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Macro Memo

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Without Positive Real Returns, Financial Plans Collapse

My job, in large part, is to help clients create positive real returns[1] on their investment capital. Without positive real returns, financial plans collapse. Those returns are created in the financial markets, and you cannot understand financial markets without understanding macroeconomics and geopolitics. They are fundamentally interdependent.

That understanding leads to my concern that most investors are unaware of and, therefore, unprepared for the magnitude, duration, and destructive power of the inflation headed our way soon. Because many are unaware, their investment portfolios are not positioned for it.

Legendary monetary economist Milton Friedman defined inflation as, "Always and everywhere a monetary phenomenon."[2] "Too much money chasing too few goods."[3] It's an equation. Price stability exists when consumption equals production. Imbalances can be created or resolved on either side of an equation.

The following five macroeconomic and geopolitical factors all point to a growing imbalance in Friedman's equation and, as a result, to higher inflation.

Chronic Deficit Spend:

Current U.S. deficits are approximately $2 trillion, or roughly 7% of GDP. For borrowers who are not a sovereign government, money is borrowed from those who have it to lend. In the case of the United States, there are no willing lenders with enough capacity on their balance sheets to loan that kind of money. The lender of last resort is the Federal Reserve Bank (The Fed). The Fed's balance sheet capacity is created by a computer keystroke. It is not representative of productive economic activity; it is, for practical purposes, printed money. This contributes to the consumption side of the equation and adds inflationary pressure. The accumulated effect of Chronic Deficit Spending has led to another problem.

Fiscal Dominance:

Outstanding U.S. public debt, and the cost of servicing that debt, has grown so high that fiscal policy is squelching the effects of monetary policy, the Fed's primary inflation management tool. While adjusting interest rates has an impact on the private sector, Congress is a price insensitive borrower. They continue to run deficits no matter the cost. Consequently, with deficit spending comprising a larger percentage of GDP, the Fed cannot slow the economy as much with interest rate increases as they have in the past. Fiscal Dominance hampers the Fed's ability to tame inflation.

Reshoring Critical Supply Lines:

A revelation made apparent by the economic shutdown of the COVID pandemic was our dependence upon foreign sourced supply lines. Many of these supply lines involved critical items. It is a matter of national security to reshore fabrication of many of these items. Their production was originally off shored to save labor costs. Therefore, reshoring them will have the reverse effect, adding to inflation pressures.

Demographically Induced Wage Inflation:

The influx of manufacturing from abroad will require qualified workers. The U.S. has an aging population. More baby boomers with qualified skills are retiring from the work force than are being replaced by younger generations. This will lead to competition for the remaining pool of skilled workers, resulting in higher wages. In one form or another, these increased costs will be passed on to consumers, adding to inflation.

Underinvestment in Commodity Capital Expenditure:

Investment in developing new supplies of critical industrial inputs has been declining for a decade, putting these key commodity markets in a condition of structural shortage.[4] Given the long cycle between initial investment and meaningful production, there is no relief to these shortages in sight. The remaining supply available will be allocated by price…higher price. Obviously, this will add to inflation.

Conclusion:

The oncoming inflation is structural in nature, not cyclical, something not experienced since the 1970s – unfamiliar territory to most investors. Moreover, the underlying element of fiscal dominance will actually weaken the Fed's ability to fight against this trend. Higher inflation means more than higher prices for consumers. Financial assets represent ownership interest in future cash flows. The value of those future cash flows is sensitive to inflation. The disinflation of the 40-year period of 1982-2022 led to higher valuations; the Price/Earnings ratio of the S&P 500 soared from just 7 times earnings in 1982 to over 35 times earnings today. As inflation takes hold going forward, investors can expect a contraction in market multiples, creating a headwind for returns.

An advantage stocks of healthy companies hold over bonds is the possibility of growing cash flows. Growth can help offset the effects of inflation. Bonds, on the other hand, typically offer a fixed cash flow (they are known as fixed income). Increasing inflation is more than just a headwind for fixed income; it gradually, but unrelentingly, destroys the purchasing power of fixed cash flows.

Generating positive real returns on investment capital during inflationary times requires recognizing and adapting to the changing economic environment. Holding an asset allocation designed for disinflationary times and hoping for the best is a recipe for disaster.

If you would like to discuss any of these ideas in more detail, I would welcome the conversation. Please feel free to reach out.

[1] Positive real returns are those in excess of inflation, e.g. If inflation is 4% and a nominal return is 5%, the real rate of return is 1%.

[2] https://www.aei.org/carpe-diem/my-favorite-milton-friedman-quotes/#:~:text=1.%20There%20is%20nothing%20as%20permanent%20as%20a

[3] ibid

[4] https://www.goldmansachs.com/pdfs/insights/pages/gs-research/2023-commodity-outlook-an-underinvested-supercycle/report.pdf

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