ECONOMY

Should Investors be Wary?

THINK STRATEGICALLY:

# Severe Inflation Affecting Our Lives, Purchasing Power and Wealth

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### The EcoFlation Risk Revisited as CPI Reaches 6.22%

Earlier in the year, we coined the term "EcoFlation Risk," and we said then, as we do now, that inflation was one of the most significant threats to the world's economy.

Last week, the key inflation indicators, the Producer Price Index (PPI) and the Consumer Price Index (CPI), rose to levels not seen in three decades. The PPI rose to 8.62 percent and the CPI to 6.2 percent.

These increases are driven by factors considered short-lived, including energy and auto prices, with other and stickier components of inflation, such as rent or the current wage-price spiral, which is forcing most businesses to pay higher wages to keep staffing levels.

### What is Making Inflation Rise?

The long-term inflation average is 3.23 percent, with the last 10-year average of 1.6 percent; however, the Federal Reserve has always stated that it prefers to maintain a CPI reading of 2 percent or lower. The CPI has been above 2 percent for the past eight months, beginning in March. Below, we highlight the monthly CPI numbers ending with the latest one.

– March 31: 2.62 percent
– April 30: 4.16 percent
– May 31: 4.99 percent
– June 30: 5.39 percent
– July 31: 5.37 percent
– Aug. 31: 5.25 percent
– Sept. 30: 5.39 percent
– Oct. 31: 6.22 percent

The principal factors for the increases in PPI and CPI are a more substantial than anticipated demand with sharper than ever anticipated supply constraints. We must also add to the mix the global supply chain disruptions, labor shortages, computer chip shortages, slower than expected global reopening, COVID-19 surges and rising commodity prices. The result is an inflation reading that, although temporary, is pushing prices higher.

All these shortfalls or imbalances show up as consumers pay for everyday items such as filling their SUV with gasoline. The highest price increases are seen in gasoline, oil, used cars, car rentals, houses, lumber, airfares and hotel rooms. To highlight the point, upon delivery of my SUV in November 2019, a full tank of gas was $39. This week, the same 75 liters cost me $60.45, a 55 percent increase in two years. A recent study found that 77 percent of Puerto Rico's consumers do not have enough money to buy groceries, 36 percent say their household income has fallen. The marked reduction in households' purchasing power puts undue pressure on consumption.

### Week in Markets: Inflation at 30-Year High, Wall Street Tanks

The U.S. stock markets ended the week with losses, except for the Birling Capital Puerto Rico Stock Index, which rose and now has a year-to-date (YTD) return of 47.42 percent.

To say the market has been shaken by inflation rising 6.22 percent is an understatement. Like all markets, there are ripe opportunities to be seized.

Also during the week, pharma giant Johnson & Johnson (JNJ) informed the markets that it would split the company into two public companies; one will focus on consumer products and the other on drugs and medical devices. The stock closed at $165.05, up $1.96, not the massive result some were expecting. Other past drug company breakups such as Bristol Meyers have not worked out well for the companies or their shareholders.

### Supply Chain Disruptions Take Inflation to New Highs

When global supply chains begin to run normally and producers can meet or surpass demand, prices will decrease. A great example is the announcement made by Toyota Motor Co. (TM) that its factories would return to normal by December, and it will make up for lost production.

Toyota plans to produce 800,000 vehicles in December, up from 760,000 a year earlier, with plans of building 9 million vehicles worldwide during its fiscal year ending March 31. Toyota is the first automaker to make such an announcement. The stock closed at $184.40, up $5.37, or 3 percent.

As most producers begin to align their supply chain with their demand and make plans to meet or surpass the current demand for the product, the broader market will slowly see a downward movement in pricing.

Hundreds of CEOs from corporations around the world are battling with supply disruptions to meet demand. In a globalized economy, there are closed borders, labor shortages, meeting health protocols that vary from nation to nation, port bottlenecks and many other problems.

Currently, the data we have evaluated point to disruptions subsiding by some time in the second quarter of 2022.

We begin to see data that point in this direction, such as the case of Toyota and others that have commented on significant improvements in the supply chain.

There is a cost increase we are seeing to lure workers back with much higher salaries, and once these new salaries are in place, they will be permanent; it all depends on what percentage of the labor force has seen its wages increase.

### What About the Fed's View on Inflation?

As we said earlier, the Fed wants inflation to be near 2 percent. Since March 31, when the CPI reached 2.62 percent, the Fed has said its view is that inflation pressures were temporary and there was no need to change its monetary policy. We are now in November and looking at the Oct. 31 CPI of 6.22 percent, a 211 percent increase when compared with the Fed's 2 percent target.

The Fed has two key issues here. First, it does not want to impact economic growth by raising rates too early while the economy is firing on all cylinders and job growth has strong momentum. The other issue is that, should inflation prove to be more permanent than temporary, it would put the Fed in a quandary in that it would be forced to raise rates faster than expected.

Fed Chairman Jerome Powell continues to affirm that inflation "will be transitory" and has said that rates will not be raised until sometime next year. Wall Street has priced at least two rate increases in its numbers. We shall see who is correct.

### The Final Word: How can Investors Protect Their Portfolios from Inflation?

In our experience, one of the best hedges to curtail inflationary pressures is investing in equities, which are more likely to outpace the rate of inflation over time. For example, if you consider the current rate of inflation of 6.22 percent, based on the performance of the four indices we follow, let's see the numbers:

The Dow Jones is up 17.95 percent; S&P 500, 24.67 percent; Nasdaq, 23.06 percent; and the Birling Capital Puerto Rico Stock Index at 47.42 percent.

All four have outpaced inflation and will still provide you with a sizable net return. On the contrary, if you invested all your money in the 10-year U.S. Treasury note that yields 1.58 percent when you discount inflation, you have a negative 4.64 percent return.

During periods of increased inflation with a probability of rising interest rates, we always look towards value and cyclical parts of the market, which often outpace the market. We favor industrials and financial sectors; currently, our preference is to take an overweight position in value investments.

In conclusion, the EcoFlation Risk is with us and we must act to derail it.

*Francisco Rodríguez-Castro is president and CEO of Birling Capital LLC. Think Strategically© is a publication by Birling Capital LLC that summarizes recent geopolitical, economic, market and other developments. This report is intended for general information purposes only and does not represent investment, legal, regulatory, or tax advice. Recipients are cautioned to seek appropriate professional counsel regarding any of the matters discussed.*

| Weekly Market Close Comparison | 11/12/21 | 11/5/212 | Return | YTD |
|---|---|---|---|---|
| Dow Jones Industrial Average | 36,100.31 | 36,327.95 | -0.63% | 17.95% |
| Standard & Poor's 500 | 4,682.85 | 4,697.53 | -0.31% | 24.67% |
| Nasdaq Composite | 15,860.96 | 15,971.59 | -0.69% | 23.06% |
| Birling Puerto Rico Stock Index | 3,014.79 | 3,000.19 | 0.49% | 47.42% |
| U.S. Treasury 10-Year Note | 1.58% | 1.45% | 8.97% | 0.60% |
| U.S. Treasury 2-Year Note | 0.53% | 0.39% | 35.90% | 0.70% |