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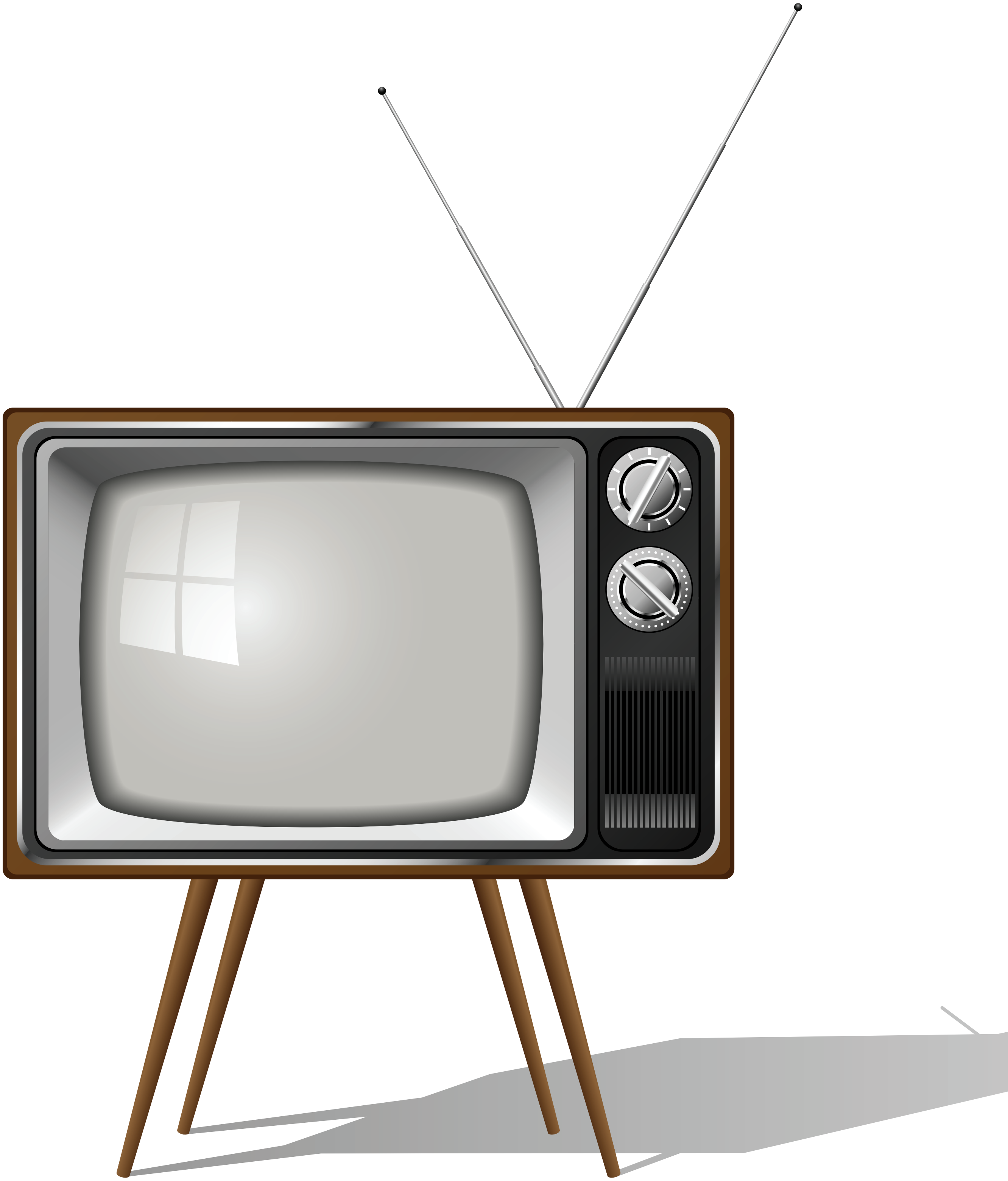


“Inflation is less an inevitable condition than a poisoned mindset—a swelling fear on the part of participants in the economy that prices will keep going higher, and so anything not purchased today will only cost more tomorrow. But it does have an antidote, and that antidote is choice.”

