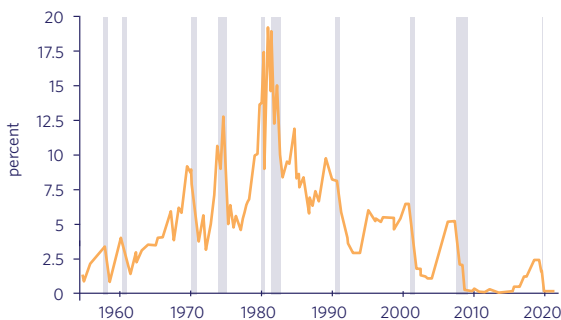


## Whip Inflation Now?

In 1974, President Gerald Ford responded to an inflation crisis by asking the American people to “grow more food, waste less, drive less, and heat less” to get prices under control. This national voluntary effort to Whip Inflation Now “WIN” failed miserably, and Alan Greenspan later described the idea as unbelievable stupidity. Fast forward to 2022 and investors are now asking: will the current bout of inflation be persistent and punitive to business, consumers, savings and investment like it was in the 1970s? If so, will the Federal Reserve choose to dramatically raise interest rates, further pushing down asset prices and potentially tipping the economy into a recession? The answers to these questions will no doubt have a significant impact on asset prices, likely more so than any other variable (Chart 1).

**CHART 1**

*Federal Funds Effective Rate*



Source: Board of Governors of the Federal Reserve System

The country’s 1970s inflation experience continues to cast a long shadow over the U.S. monetary policy framework. Inflation averaged almost 7% throughout that decade and twice it surged over 10%. Not until Paul Volcker “broke the back of inflation” in 1979 did it finally fade to 4% by 1983. Volcker voluntarily put the country into recession

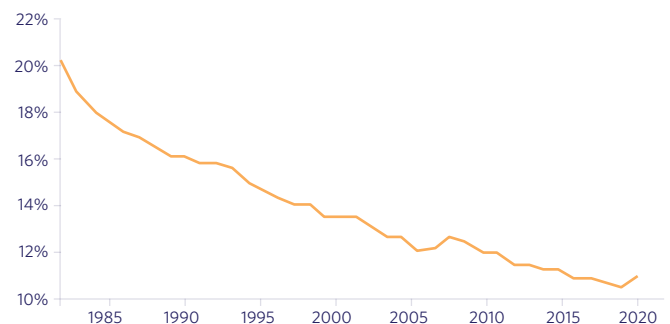
by massively raising interest rates. Indeed, the Federal Reserve’s dual mandate since 1977 is to promote both maximum employment and stable prices. This exists in large part as a response to that era. Higher interest rates, not slogans, got inflation under control.

This policy response in the late 1970s was highly appropriate. In 1973 the OPEC embargo caused the price of oil in the U.S. to quadruple. The U.S. was a more heavily unionized and manufacturing-dependent country at that time. Labor markets were more static. If demand for a product stalled, firms were handcuffed and unable to adjust by laying off workers, as contractual relationships between labor and management were in place. This fact pattern led to quickly deteriorating profit margins unless firms were able to pass those additional costs on to their customers in the form of higher prices. This in turn led to labor seeking additional compensation – evolving into a wage-price spiral. This is a potentially destabilizing monetary phenomenon, and one that policy makers want to avoid.

Today’s economy is less susceptible to this risk. Labor and product markets are now much more global. The U.S. became a net exporter of all oil products as of 2019. Services make up a much larger share of the U.S. economy. Private labor unions have lost most of their membership (Chart 2) as only public sector employees have large union

