July 6, 2021

Dear Clients and Friends:

Inflation appears to be on the mind of investors. This concern was primarily responsible for driving the yield on the 10-year Treasury from 92 bps at year-end 2020 to an almost inconceivable 175 bps at the end of the first quarter 2021. Now, inflation is a tricky thing. It is said that there are few advantages to getting old, and as one who is definitely in that unfortunate demographic, I concur. However, we old folks have lived through some times, and we have seen some things. As I write this, I have just returned from my father's funeral. He was 93 and lived a full life. It was a wondrous event. As I watched his contemporaries…there are not many, as he was 93…I was struck by what they had seen and experienced. There have been vast changes to essentially everything in their lives, almost none of which could have been predicted.

As I returned home and my thoughts turned, as they always do, to our markets, I was struck by the hubris of the Federal Reserve and their insistence that the current inflation surge is "transitory." This seems to be based upon nothing more than recent history. It is not as if they have a model that can predict inflation; they have been consistently wrong about it for decades. They just recently revised their forecast on inflation for calendar year 2021, raising it a full percentage point from their forecast in March! This is akin to forecasting yesterday's weather.

In other words, they haven't a clue, but they do have a fervent hope. This hope is based upon their fear of the consequences should they be wrong. In fact, I believe they are in the first stage of the five stages of grief, the first being denial. In coming months we will explore the subsequent stages of anger, bargaining, depression, and finally acceptance. If you were unfortunate enough to live through the 60's and 70's, as I was, you will be able to see how these played out at that time.

I will share with you one example made prominent in the early to mid 70's. There was a slogan that was actually promoted with buttons. They were the "WIN" buttons, which stood for Whip Inflation Now. A chief proponent? Why it was none other than the maestro, Alan Greenspan. His attempt to bargain with the masses was met with the disdain it deserved, and inflation accelerated to new heights. Alan Greenspan was a failure then and in many, if not most, areas of his life as an economist. I say this not to disparage the man but to provide some context to current Fed policy. His tenure as Chair of the Federal Reserve was, for a time, a smashing success but as of late has become a bit more muddled. The reason for this muddled historical view should be clear in the current discussion about inflation.

You see, Greenspan converted inflation as it was typically known, and still is by the myopic and sclerotic Fed, from the consumer price index to asset price inflation. This latter form, which we are plagued with today, is every bit as lethal, yet the effects are more pernicious. We cheer at the ascent of the stock market and our home prices, or for that matter, the price of almost any asset. The left side of our personal balance sheets increases seemingly without bound, yet these prices are fueled by debt and artificially low interest rates. They are without question unsustainable. So the question is, what will break the back of this pernicious inflation? In the 70's, it took an exhausted population and a crusading folk hero, Paul Volcker, to break its back. This will be much more difficult now, as the cost of this inflation is serial crashes, the effects of which are ameliorated by the entity that created them. These relatively brief periods of horror are replaced by a long run of asset price inflation. The crash appears inevitable.

So is inflation coming? It is, and it is here. It is simply a question of what form it will take. It is our belief that the traditional form of inflation, CPI, will take hold. Interest rates will be forced to rise, and asset prices will be forced to fall. The Federal Reserve will be forced to return to a more traditional role, and if they survive, the populist revolt sure to occur will be a chastened institution, their influence appropriately diminished and the cult of personality about it since Greenspan, banished.

The portfolio strategy is astonishingly clear. Recognize the issues? Check. Recognize the risk reward? Check. Now the hard part. Be comfortable giving up very modest gains for protection against potentially cataclysmic losses? This is a struggle for many, just as buy low/sell high, while seemingly simple, is exceptionally difficult. This is why you hired us. This is what we do. We will maintain a low risk strategy. We will forego modest upside in order to prevent larger losses. We have rarely been more confident in our view and positioning.

Sincerely,

Mark M. Egan, CFA
Managing Director