Inflation and the Power of Choice

People of a certain generation (the author included) recall a television-watching experience bearing no resemblance to the experience of today. For starters, the TV itself had a bulky physique, with rabbit-ear antennas for improving the staticky reception and twin circular knobs for changing the channel and adjusting the volume. Fancier sets came with a remote control that made a “click” sound when you pressed a button (hence the term *clicker*), which was a nice convenience, albeit for a limited set of broadcast television options dominated by the three networks ABC, CBS, and NBC. While remotes were certainly helpful, changing the channel meant potentially missing part of a show, and in an era where video-cassette recorders were notoriously difficult to program, the only recourse would be to wait until the summer, when network programming was heavily occupied by reruns. That’s pretty much how things worked until the early 1980s, when the widespread distribution of cable television changed the industry forever, providing greatly improved picture clarity and a much broader range of programming. Cable television was a revelation, delivering a level of entertainment that American households had simply never seen before, accompanied by something else that American households had never seen before: a cable bill. While television via antenna was free, television via coax was not. Over time, that cable bill would only rise, an inflationary by-product of the enormous leverage that cable companies held over consumers, whose only alternative was to return to the TV equivalent of the dark ages.

Inflation in other areas of the economy has been mostly muted in recent years, but it is very much on investors’ minds these days as the world emerges from the forced economic hibernation brought on by the pandemic. The widespread distribution of the vaccine has opened the door for a return to normalcy, and many of the newly vaccinated are rushing through at once, anxious to resume a way of life that went suddenly dormant early last year. This pent-up demand has already produced a measurable impact, driving the Consumer Price Index (CPI) up 5% in May on a year-over-year basis, the largest increase since 2008, when the CPI rose 5.3% before the Global Financial Crisis led the US into its worst recession since the Great Depression. In the wake of this latest CPI report, market participants are examining today’s conditions as well as past inflationary periods in an effort to divine the monetary policy response and determine how to best position portfolios to withstand the potential pressure on financial assets.

Inflation is less an inevitable condition than a poisoned mindset—a swelling fear on the part of participants in the economy that prices will keep going higher, and so anything not purchased today will only cost more tomorrow. But it does have an antidote, and that antidote is choice. While some believe that we may be at the beginning of an extended inflationary cycle in which consumers are forced to pay increasingly higher prices, this view discounts the leverage that consumers have been accumulating over the past number of years, driven in

large part by globalization and advances in technology that have increased competition and given consumers a range of purchase options they've never had before. As we consider the case for inflation and the myriad challenges to reposition portfolios accordingly, it's important to understand whether the fear of inflation could be overwhelmed by the reality of choice, and whether it makes sense to aggressively prepare for a threat that may never fully emerge.

Lessons from the Demise of Cable Television

From the beginning, cable television providers eschewed an à la carte model. They provided packaged plans consisting of lots of channels, and customers had to pay for these channels whether they watched them or not. Over time, most fell into the category of "not." By 2013, the average TV household had over 189 channels, yet watched a mere 17 of them.[1] This came toward the tail end of a 20-year period where cable prices had been rising 5.8% on average each year, while inflation was rising an average of 2.2%.[2] Few products or services had the ability to force customers to make monthly payments for something they didn't use, but this scheme has always been a prominent feature of the cable television model. A recent report studying the cost of cable's top channels showed that ESPN, by far the most expensive channel in basic packages at around $7.64 per month, was only regularly watched by 20% of subscribers, which means that 80% of subscribers were paying for the most expensive channel and not getting much value from it, if any at all.[3] A system like that was always ripe for disruption. It just never had a decent enough alternative.