**CHART 2**

*Union Membership as a Percentage of Employed Wage and Salary Workers*



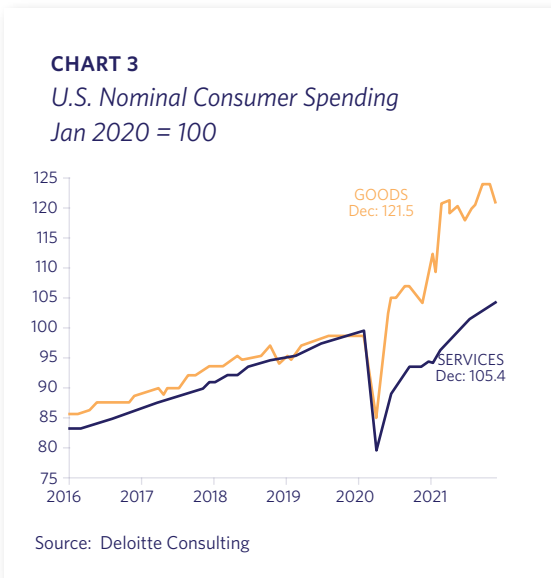
Source: Bureau of Labor Statistics



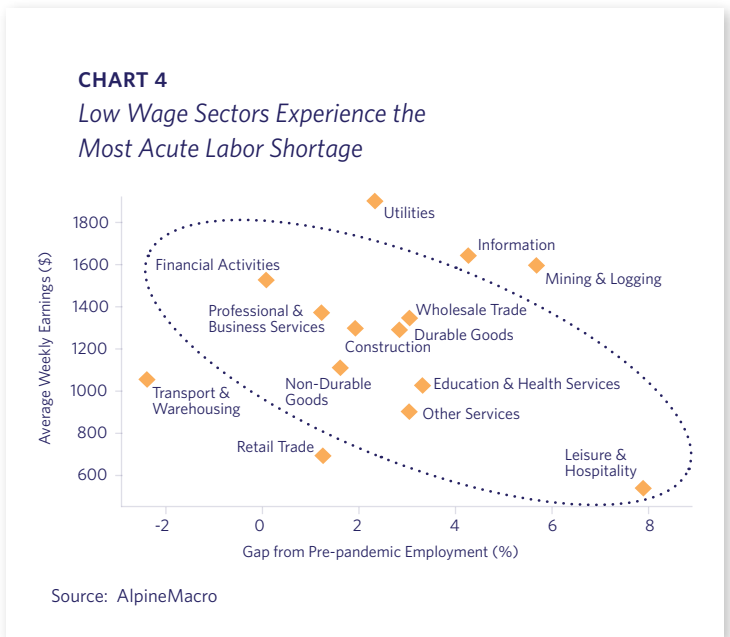
representation. This allows for a much more flexible system, as firms are no longer held captive to the demands of organized labor and our energy demands are less vulnerable to the Middle East.

Perhaps most importantly, software and technology development continue to act as a very potent deflationary force. If companies cannot find a person to perform a role, they now decide whether they need to pay more or perhaps automate the task using software or machinery. This is a simplified yet real choice that firms are facing, especially in today's labor-starved marketplace.

Finally, an under-appreciated fact is that there was a massive spending shift from services to goods during the pandemic. This shift is now winding down and will likely normalize over the next 12 to 18 months (Chart 3). As this excess demand for goods declines, prices should follow suit.



The labor shortage is the real economic problem we face. There is a shortage of labor across large swaths of the U.S. and global economy. There are not enough truck drivers, construction workers or longshoremen. There are not enough restaurant servers. There are not enough healthcare workers. Entry level jobs are going unfilled, and firms with skinny operating margins dependent on this labor are very stressed. We cannot automate many of these jobs, so the only solution is an increase in willing workers (Chart 4).



The supply chain breakdowns are part and parcel of the labor shortage. Lockdowns and mandated quarantines (blunt public health policy tools with large unintended costs) are akin to throwing sand in the gears of domestic and global trade. The ripple effects throughout a global economy which spent several decades building just-in-time inventory delivery systems cannot be understated. Almost two years into the pandemic, the working conditions and demands on those men and women whose job is to assure things “work” have pushed many to the breaking point. In fact, we believe wage inflation for workers in many of these capital-intensive businesses, where labor is not a large input to the costs of production, is a silver lining and long overdue.



Despite two years of societal adaptation and the reported less severe disease associated with the Omicron wave, our policy response has sidelined an extraordinary number of additional people. It was estimated in a January 7th, 2022, *Wall Street Journal* article that five million workers called in sick in the U.S. that week. Layer in school closures and the ripple effect this has on the workforce and the labor shortage becomes very apparent.

In fact, it is now clear that our reaction to the current Omicron wave is further stoking inflation. Instead of the great re-opening we've all been waiting for, the 2021 holiday season was back to case-counting, booster shots, quarantines and many of the same public health policies which helped stoke inflation in late 2020/2021. With this thrice postponed re-opening, the Fed has now pivoted, concerned that two years of this labor-starved economic mix may in fact make inflation less transitory and more sticky.

