The Long Run

INVESTMENT LETTER
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REYNDERS, MCVEIGH CAPITAL MANAGEMENT, LLC

"Don't bore us, get to the chorus."
—Tom Petty

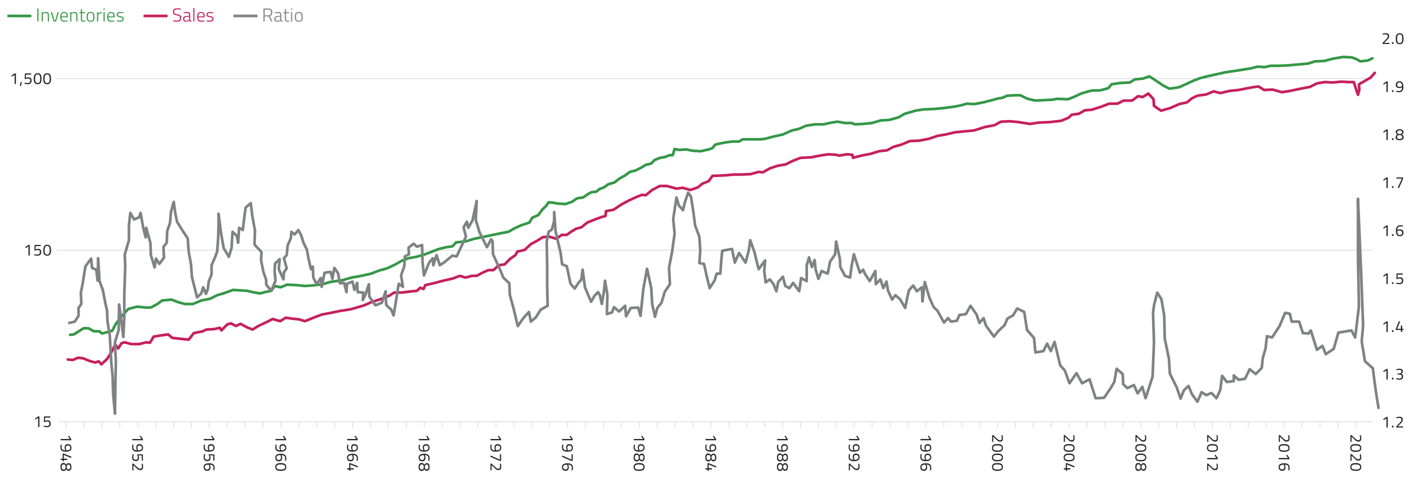
It's summertime, and the United States is back to taking vacations following a long period of COVID-enforced quarantines. So we'll accept that attention spans may be short for any lengthy economic commentary, skip the verse, and go right to the chorus.

Both Wall Street and Main Street have been dusting off B.B. King's Inflation Blues — "things are going up...and my check remains the same" — as inflation has surged to its highest level since 1992. Historically, high inflation has been bad not only for consumers, but also for financial markets. Yet, despite higher prices, stocks surged to new highs during the most recent quarter. Does the inflation song not remain the same as in years past?

In previous missives, we have tried to delineate that inflation does not always offer a Hobson's choice of two bad alternatives — incomes and financial assets are eroded. In fact, we believe inflation can be good (e.g., wage inflation) and bad (e.g., goods inflation). While we currently are experiencing both types of inflation, we believe there is a good chance that the bad inflation will dissipate.

As with most everything over the past 18 months, the economy has experienced things it has never seen before. One constant of recessions is that income and savings go down. (In the last major recession in 2008, U.S. households lost $8 trillion.) As a result, businesses made the rational choice last year to cut inventories and capacity. Surprisingly, however, while not everyone came out ahead, U.S. households added $13.5 trillion in wealth during 2020. Credit card debt was paid off, savings accounts increased, and homeowners refinanced mortgages. Americans are now looking to do what they historically have done best, consume, although they have been stymied by shortages of all kinds. As the following chart shows, the ratio of inventories to sales is at its lowest point since 1950. The resulting shortages — and the frantic ordering by businesses to replenish shelves — have been the primary culprit in pushing up prices.

Ratio of Inventories to Sales (USD billions, log scale)



It is fairly typical for commodity prices to rise at the beginning of recoveries as inventories are refilled. As the below graph illustrates, it is also typical for commodity prices to decline after an initial surge. We believe there is a good chance this will play out again and that the worst of "bad" commodity inflation has already been experienced.

The post-GFC environment, which saw inflation concerns around QE and stimulus, production curtailments, and negative real rates, also showed input cost inflation. There is probably room to run, but eventually it stagnates as capacity returns. Marginal cost pricing usually wins, and production improvement drives real pricing declines.

CRB Commodity index

As we first mentioned in our January letter, wage inflation is likely to pick up somewhat and be persistent. Throughout our history, possibly because the United States was founded by two distinct groups — the Puritans, who could not tolerate slavery in order to benefit the economy, and the followers of the Church of England, who had no trouble with this path — the pendulum has swung between a push for cheap goods with the exploitation of labor and a push for pro-labor policies. Over the past five years (and made more evident by support for essential workers during quarantine), society has been shifting its support back to labor and away from big business. We believe this will result in some wage inflation, but also believe this is a positive development for the economy, given the income inequality that has grown in recent decades. If there is a chorus to focus on for the foreseeable future, it likely is that labor "won't back down."

A chorus can be part of a song, but it also can be what a large group of people are saying at the same time. Though society and the government remain split on most issues — and we don't anticipate major changes — we do believe there is a coalescing of support behind efforts to fix our country's immigration system. Since 2014, the backlog for citizenship applications is up 80% and the average time to approve employer-sponsored green cards has doubled. We believe the current administration's efforts to return the country to one that is based on diversity and opportunity will move ahead and is needed. As China moves to cleanse its population and weaken its outlook, the U.S. needs to move in the other direction for both ethical and economic reasons. If we have learned anything over time, it is that our strength is in our diversity. As our friends at Green Alpha recently wrote in a blog post, "if we want to remain the vibrant, innovative, massively economically-productive juggernaut that we are, we need that time [reopening our society] to come again."[1]

Improved labor and immigration policies are the chorus we would focus on in the coming year if one wants to hear where the economy and financial markets are likely headed. As always, we will continue to balance an optimistic outlook with the checks that high debt, a fractious government, and some valuation bubbles in speculative investments may have on near-term asset prices. RM

[1] Green Alpha Advisors: https://greenalphaadvisors.com/this-is-how-we-outcompete-china