That all changed with streaming. These new entertainment platforms, led by powerhouses like Netflix, Hulu, Amazon Prime, and Disney+, have transformed the industry in a staggeringly short period of time, giving customers the one thing that cable television had never generously offered—choice. "Cord-cutting," once disregarded by the cable industry as a myth,[4] completely upended the industry, allowing customers to sever their ties with cable television and adjust the power dynamic that had been entirely one-sided for so long.

That divorce is now well under way, with no signs of slowing down. According to a survey from the Pew Research Center, the share of Americans who say they watch television via cable (or satellite) has plunged from 76% in 2015 to 56% in 2020. Around 71% of those who do not use these services say it's because they can access the content they want online, while 69% say the cost of these services is just too high. As expected, it comes down to choice and cost. Only about a third of Americans ages 18 to 29 now get TV through cable, down 31 percentage points from 2015.[5] This trend is unlikely to reverse, as leading the charge are younger people, who are more inclined to embrace change rather than revert to behaviors that dominated the past, especially those so clearly financially disadvantageous.

Offline and Online Competition

Entertainment is a very modest part of any household budget, but the competitive forces that

[1] "The Rise And Fall Of Cable Television" Forbes, Nov 2020
[2] "Report on Cable Industry Prices" Federal Communications Commission, Feb 2018
[3] "The True Cost to Consumers of Pay TV's Top Channels" Variety, Oct 2020
[4] "R.I.P. Cable TV: Why Hollywood Is Slowly Killing Its Biggest Moneymaker" Variety, Jul 2020
[5] "Cable and satellite TV use has dropped dramatically in the U.S. since 2015" Pew Research Center, Mar 2021

have shaped pricing in that industry are applicable to more important areas of commerce as well, where technology and globalization have made goods and services more accessible—and more competitive—than at any point in human history. Consider food, one of the higher-expenditure items for the average US household. There are roughly 40,000 grocery stores in the US in which people can shop, which creates competition and gives customers choices. According to the Economic Research Service of the US Department of Agriculture, the distance to the third-nearest store gives a sense of the amount of choice consumers have and the amount of competition the nearest store faces. The researchers found that the median distance to the nearest food store for the overall US population was less than a mile, and the median distance to the third-nearest food store for the overall population was 1.7 miles. When researchers looked at rural food-store access, they found that the median distance to the nearest and the third-nearest food store was 3.1 miles and 6.1 miles, respectively.[6] Traditional food-chain prices can vary widely on the same item (cereal price differences can be especially vexing), but the exploration of alternatives and the range of substitutes provided by the food industry do give consumers some degree of leverage. Like a gas station that sells regular unleaded for a nickel more than a competitor a mile down the road, it's not uncommon to find the same product selling for different prices at grocery stores in close proximity to one another.

Online access creates the same leverage for consumers because it erases the friction of comparative price discovery. Comparison shopping used to be a more-involved exercise, far from convenient and reserved largely for bigger-ticket items, like automobiles or appliances. But today, almost nothing is bought online without confirming that it can't be purchased more cheaply elsewhere. During a recent online search, Apple's new AirPods Pro were $249 at the Apple Store, but the exact same product could be found at a nearby Target for $50 less, including free same-day delivery. The ease of price discovery impacts the seller as well. Retailers with an online presence can know precisely what other retailers are charging for the same items, and determine whether they want to improve their competitiveness by selling the item at a lower price. This discovery process, now hardwired into human behavior, can act as a natural counterweight to price inflation.

Of course, consumers are buying finished goods, not the components comprising these goods. Some of these components have seen significant inflation recently, but the question of how permanent these price increases will be is important when determining whether their impact on inflation will be transitory or long-lasting.

Commodity Inflation and The Fed

Up until mid-2020, an examination of a 25-year price chart for lumber (as measured in dollars per thousand board feet) showed exactly the predictability that commodity buyers crave.