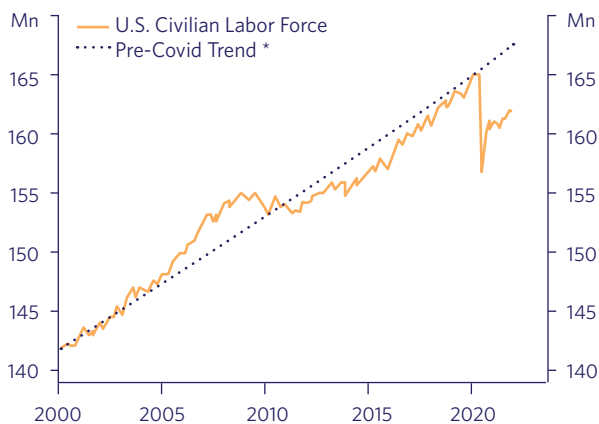
Importantly, according to Bureau of Labor Statistics data, the U.S. labor force has contracted by roughly five million jobs since the pandemic began (Chart 5). Early retirements are a large component of the calculus. Because of the smaller labor force, the Fed now believes the economy is at full employment.

Therefore, the Fed has shifted its priority from maximum employment to fighting inflation. In its defense, commodity prices across the board are much higher. The Consumer Price Index ("CPI") printed 7% in December, the highest rate since the 1970s. The details below this headline number are fascinating, as used car prices spiked 37% year over year! This type of price change will not continue, regardless of Fed policy.

While Lyell Wealth Management is not overly fixated on the year-over-year number, it is politically difficult for the Fed to ignore the current CPI figures. The Fed is therefore not only backing off stimulative monetary interventions but has also indicated it may head in the other direction and remove liquidity from the economy. Indeed, the Fed has telegraphed several interest rates hikes this year, indicating they may move at the fastest pace in a few decades. We are skeptical. In fact, we think this has resulted in a "peak hawkishness" message received by the market which is likely to be unwound. Recall that it was less than 18 months ago that the Fed adopted a new "symmetrical" policy framework, asserting that lagging its 2% inflation target for almost a decade now necessitated accepting more inflation to close this gap (Chart 6).

**CHART 5**

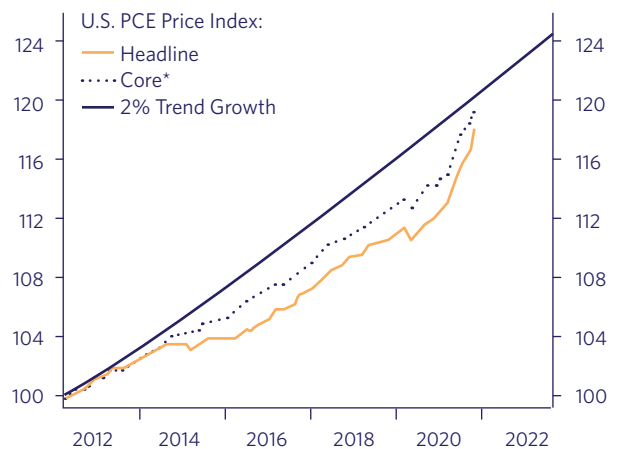
*The Labor Force is Significantly Lower Than the Pre-Covid Trend*



\* Alpine Macro calculation  
Source: Alpine Macro, Bureau of Labor Statistics

**CHART 6**

*Prices Still Lag New Fed Anchor*



\* Excluding food and energy  
Note: All series are shown rebased to Jan 2012 = 100  
Source: Alpine Macro

