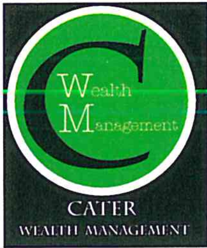

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12/13/2021

Greg Cater Sr. & Greg Cater Jr.

Does High Inflation Lead to High Interest Rates?

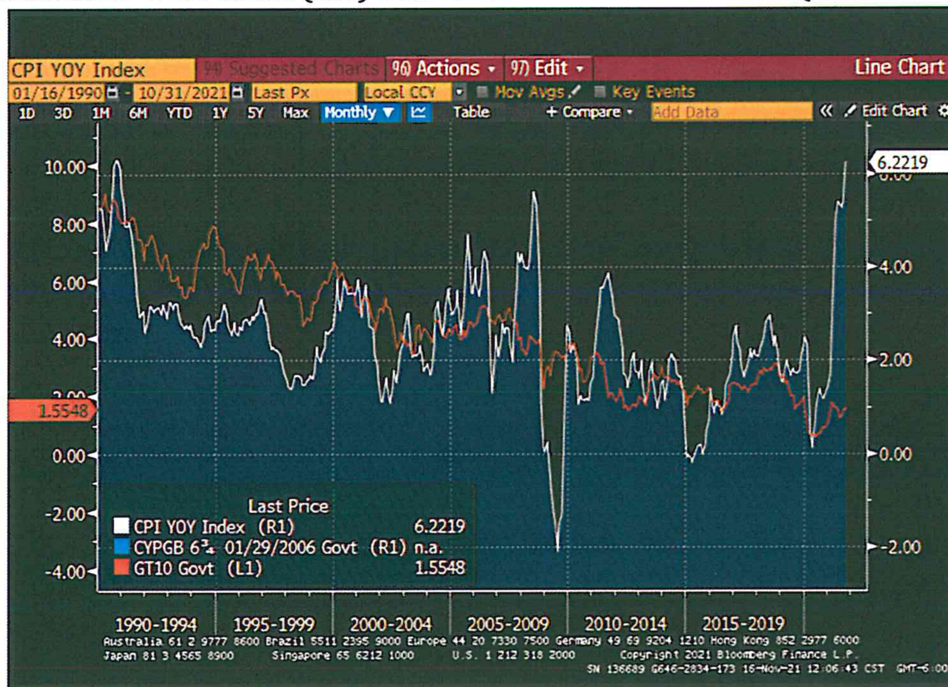
Last month (Oct'21) the year-over-year CPI inflation rate hit 6.3%, the highest reading in 30 years!

This month (Nov'21) the year-over-year CPI inflation rate hit 6.8%, the highest reading in 40 years!

The consensus among some economists, investment "experts" and most everyone else is inflation is not "transitory" and will eventually lead to much higher interest rates. Bonds are to be avoided at all cost and gold and even speculative trends such as Bitcoin look attractive as inflation hedges.

	Jun'82	Nov'90	Nov'21 (today)
CPIYOY Inflation	7.1%	6.3%	6.8%
10-year Treasury	13.68%	8.62%	1.45%

Consumer Price Index (CPI) Year-Over-Year Inflation Index (1990-2021)



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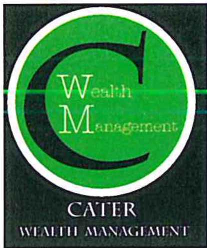

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"Tucker Carlson Tonight" on December 10th, 2021, devoted the first 17 minutes of his show to inflation. He said crypto currencies like Bitcoin are a natural inflation hedge and his guest, Peter Schiff, warned of increasing inflation, possible hyperinflation and the debasement of the US Dollar. Tucker Carlson Tonight is often the most watched cable news show with 3.4 million daily viewers.

It's no wonder people are worried. Fear can lead to investment mistakes. Let's examine what really happened with inflation and interest rates 30 and 40 years ago when we recorded similar CPI numbers.

In Jun'82 CPI hit 7.1% and dropped to 2.5% in 14 months!

In Nov'90 CPI hit 6.3% and dropped to 2.6% in 14 months!

Today its 6.8%,

Let's also look at interest rates. In Jun'82, the 10-year-Treasury-bond yield was 13.68%, in Nov'90 it was 8.62% and today it's 1.45%.

What causes "inflation" anyway? Most think the main problem today is all the extra money floating around due to the Federal Reserve's QE (Quantitative Easing) program. The Fed's bond buying has increased its balance sheet from $872 Billion in 2008 to over $8.6 Trillion today!

That's a lot of new money!

The problem with this theory is that it is very difficult for this new money to make its way into consumer inflation. When the Fed buys bonds with newly printed money, they don't buy from you and me, they tend to buy from large institutions like Pensions Plans, Mutual Funds, and Insurance Companies. The new money in these large portfolios doesn't have an easy path to the grocery store to buy eggs and milk or to the gas station to buy gas. Because these companies don't buy things like milk or gas, the only place this Fed money can readily go is into other financial assets. This is most likely fueling the current gains in stocks, bonds, real estate, gold and even Bitcoin. It doesn't lead to consumer inflation.

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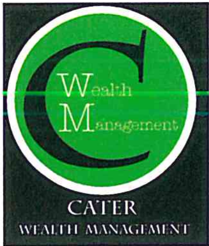

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There are two types of inflation, Monetary and Supply vs Demand. Prices go up either because there is too much money in circulation (creating new demand that was not there previously), or because there is not enough supply of goods and services to meet normal demands.

We believe that in our current situation, the main cause is lack of supply due to widespread shortages. The private sector is very good at reversing Supply vs Demand inflation. High prices cause producers to increase production which eventually brings prices back down.

The idea that whatever just happened is the most important data point for predicting the future is known as "Recency Bias". Another name for "Recency Bias" is "Momentum Trading". It can be argued the recent gains in stocks, bonds, real-estate, and even crypto currencies have made us "feel" richer and this can make us comfortable paying more for goods and services. This is the so-called "Wealth Effect". This seems reasonable but in reality, the price of something depends only on the cost to produce it and its demand relative to its supply. If something costs more to produce than it can be sold for it won't be produced. If, on the other hand, a product or service can be sold for more than its cost it will be produced. If a product can be produced for an exceptional profit, others will enter the market, produce an excess of said product, and cause the price to decrease.

Precious metals are also sold as inflation hedges. If you bought gold ten years ago (Nov'11) you would be up 1.61% (.16% annualized). If you bought silver, you would be down 28%. Both numbers are assuming zero transaction/storage/administrative costs, which is unlikely.

Cater Wealth Management continues to believe the current high inflation numbers are the result of shortages relative to demand. Further, we believe that the Private Sector is already in the process of ramping up supply which will lead to overproduction and significantly lower levels of inflation in the long run.

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