ALTA
CAPITAL MANAGEMENT
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MARKET LETTER

September 2022

Inflation: Back to Basics

When asked if inflation swindles equity investors, Warren Buffett responded, "Inflation swindles the bond investor, too. It swindles the person who keeps their cash under their mattress. It swindles almost everybody."

When inflation is low and predictable, people and businesses can better plan for their future. An individual setting an annual budget or planning for retirement or a business entering long-term supply contracts must deal with uncertainty trying to forecast future events. Inject into the calculus an unstable currency or price-level, and those forecasts quickly become less tenable and more uncertain. When economists list the necessary institutional constructs that most likely lead to a robust growing economy, basics such as 1) the rule of law, 2) property rights, and 3) a stable medium of exchange (currency) are generally listed. For this reason, the Federal Reserve has long targeted a low, predictable 2% inflation rate to help bolster economic activity and growth.

The 12-month percentage change to core CPI (the Consumer Price Index*, less food and energy), reached 3.0% in April 2021, a level not seen for nearly 30 years. Since April 2021, the price level has continued to climb, rising steadily from 3.0% in April 2021 to 5.5% in December 2021. In 2022 it reached 6.4% in March before leveling over the summer. As of August, it stood at 6.3%.

The Federal Reserve, the institution tasked with keeping inflation at predictable, low levels, has ample tools to combat inflation. Actions that would curtail inflation, however, often slow the economy as well. For this reason, the Federal Reserve often attempts to thread the needle between keeping inflation stable at around 2% and not inhibiting economic growth to the point of recession. Those who follow the financial press likely remember the inflation debate in the spring and summer of 2021, with the Federal Reserve infamously stating that inflation appeared to be "transitory". It wasn't until November 2021 that Federal Reserve chair Jerome Powell suggested it was "time to retire the word 'transitory'".

Hindsight is 20/20, and as investors, we are focused on the future. For various reasons, the Federal Reserve chose not to begin raising the federal funds target rate until March 2022, four months after suggesting inflation may be stickier than first thought. The Fed seemed slow to respond to heightened inflation pressures but since March, has moved swiftly to counter inflation. A year ago, many in the financial press chastised the Federal Reserve for not tightening financial conditions in the face of rising inflation risks. Now, many in the press suggest the opposite; that the Fed is tightening too much too fast to rid us of inflation, putting the economy at risk of a deep recession.

We at Alta can debate whether a 50 or 75 basis point increase in the federal funds rate is appropriate for the current situation. We may have differing opinions on the Fed's decision to reduce its balance sheet while simultaneously increasing rates at a pace not seen for decades. We agree on one point, however. The financial markets are not likely to begin healing until inflation is back to a 2-3% annual trend. We see myriad risks and opportunities in the global economy today, but emphasis is now rightly being placed on fixing inflation first. A new trend toward the Fed's inflation target could come in two months, it could take six to nine months, but stable, predictable prices will then help unleash innovation and growth into our economy. The stock market is a discounting mechanism and has historically reacted positively to inflation expectations trending back to target levels (see market returns for the early '80s and early '90s).

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** The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.*

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