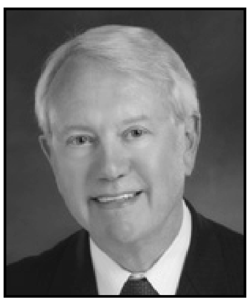
ECONOMY

A look at inflation, the stock market and employment

By Jim Flinchum

The COVID-weary economy continues to bounce back. For example, the latest index of leading economic indicators rose another 1.1%, the highest since May.



Jim Flinchum

Unemployment is only 3.9%. Capacity utilization rose to 76.8%, the highest of the COVID-era. How can the economy be so good, as we fight the last variants and wait for the next? When population growth is stagnant? When we're burdened with political intolerance?

Inflation: Inflation seems to have suddenly appeared and has several causes. First, there was a surprisingly sudden increase in government spending (American Rescue) to combat the virus. Second, there was a similar increase in the money supply by the Fed. Both energized "demand-pull" inflation.

In addition, thorny supply chain problems increased costs. Plus, the extreme climate events of last year pushed prices up. For example, the Texas freeze last February drove up demand for natural gas, and Hurricane Ida in August reduced supply, leading to record high prices by October. Another example is the worst freeze in 25 years in Brazil drove up coffee prices worldwide. Both energized "cost-push" inflation.

This perfect storm of demand-pull and cost-push caused inflation to reach 6.8% by November. Most of this inflation in the prices of goods, not services, but that can be expected soon.

Depleting the American Rescue funds will reduce some inflationary pressure, as will continued unwinding of the supply chain problems. One difference with this round of inflation is the hyper-awareness of it.

Interest rates: The benchmark yield on 10-year Treasuries is approaching 1.8% and still rising. This normally hurts tech stocks and benefits bank stocks. The Fed is expected to slow their bond purchases, which decreases demand for the bonds, therefore reducing the bond prices, which increases interest rates. This two-fisted approach raises interest expenses, slowing both the economy and inflation.

The labor force: One of the more subtle effects of the pandemic has been the scrambling of economic data, especially employment-related. I've never had less confidence in job data, but it is all we have. After all, how do you lose 4 million workers? The booming stock market has made it possible for many baby boomers to retire. The lack of reliable child care has kept many mothers from returning to the workforce. Schools vacillate too much to be reliable. Most hopeful, there has been a surge in self-employment.

The latest data is that unemployment dropped to 3.9%, down from 6.4% last January. There were 10.6 million job openings last month and 4.5 million workers felt confident to quit their jobs, likely causing the 0.6% increase in average hourly earnings during the month of November.

While all this sounds good, keep in mind that the data was collected on Dec. 12 before the impact of omicron was clear.

The stock market: It was the third consecutive year of double-digit gains for the stock market. Last year, the S&P 500 substantially beat the mega-large companies of the Dow, 26.9% to 18.7%. The tech-heavy Nasdaq also outperformed the Dow with 21.4%. The smaller company index, Russell 2000, rose 18%. One cause of this great performance was the record high $850 billion in buybacks, which reduces the supply of stock available to buyers.

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Does that mean the stock market is overvalued? I don't think so, because earnings are still increasing faster than interest expenses.

Growth stocks beat value stocks again, but Jeremy Siegel of Wharton predicts we have reached the pivot point, where value stocks finally outperform. It's time!

Internationally, it was a mixed bag. Canada was up 22%, and Mexico was up 20%, while Latin America was down 13%. Under the radar, the Eurozone was up 20%, led by Sweden at 35% and lagged by Spain at 7%. In Asia, the MSCI regional index was down almost 4%, but that was heavily skewed by China's pounding of Hong Kong. China was up 4%, while Hong Kong was down 15%.

Because commodity prices adjust so quickly, they are often used for inflation protection. The Dow Jones Commodity Index was up almost 30%, led by oil at 58% and natural gas at 40%. Gold lagged, down 4%.

Free-floating angst: Remember the angst as Dec. 31, 1999, approached? We were concerned computers would fail us. For many decades, the financial industry has used LIBOR (London interbank offered rate), which was used to price loans or determine interest rates payable. Most complex products like credit default swaps depend on LIBOR. In 2017, a scandal revealed that it was being manipulated by unscrupulous bankers. Effective this year, the industry switches to SOFR (secured overnight financing rate). Computer errors could be destabilizing, especially to derivatives. There is room for a black swan event here.

Another anxiety is the increasing concentration of wealth and economic power in the technology sector, such as Apple, Microsoft, Google/Alphabet and Facebook/Meta. Especially in social media, the technology sector desperately needs more regulation, and they are indeed asking for more. Without better regulation, social media is a "real and present danger" to our democracy, but it needs delicate surgery.

Unintended consequence: In 2020, about 350,000 Americans were killed by COVID. In 2021, another 500,000 Americans were killed. In both 2020 and 2021, Wall Street boomed. So, how can the stock market continue to rise so much when so many Americans are being killed?

Money supply increased about $3.8 trillion in 2020 and another $2.4 trillion in 2021. According to monetarists, assets will soak up whatever money is available to soak up, increasing prices. Hence, we first saw inflation in stocks and now inflation in goods, with inflation in services just beginning. Of course, in our insanely politicized world, Republicans blame President Joe Biden and Democrats blame former President Donald Trump.

It might be easier to blame Fed Head Jerry Powell … but also unfair. If the Fed had not been so aggressive increasing our money supply, I am convinced that the 2020 "swan dive" would have become a depression.

A bigger, long-term result of the pandemic is the increased concentration of wealth. Saving us from depression, the Fed made the rich richer.

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