The Tale of Two Inflations

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Recent statistics on measures of inflation have begun to accelerate and the pundits are chiming in with the boogeyman story of how inflation is going to undermine the bull market and the economic expansion. These stories often refer to the historical experience of German inflation after WWI, inflation in the African country of Zimbabwe and more recent experience with surging prices in Venezuela. While these statistics do document scary levels of inflation and ultimate economic collapse, they are not the right examples for evaluating our current economic circumstances.

In each of these examples, the culprit was a collapse in the supply of goods and services. In Germany, the Allies imposed enormous reparations on the Axis powers and the availability of goods shrank as output was shipped to the conquerors. In the case of Zimbabwe, the country's leader Robert Mugabe, sent away most, if not all white farmers and replaced them with his supporters. The problem was that the new farmers did not know how to farm, and farm output collapsed - leading to soaring prices for food and other commodities. A similar story can be told whenever a government takes steps to reduce output or the supply of goods and services.

A good example of "supply-side" inflation is the Arab Oil Embargo in 1973. When the Arabs collapsed the availability of oil for U.S. consumption, the price quadrupled and the surge in energy prices caused inflation to rise into the double digits. The problem occurred from time to time with every shortage of oil due to OPEC price manipulation.

In other words, supply-side inflation is destructive as it brings about economic declines and hardship – such as Venezuelans have endured for years. Investors should be concerned when there are signs that a collapse in output is imminent. Government actions in 2020 to offset a potential collapse in output due to the Coronavirus brought about stability and an economic recovery that had no inflation.

The other side of the coin is "demand-side" inflation, which comes from a surge in demand when supply is stable. This type of inflation occurs during periods of accelerating economic activity where the private sector cannot meet the demands of consumers and businesses. A surge in prices is the result but the outcome is different; the economy continues to grow and there is a wealth transfer from consumer to producer. We are probably at that point in our economic recovery, where demand-side inflation will cause prices to rise. The important distinction is that, during this period, economic activity will be rising accordingly. To back up that expectation, The Federal Reserve Bank of Atlanta's NOW forecast for economic growth in the first quarter is 9.5% annualized. Goldman Sachs is forecasting economic growth for the year at 6.8% - with their latest revision being up. The bottom line is that investors will be happy with the ultimate impact of demand-side inflation and equity markets are likely to continue to do well under this economic scenario.