[6] "U.S. Shoppers' Access to Multiple Food Stores Varies by Region" USDA Economic Research Service, Jun 2019

Source: https://tradingeconomics.com/commodity/lumber

Except for a short period in 2018, the price had almost always fluctuated between $200 and $400. But toward the middle of 2020, the price started to rise significantly, driven largely by home renovations and new home construction. By March 2021, the index touched a previously unthinkable high of nearly $1500, helped not only by the demand but by supply-chain disruptions and the lack of alternatives for the commodity. As the country's nearly 3,000 sawmills were brought to capacity to meet the unexpected demand, this became a textbook example of how the fear of inflation could feed on itself. It turns out that as prices started to run up, wood was being hoarded by builders, retailers, and others that were worried about running out of material during a construction season sent into overdrive by low mortgage rates and federal stimulus payments. "Everyone was buying more than they needed," said Mike Wisnefski, a former lumber trader and chief executive of online marketplace MaterialsXchange. "There was this fear of lack of availability."[7]

But then something strange happened: lumber buyers discovered an alternative. That alternative was to simply hold off on construction until the price of lumber retreated. Home-improvement projects were delayed, and the professional homebuilding industry, the largest source of demand for lumber, also slowed down, with many builders citing high prices for

[7] "Lumber Prices Are Falling Fast, Turning Hoarders Into Sellers" Wall Street Journal, Jun 2021

wood as a reason to pause construction. Soon after, the market became flooded with additional inventory from the very buyers who had helped cause the runup in price, and who were now selling from their own inflated stockpiles. It turns out the dramatic price acceleration wasn't a by-product of a market being entirely fed by runaway demand. It was more a temporary lack of supply.[8]

What some fear to be the beginning of a period of sustained inflation across a number of commodities and product components is now being considered by others as merely a temporary mismatch between supply and demand. Included in that group is Jerome Powell, the chairperson of the policy-setting Federal Reserve, who said that he expects supply chains to adjust as economic growth accelerates. "It's very possible, let's put it that way, that you will see bottlenecks emerge and then clear over time…. These are not permanent. It's not like the supply side will be unable to adapt to these things. It will—the market will clear. It just may take some time."[9] Other economists share Powell's sentiment. "The strength in the top line indices was driven largely by categories that have been heavily disrupted by COVID and remain under pressure from supply chain disruptions," wrote Eric Wingorad, senior economist at Alliance Bernstein. "The more persistent categories of inflation—the ones that do a better job of capturing the sustainable trend—are significantly more subdued. That means that the details of today's print continue to support the idea that the spike in inflation is transitory, even if it is more intense than most forecasters (myself included) would originally have anticipated."[10]

The Wild Card of Wage Growth

At a sign next to a rest-stop McDonald's along a stretch of Interstate 95 in Massachusetts, there's an advertisement for new hires. The wage is $17 per hour, $3.50 better than the state's minimum wage and a staggering $10.25 above the federal minimum. The CEO of McDonald's, Chris Kempczinski, earned $10.8 million dollars in 2020, which according to McDonald's translated to a CEO-to-median-employee pay of 1,189:1. In a federal filing, McDonalds's said, "The company believes that this ratio is not indicative of a typical year, given reduced CEO pay resulting from the negative impacts of COVID-19." So in a normal year, that number would be even higher.[11] And the prior year it was, with Kempczinski earning nearly 2,000 times as much as the median employee. This is not just a McDonald's problem, it's a problem across the US corporate landscape. In 2019, the ratio of CEO-to-typical-worker compensation was 320:1, up from 293:1 in 2018 and 61:1 in 1989. In 1965, it was 21:1.[12]

It's become clear in this country that excessive CEO pay is another contributor to rising inequality, and arguments that CEOs possess specific, high-demand skills and need to make this type of money in order for their companies to succeed on behalf of all of their workers are falling on increasingly deaf ears. "This escalation of CEO compensation, and of executive compensation more generally, has fueled the growth of the top 1% and top 0.1% in-

