Tarheel Advisors Newsletter

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# Inflation is Here Now

The Federal Reserve Bank (Fed) was established by Congress in 1913. The original act was amended in 1977 as a result of the events of the 1970s, a decade that brought simultaneous high inflation and unemployment, known as "stagflation." Shaped by the economic scars of that time period, Congress explicitly stated that the Fed's goal henceforth should be to maintain maximum employment and stable prices with moderate long-term interest rates. In this dual mandate, maximum employment doesn't mean 100%, which is not possible, but rather the level of employment that is likely in normal economic conditions. Stable prices and moderate long-term interest rates can be viewed as one mandate, since long-term interest rates are set with an eye to managing pricing pressure and inflation.

Ever since, the Fed has been trying to thread the needle and foster an economic environment with a goldilocks inflation pegged at 2-3%. The rationale is that when households and businesses can reasonably expect inflation to remain low and stable, they are able to make sound decisions regarding saving, borrowing, and investment. These all contribute to a well-functioning economy. If inflation runs too hot or too cold for long periods of time, then we start to see all sorts of severe economic distortions. Guess what? We are getting there now!

The Consumer Price Index (CPI) measures the average price of a basket of consumer goods and services, and it has spiked up 5.3% over the last 12 months. The Social Security Administration uses the CPI as a measure to adjust its distributions annually, and it expects that 2022 payments will increase by 6.2%! If you have filled up a tank of gas, shopped at the grocery store, or even looked up the value of your home on Zillow, you know that all these estimates are significantly lower than the *actual* inflation persistent in the marketplace. The Fed has stated many times they it is "data dependent," and it makes key decisions on the adjustment of interest rates based on this data. The problem with that strategy is statistics can be manipulated or misconstrued. For example, the annual table to the right taken from Wikipedia shows the components that make up the CPI and Personal Consumption Expenditure (PCE) index. The latter of these is the Fed's preferred barometer.

| Consumption category | CPI-U | PCE-UNADJ | PCE-ADJ |
|---|---|---|---|
| **Food and beverages** | 15.1% | 13.8% | 17.0% |
| Food at home | 8.0% | 7.1% | 8.7% |
| Food away from home | 6.0% | 4.9% | 6.0% |
| Alcoholic beverages | 1.1% | 1.8% | 2.3% |
| **Housing** | 42.4% | 26.5% | 32.9% |
| Rent | 5.8% | 3.4% | 4.1% |
| Owner's equivalent rent | 23.4% | 12.9% | 15.9% |
| Other housing | 13.1% | 10.2% | 12.9% |
| **Apparel** | 3.8% | 4.5% | 5.5% |
| **Medical care** | 6.2% | 22.3% | 5.0% |
| **Transportation** | 17.4% | 13.9% | 17.3% |
| Motor vehicles | 7.9% | 5.3% | 6.5% |
| Gasoline | 4.2% | 3.4% | 4.3% |
| Other transportation | 5.4% | 5.2% | 6.5% |
| **Education and communication** | 6.0% | 5.4% | 6.7% |
| **Recreation** | 5.6% | 6.8% | 8.4% |
| **Tobacco** | 0.7% | 1.0% | 1.2% |
| **Other goods and services** | 2.8% | 5.8% | 6.0% |
| | 100% | 100% | 100% |

You'll note that the largest component is Housing. However, you do not "consume" housing if you own a house, but rather you invest in it. So, economists came up with the term Owner Equivalent Rent (OER) that supposedly represents that segment. Basically, they do a phone survey and ask owners how much they would charge someone to rent their house if they didn't live in it. That's obviously pretty subjective, and likely inaccurate (the latest data point was up only 2.5%). Stand alone rent also seems to be measured unreliably. In the graph below, there is a huge dislocation between the index calculation and what is being observed in the marketplace. With expiring rent moratoriums, don't be surprised if these data components spike up further in the coming months. **(continued on back)**

**Figure 2. Rental prices**


Source: BLS; Zillow; CEA.

## 2021 Market Update

| | |
|---|---|
| **S&P 500** | **+15.0%** |
| **DOW** | **+11.2%** |
| **RUSS 2000** | **+11.6%** |
| **MSCI World** | **+7.0%** |
| **BONDS** | **-1.6%** |
| **GOLD** | **-8.1%** |

## Mortgage Rates

| | |
|---|---|
| **15-Year** | **2.3%** |
| **30-Year** | **3.1%** |
| **5/1 ARM** | **2.0%** |

## Did You Know?

* The S&P 500 was down 4.8% in September, marking the worst monthly performance by the broad market since March 2020.

* The Case Shiller National Home Index shows that the average residence has risen in value 18.6% over the last year.

* The Treasury Department warns there are only enough funds to meet US debt obligations until October 18th, potentially setting up another political standoff to raise or eliminate the debt ceiling.

