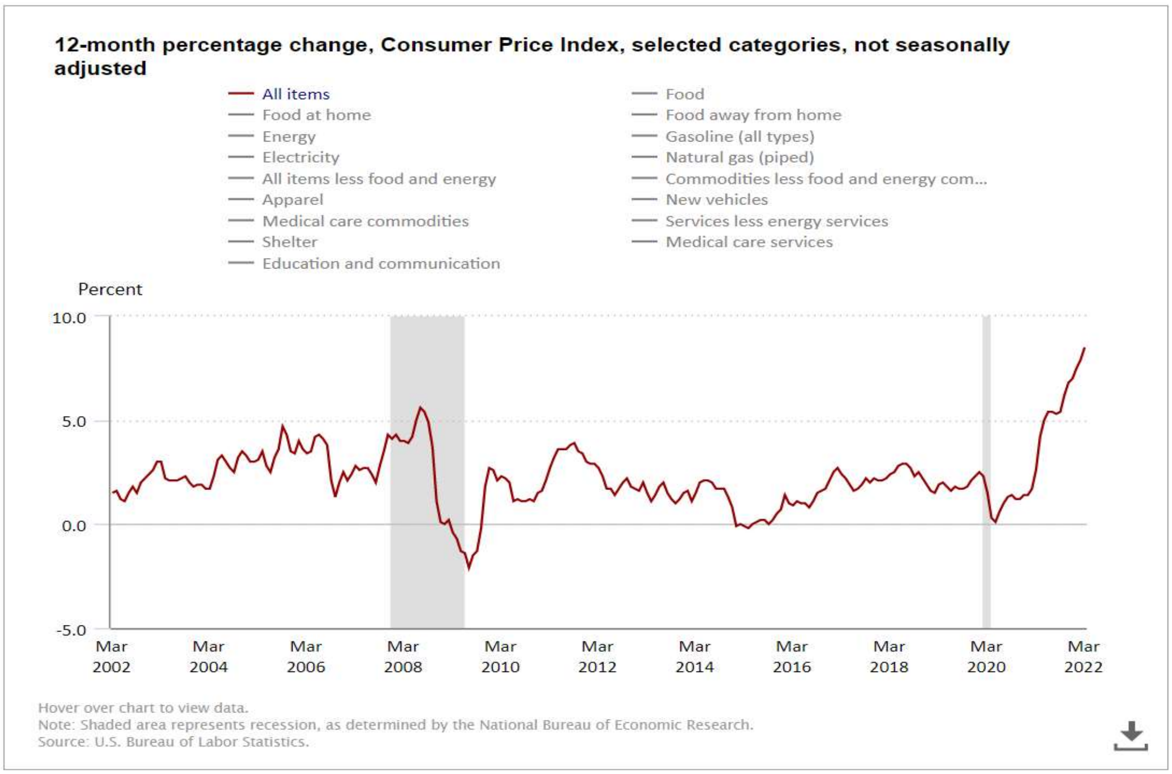
Bubble Popped? Inflation to Eventual Deflation

Inflation

As everyone can see, the cost of just about everything has gone up in the last 2 years. There have been a number of factors that have driven inflation. A few of the big ones are the federal stimulus money, increased consumer spending on goods after the 2020 lockdowns, global supply chain disruptions, and bad US energy policy decisions. The chart below shows the Consumer Price Index. The Consumer Price Index (CPI) is made up of goods that the average consumer uses. As you can see in the chart below, prices for consumers are at their highest level in the last 20 years. The biggest problem for the future is that in order to get inflation to come down, there almost always must be an economic slowdown.