[8] "As Lumber Prices Fall, the Threat of Inflation Loses Its Bite" New York Times, Jun 2021
[9] "Everywhere You Look, the Global Supply Chain Is a Mess" Wall Street Journal, Mar 2021
[10] "Consumer Prices Jump 5% in May, Fastest Pace since the Summer of 2008" CNBC.com, June 2021
[11] "McDonald's CEO Chris Kempczinski 2020 Pay Totals $10.8M" Nation's Restaurant News, Apr 2021
[12] "CEO compensation surged 14% in 2019 to $21.3 million" Economic Policy Institute, Aug 2020

comes, leaving less of the fruits of economic growth for ordinary workers and widening the gap between very high earners and the bottom 90%. The economy would suffer no harm if CEOs were paid less (or were taxed more)."[13] Of course, this pay inequality dynamic has been widely known and understood for some time. Why does it matter now, when assessing the inflation picture?

When trying to divine whether any inflationary forces could be a problem down the road, wage growth could be the proverbial canary in the coal mine. Increasing demand for workers could (and should) result in higher wages, a position likely to find continuous broad support given the ever-widening gap in wage disparity. Many believe that wage-growth-driven inflation would be an acceptable societal tradeoff given how wide the economic disparity has become, but the question remains how these cost increases would impact the cost of goods and services going forward. Job growth has occurred in the past without significant inflation, but job growth with a material wage-growth component could be different.

The Power of Price Sensitivity

Our crystal ball for all things macro is permanently cloudy, and so we obviously can't say with any degree of certitude whether the post-pandemic economic growth will translate into low, moderate, or high inflation. Those who believe the economy is headed for the latter will likely shift toward traditional inflation-hedging assets like commodities and low-risk real estate. Yet, absent confidence in a highly inflationary outcome, one must consider the wide range of possibilities from what are generally low-return strategies. A meaningful portfolio hedge demands a sizable exposure and therefore introduces the risk of mediocre or outright poor performance if inflation does not turn out to be problematic.

The collective concerns of market participants will play a part in the outcome for sure, which is why the Fed is trying to allay any fears. Inflation has provoked this emotion in the past, often spurred on by the rhetoric of leaders tasked with combatting it. In 1980, when inflation was running at 15%, Ronald Reagan said, "Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man." Not a lot of subtlety there. Investors naturally look toward the past to help understand the present, but inflationary periods of the past simply don't look like today. The world is different, just like the world was different during the inflationary periods coming out of the First and Second World Wars, and the inflationary period preceding the Global Financial Crisis. The economic pump is certainly primed for significant growth today, but technology and productivity enhancements have changed the entire complexion of competition and consumer choice and altered the mechanisms for price discovery, a key component for keeping prices under control.