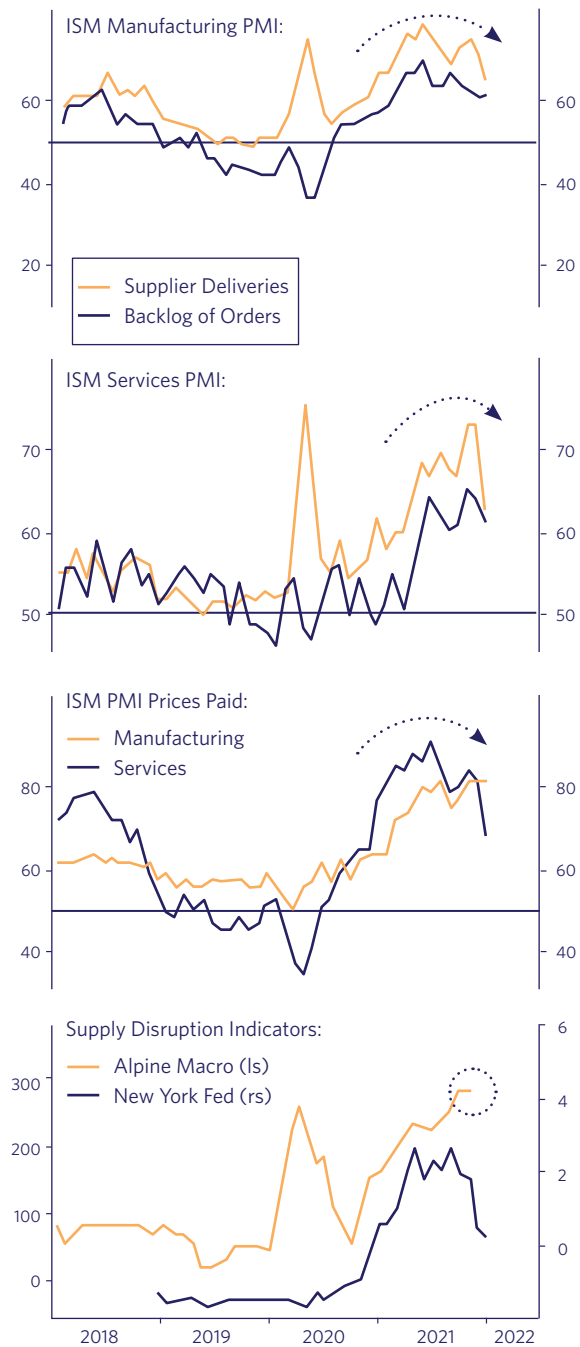


Surprisingly, despite the aforementioned labor issues we continue to face, the ISM Manufacturing and Services PMI pricing data appears to be rolling over. Perhaps supply bottlenecks around the world are passing their worst points (Chart 7). Nonetheless, this abrupt shift in Fed policy messaging has led to very large dislocations in stock prices, particularly for higher growth businesses. These companies are by definition less focused on current profitability versus long term market power, and in turn are more vulnerable to a correction if interest rates move materially higher.

It is important to remember Lyell Wealth Management's investment approach. We are buy-and-hold investors. We are acutely aware of the futility of market timing and believe having a long-term orientation is one of our primary competitive advantages. We constantly try to zoom out to longer time frames because we believe that is the only way we can confidently handicap how much a company could be worth. The large majority of institutional investors operate in much more compressed timeframes.

Our base case for 2022 is a tale of two halves. The near term – which has already seen the NASDAQ suffer its worst-ever start in its 51-year history – will be difficult. We will have continued market volatility as each inflation print that hits the tape appears very consequential. However, we also believe that at some point the Federal Reserve's messaging will be too hawkish and they will be forced to stand down.

**CHART 7**  
*Supply Bottlenecks  
Past the Worst*

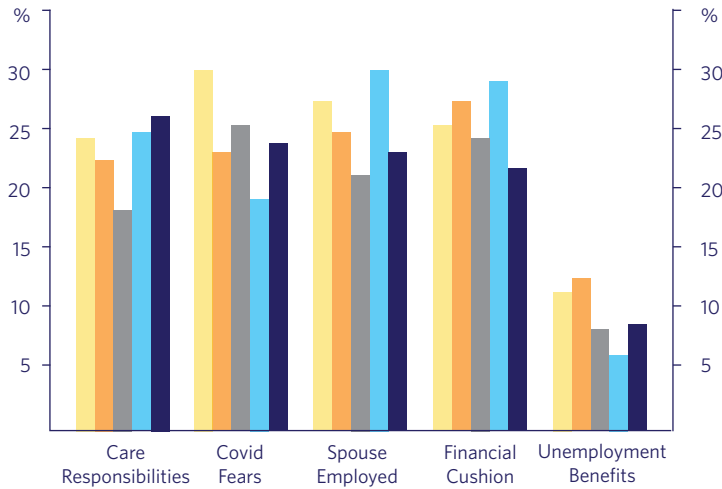


Source: Alpine Macro

**CHART 8**

*Many Reasons for Lack of Urgency for Employment*

June      September  
July      October  
August



Source: Alpine Macro, Indeed

We believe there is significantly more slack in the labor market than as modeled by the Fed. There are several different factors at play (Chart 8). As Covid policy responses become more pragmatic and fiscal stimulus wanes, capitalist theory says a surge of both workers and products will catch up to meet demand, bringing inflation down with it. The Fed may have little need to actively fight inflation in this scenario and the consequences for over-tightening could be very severe. Removing the extremely accommodative policy of the last two years is overdue but going beyond that is likely a step too far. A flattening yield curve, where long term inflation expectations remain well grounded, is sending this message to the Fed today.