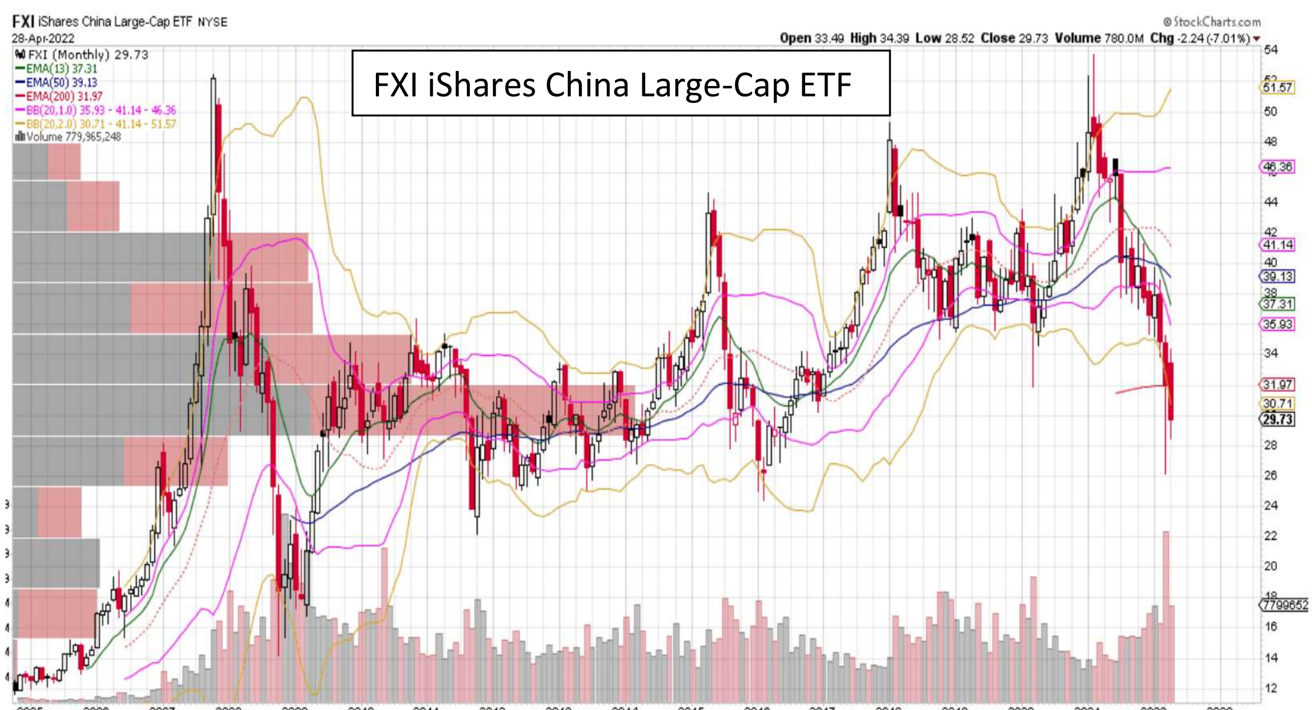


Bonds

As inflation goes up, so do bond yields. When bond yields go up, the cost for consumers and businesses to borrow money goes up as well. When the cost of borrowing money gets too expensive, people stop borrowing or are not able to borrow. Why is this a problem? The best way to think about it is that one person's spending is another person's income. As consumers start spending less or are forced by inflation to spend more on basic items such as food, gas, and rent, they take away money from someone else. Below is a chart of the 10-year US Government Bond yield. Since the last inflation peak in the late 1980's, bond yields have been on a downward trend. As anecdotal evidence, every time bond yields have touched the top of the down-trend line, there has been an economic slowdown in the US economy.

Global Growth

China has been one of the biggest drivers of global growth next to the US after the 2008 crisis. China has a tendency to slow approximately 9 to 12 months before the US does. As you can see below, China started to slow economically in March of 2021. China has tried to stimulate its economy a couple of times in the last year. These measures have not done much as global inflation and the renewed lockdowns of Chinese cities continues to slow growth.



Foreign and Domestic Currency

One other problem with China is that they have a fixed currency. What that basically means is that the Chinese government sets a price for what they think their currency is worth compared to the rest of the world. In the chart below, the Chinese yuan is priced against the US dollar. As the number on the right-hand side goes up, the value of the Chinese currency goes down compared to the US dollar. This helps Chinese product exports be more competitive with other manufacturing countries. The negatives are that it costs more for the Chinese to buy raw materials from other countries and consumers inside China have less purchasing power; i.e. their money does not buy as many goods as before. As China devalues their currency, it forces other exporting countries in the East Asia region to follow along. This devaluation can work for a while, but in the end it creates problems in China and in other global markets.

US Dollar

The US dollar is in an interesting position. The dollar's value is appreciating against every major currency in the world. This happens when either the US economy is growing faster than the rest of the world or there is a demand for safe haven assets globally as the world and US economy slows. With the slowdown in US growth being shown by the -1.4% GDP number for the first quarter of 2022, the dollar strength is most likely due to a global and domestic slowdown. As the dollar appreciates against other countries' currencies, those countries must spend more to buy raw materials and foreign goods. For those that don't know, almost all global commodity purchases and sales are done in US dollars. Below show the US dollar index.

Equity Market - The outlook for equities is very poor.

The biggest driver of the US stock market is what inflation and growth are doing. If growth and inflation are going up at the same time, speculative assets like small cap stocks, cryptocurrency, and oil and gas perform well. If inflation is going up and growth is slowing, bonds, oil and gas, and mega cap growth stocks do well. If inflation is slowing and growth is accelerating, just about everything does well.

So where are we now? We are in a slowing growth period and are going to be eventually entering an inflation slowing period. Most assets other than government bonds and US dollars do poorly in this environment. Gold and silver might do reasonably well, but in a financial crisis everything gets sold. Now it may sound weird that inflation is slowing with it currently being at record high levels, but the biggest thing to look at is the rate of change in inflation. As all the factors covered above start to pile on, people have less money to spend on non-essential items, which means that prices will come down. With the global supply chain issues that are currently happening, inflation will take a bit to meaningfully come down but eventually will. Does this mean inflation will get back to the 1% to 3% range it was in before Covid? Possibly, but not likely due to the fiscal response that will continue to happen; i.e. the government will hand out more free money if there is a slowdown. Also, the commodity and goods supply chain disruption will last for quite a while until enough demand is destroyed.

So how does this affect the stock market? Crappy growth stocks that rely on cheap, easy money have been having issues since March of 2021 when global growth peaked and inflation issues really started to take hold. Below is a chart of the ARK Innovation ETF; it is down 70% from its highs and below pre Covid-19 stimulus levels.

Indices like the NASDAQ and S&P 500 have performed better but are now starting to have issues as can be seen in the following two charts.

As you can see, inflation and slowing growth are starting to have an effect on almost all stocks now. The other problem facing stocks and the economy is that there is no new direct government stimulus on the horizon. This creates a spending shortfall for most people compared to the last 2 years. Looking at the charts, you can see where the Covid-19 lockdowns happened and the subsequent stimulus. With this stimulus removed and high inflation, companies are reporting slowing earnings growth.

If you've read this far and want more information, feel free to contact me.

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