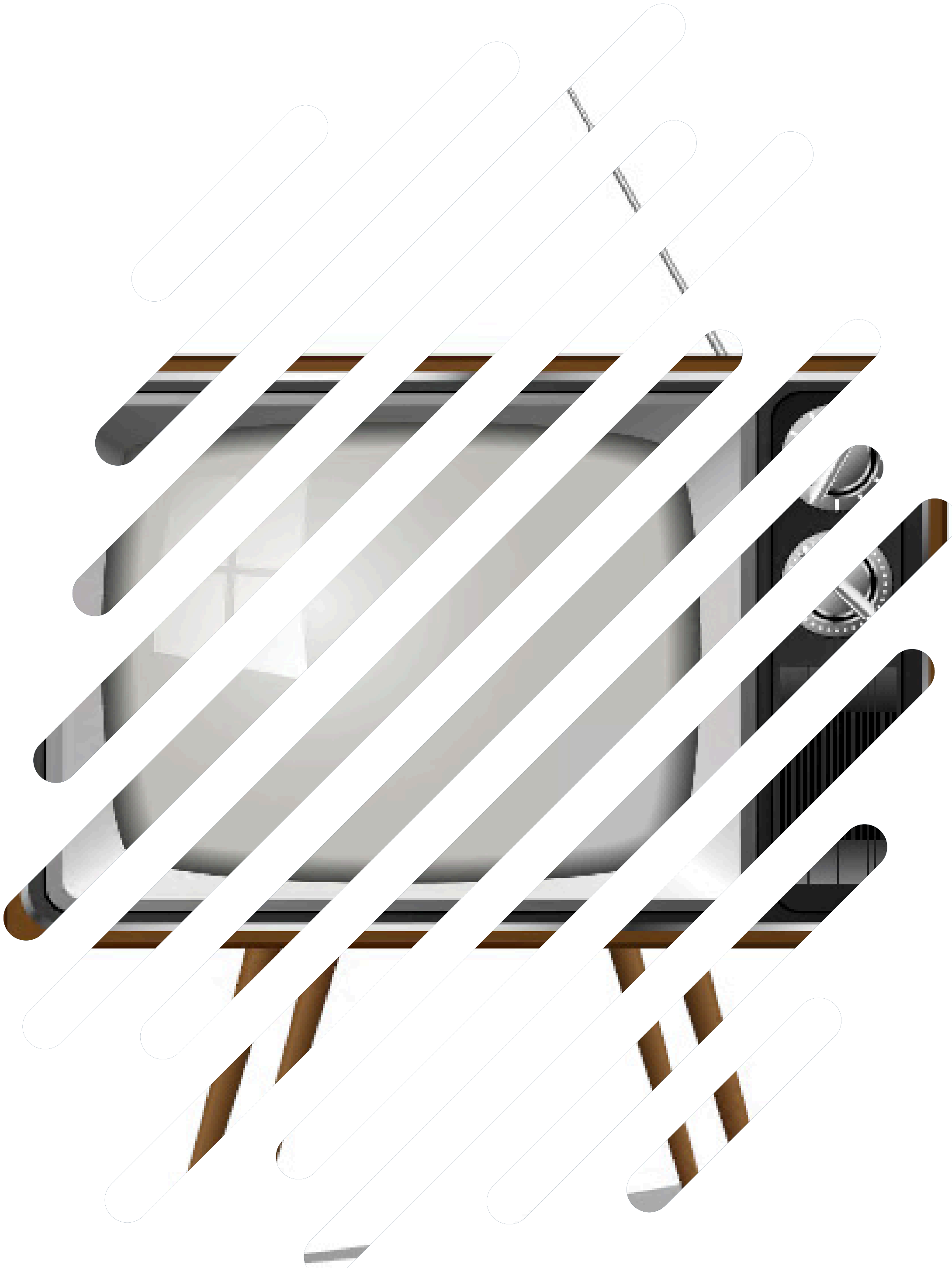
Of course, what comes with price discovery is price sensitivity, and that extends to all products and services, including the streaming platforms that continue to take share from cable. While everyone was home during the pandemic, streaming services thrived as people signed

[13] Ibid.

up for a number of different platforms, but now people are shifting back to work and spending money on other things. That hasn't stopped some of these services from raising prices, though, which probably should be expected given their success and penetration.

But these companies had better be careful. Streaming services are great, but there are lots of them now, all providing a seemingly unlimited amount of entertainment options. Each may think that their offerings make them indispensable to customers, and that they can enjoy the inflation leverage that cable companies once did. For some that may be true, but that approach carries risks. Customers are smart and have undoubtedly learned lessons along the TV-watching way, including years of paying too much for cable. When asked in a recent study what would make them want to cancel a video-streaming service subscription, the results were telling, although not entirely unexpected.[14] Over 70% of respondents didn't say they would cancel over content. They said they would cancel over price.

[14] "Price Hike Biggest Streaming Sub Cancellation Threat: Survey" Variety, Jan 2021



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