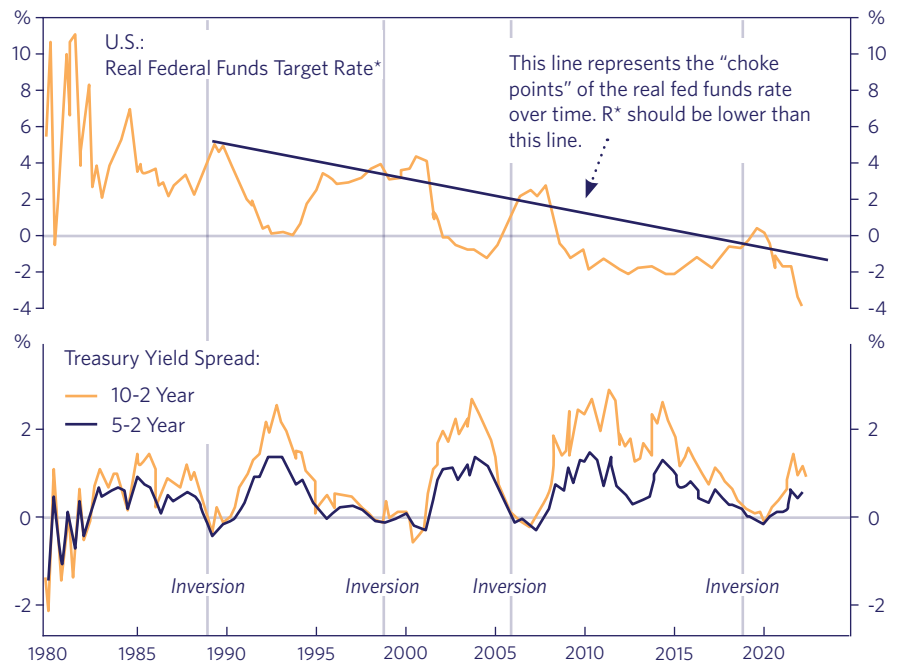
Critically, we do not believe the post-Covid economy will be vastly different from the economy we have lived in for the previous decade. Demographics have not changed. Yes, globalization is slowing and China's role as a deflationary force in the world is ebbing. However, we do not think interest rates will need to adjust significantly higher, especially as unacceptably high levels of inflation abate with a normalized labor market. This is in large part due to the neutral rate of interest for the U.S. economy.



There is an enormous amount of research on how to estimate the neutral rate of interest for the U.S. economy, much of it produced by the Federal Reserve. This interest rate, called  $R^*$  in Fed circles, is by definition neither accommodative nor restrictive. It is influenced by demographics, employment, productivity, demand for safe assets and capital efficiency. To the chagrin of many savers, this neutral rate has fallen continuously for decades. This is what one should expect from an aging society with slowing population growth. In fact, this secular decline of  $R^*$  has become so pronounced that  $R^*$  should be roughly -1% for the U.S. economy assuming inflation is in the 2% range. That would imply risk-free Federal Funds rates of around 1.0% (Chart 9). If this is true and inflation dissipates as we expect, it would be quite bullish for long duration risk assets like growth stocks.

**CHART 9**

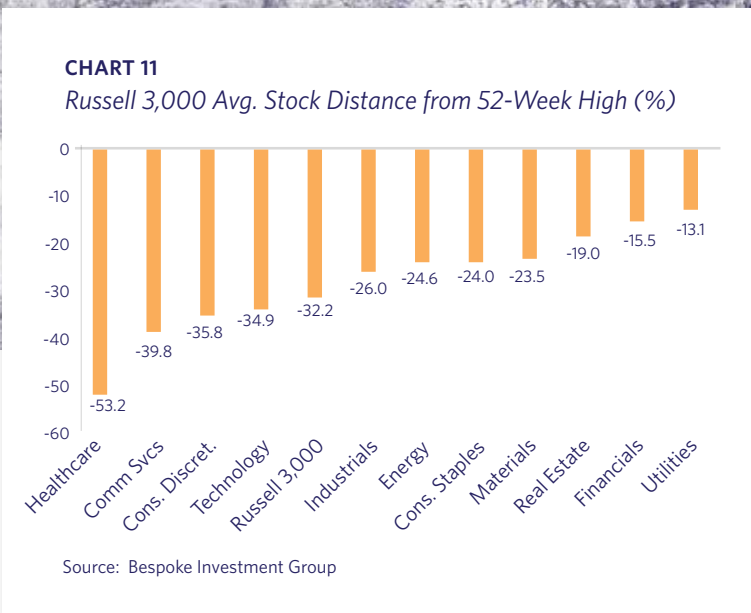
*U.S.: Real Fed Funds Rate, Choke Points and  $R^*$*