The Fed has acknowledged that current inflation is higher than the long-term goal, but it also has decided that current rates are "transitory" in nature rather than "persistent." Fed Chairman, Jerome Powell, has attributed much of the dynamic to the economic supply and demand inefficiencies brought about by the Covid Pandemic. That may at least be partially true. However, the Fed also soon may have to acknowledge that we may have a more structural inflation problem. If that's the case, the soaring prices of consumer goods and services will only be exacerbated further by the Fed flooding the system with liquidity and artificially keeping interest rates low. Maybe it's time to hit the brakes on all this monetary stimulus ala former Fed Chair Paul Volcker in the 1980s. Will Chair Powell or whoever else is nominated for his job come February have the political will to make these hard decisions? Stay tuned.

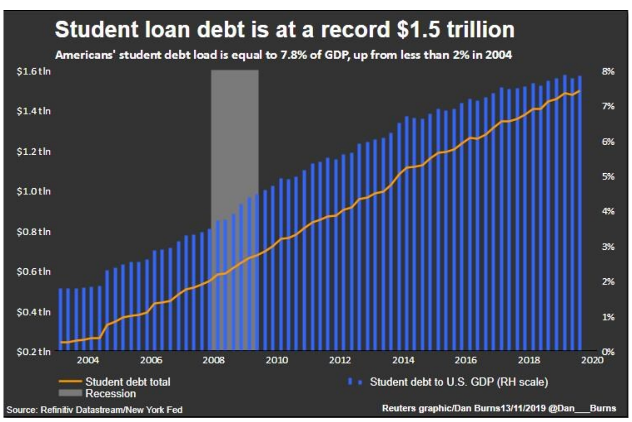
**-Walter Hinson, CFP®**

# Forgive-Me-Not

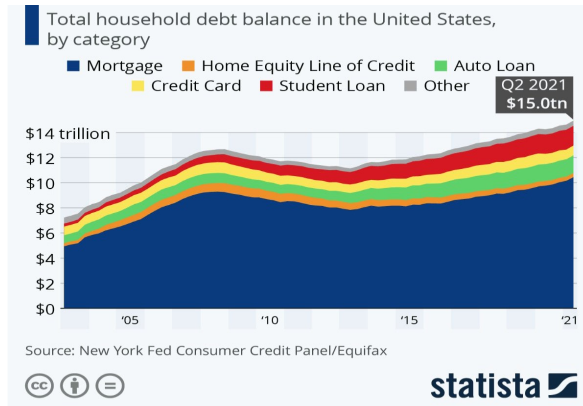
For the past year, there has been a substantial amount of debate around student loan forgiveness. Politicians, mainly on the left, have advocated for the forgiveness of between $10,000 to $50,000 of debt. This leaves those with student loans in the precarious situation of deciding whether to pay off these existing loans, or delay payments in hopes of a windfall from Uncle Sam.

Some action has been taken already by the Biden administration in this matter. In August, loan discharges of $5.8 billion were given via executive order to approximately 323,000 borrowers who have a total and permanent disability. This was a significant forgiveness. However, it is safe to assume that the bulk of these loans were uncollectable, so the government is essentially just recognizing that fact, and cleaning up the books.

Total student debt has nearly tripled over the last decade and climbed to over $1.5 trillion in the United States. In comparison, the other categories of debt have grown but stayed relatively stable over the same span. It is interesting that after the 2008 financial crisis Americans were quite responsible with debt, relatively speaking, with the exception of those in college.




If you have student debt, should you pay off those loans or keep waiting for a bailout? When trying to read the political tea leaves, one must decide if the current majority party has both the numbers and the political capital to pass a significant bailout either legislatively or via executive order (scholars debate whether the




President has legal authority for wide-spread forgiveness). With slim majorities in the House and Senate, the democrats currently have the numbers until at least the 2022 mid-term elections. Given that Congress and the Biden administration have prioritized spending for Covid bailouts and infrastructure this year, it is not far-fetched that they may try to tackle broader student debt relief as well.

A package that would pay off $10k per borrower would have a price tag of around $400 billion, while the $50k forgiveness target would cost an estimated full $1 trillion. Personally, I don't see the Democrats having the political capital to execute the $50k per person forgiveness. However, the possibility of a smaller forgiveness coming through seems plausible. For those who are looking to accelerate student loan payoffs, we're advising them to put the cash on the sidelines for the next few months and patiently wait.

Mid-term election cycles historically have caused the ruling party to lose seats in Congress. Should this occur, we'd be looking at a Republican controlled legislature that would be less likely to broker a compromise with the White House. If we don't see loan forgiveness prioritized in the next six months, the chances of it coming to fruition drop dramatically. Planning for a small windfall may be prudent in this matter, but for those with larger student loan debt, we implore you to attack those balances and not idly wait for politicians to come to your aid. The government has been more than happy to put provisions in place that enables borrowers to amass huge student loan balances, so expecting that same government to be the one to save you from it is most likely a fool's errand.

**-Ryan Glover, CFP**