ZANETTI FINANCIAL, LLC

Zanetti Monday Missive 2022.06.27
If Mr. Churchill Is Right

"Generals are always prepared to fight the last war."
~ Winston Churchill

If Mr. Churchill is right, then a corollary might be this:
economists are always prepared to fight the last recession.

I believe that is what is happening now.

Let's go back to the 1970's. That is the last time the US had to deal with raging inflation.

Back then, a tall, bald, grouchy, cigar-chomping Fed Chair by the name of Paul Volker assessed the root causes of inflation as the following:

- Rising wages, and
- Increased velocity of money

In the 1970's, trade unions had far more power than they do today. Unions could demand higher wages and get them. Of course, rising wages meant the end-products cost more.

When those prices rose, workers struggled to keep up. So, they demanded higher wages.

You can see how this dynamic could cause prices to spiral upward.

Moving on…

The concept of money velocity is a little more arcane. But we at Zanetti Financial do arcane well!

Imagine that the Federal Reserve "prints" $100 and gives it to you. You then take that $100 and invest in a 5-year CD. That $100 doesn't move much. It just sits at the bank for five years earning interest.

There is not much velocity there.

Thus, when the Fed added $100 to the money supply, it “behaved” like $100 and not much more.

Now imagine that it is 1979. Prices are going up every week. As a recipient of the $100, you might think, “I need to spend this money fast before prices go up and my $100 won’t buy as much.”

As a result, you race out to buy groceries.

The grocer also thinks like you. The grocer hurries to buy some shoes. The shoe salesman then buys flowers. The florist goes to the casino. The blackjack dealer goes to a nice restaurant and orders an expensive bottle of wine. You get the idea.

Velocity made the $100 that the Fed originally created “feel” as if $500 had been added to the money supply. The economy was overheating.

Our 1979 cigar-chomping Fed Chair read that situation clearly. His remedy? Hike interest rates.

Volker believed (rightly) that by hiking rates, he could slam the US into a recession. That would slow both the wage spiral and velocity.

He succeeded.

In fact, he succeeded so well that we had back-to-back recessions. That, coupled with President Reagan firing the air traffic controllers, put a damper on the wage-price spiral.

And when the prime rate hit 20% (!), Americans surrendered.

They said, “I shouldn’t be spending money. I should be saving money. I can get CDs that pay 18%? Sign me up!” That slowed velocity.

And the back of inflation broke. Prosperity followed.

But that was the last inflation war.

This inflation is not the same---IMHO. :>)

Today’s inflation is not being driven by rapidly rising wages. Nor is it being driven by an overheated economy. No. Today’s inflation is being driven by two things:

- Scarcity, and
- Distrust of currencies

It’s no secret that a combination of short-sighted government policies, Covid, and the war in Ukraine has caused supply chains to break. We’ve all seen the “holes” on the shelves. We know there are long waiting times for hundreds (thousands?) of products.

We also know that every major nation on the planet has chosen to stimulate its economy via money printing. The US has printed trillions. So have the Europeans, Japanese, Chinese, Argentineans, Venezuelans, etc.

Global debt is now north of $300 trillion.

Global GDP is roughly $93 trillion.

The analogy would be like you making $93,000/year but owing $300,000 on your credit card.   Could you make it?

But governments can do something you and I can't. They can print. And they have done so…by the trillions.

Therefore, is it any wonder people around the world are saying, "What is my dollar/euro/yen/yuan/peso worth?"

Now enter Fed Chair, Jerome Powell.

He is raising rates to fight inflation just as his hero (yes, he said that) Paul Volker did. Powell knows this will slam us into a recession. He believes the recession will cure the inflation problem.

But he is fighting the last inflation war.

When we go into a recession, the following will happen:
- Companies will go bankrupt.
- Unemployment will rise.
- Fewer goods will be made.
- Fewer goods will be imported.

Won't this lead to more scarcity? If that happens, the goods that are still available will cost more.

And, since all currencies today are backed by confidence in the underlying economy, won't a weakening US economy lead to a deeper distrust of the dollar?

And won’t a devalued dollar mean higher prices as well?

I’m no Winston Churchill, but Mr. Powell is fighting the last war.

Your Maybe-I-Should-Chomp-Cigars Financial Advisor,

Walt

Our mailing address is:

5120 San Francisco Rd NE
Suite A

Albuquerque, NM 87109

505-858-3303