\* deflated by core PCE inflation  
Source: Alpine Macro



One final and critical point. Although there are understandably many comparisons of current conditions to the 1970s, Lyell Wealth Management thinks the parallels may be closer to the post-World War II era. An extraordinary major event created massive dislocations in labor, resources and infrastructure which resulted in high inflation. As one of the measures to manage the post-war adjustment, the U.S. engaged in active yield curve control. This means inflation was allowed to run hot, but because the war led to large spending and debt issuance, interest rates were capped and remained controlled. Ultimately the U.S. was able to “pay back” a great deal of this debt with inflated dollars. Following this playbook is probably the only way out of this monetary situation, especially considering the alternative. So, it would seem the Fed should allow inflation to run as “hot” as possible, without becoming too disruptive to economic growth (Chart 10).



As of this date, the broad stock indexes are well off their highs. In fact, the average stock in the Russell 3000, a very broad index, has declined over 32% from its 52-week high. A sector analysis shows this drawdown has hit many sectors extremely hard (Chart 11). This is likely to get the Fed’s attention sooner rather than later. Roughly two-thirds of the U.S. economy is dependent on consumer spending. However, spending is not strictly a function of income. The wealth effect, or the consumption of savings and investment largely invested in the equity market, has become a critical source of spending for many Americans. Lower asset prices will impact demand which, in turn, will quickly cool the economy.

**CHART 10**  
Yield Curve Control & World War II

| Year | 3-Month Treasury Bill (%) | 10-Year Treasury Yield (%) | Inflation Rate Y/Y Pct. Chg. (%) | Federal Surplus/Deficit As Pct GDP | Corporate Spreads (bps) | S&P Return (%) |
|------|---------------------------|----------------------------|----------------------------------|------------------------------------|-------------------------|----------------|
| 1940 | 0.04                      | 2.20                       | 0.7                              | -3.0%                              | 64                      | -9.6           |
| 1941 | 0.13                      | 1.99                       | 5.1                              | -4.3%                              | 78                      | -11.6          |
| 1942 | 0.34                      | 2.11                       | 10.9                             | -13.9%                             | 72                      | 20.1           |
| 1943 | 0.38                      | 2.07                       | 6.0                              | -29.6%                             | 66                      | 25.6           |
| 1944 | 0.38                      | 2.09                       | 1.6                              | -22.2%                             | 63                      | 19.5           |
| 1945 | 0.38                      | 1.73                       | 2.3                              | -21.0%                             | 90                      | 36.3           |
| 1946 | 0.38                      | 1.74                       | 8.5                              | -7.0%                              | 79                      | -8.0           |
| 1947 | 0.60                      | 1.85                       | 14.4                             | 1.7%                               | 76                      | 5.6            |
| 1948 | 1.05                      | 2.15                       | 7.7                              | 4.5%                               | 67                      | 5.4            |
| 1949 | 1.12                      | 1.93                       | -1.0                             | 0.2%                               | 73                      | 23.6           |
| 1950 | 1.20                      | 2.05                       | 1.1                              | -1.1%                              | 58                      | 32.6           |

Source: Strategas Research Partners

We do not want to sound Pollyannaish about this particular mix. The Federal Reserve is faced with a very difficult set of trade-offs. Tighten too soon and too aggressively and the U.S. will experience a recession and higher unemployment. Let inflation run too hot for too long and the credibility of their inflation-fighting credentials will be called into question. However, we believe that the Fed understands the risks posed by both scenarios and is likely to take its time and course-correct should it prove necessary. The most reasonable path forward is for the Fed to normalize policy slowly while allowing labor markets to naturally return to equilibrium. Similar to the post-WWII period, this may involve accepting higher than desired inflation for an extended period of time. Our client portfolios are constructed with this in mind.



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