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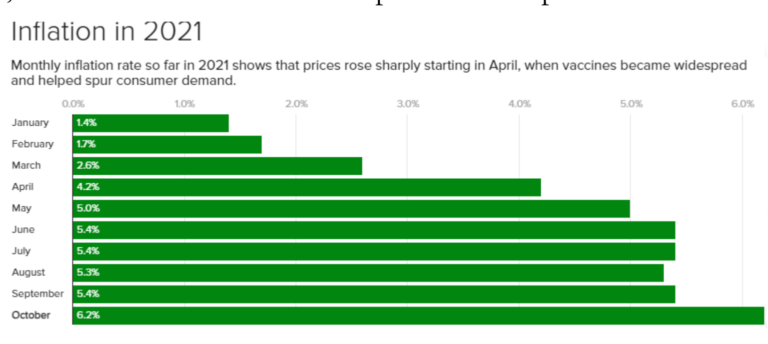
It is quite ironic that, in April of 2020, after years of inflation running at undesirably low levels, the Federal Reserve unveiled a series of new policies that were designed to elevate the inflation rate. These changes included a shift to "average inflation targeting, where they

would seek an average inflation rate of 2%, as opposed to their previous policy of making 2% a "hard ceiling" for inflation.

Of equal importance, they shifted from their decades-long policy of proactively battling inflation as soon as it became a potential threat, to the current reactive policy of waiting to respond to inflation until after it is already a clear and present danger.

It would be an understatement to say that the Fed was successful in achieving its objective, albeit with the help of the pandemic, as the U.S. economy has gone from experiencing undesirably low inflation to facing the highest consumer inflation rate in thirty-one years. To put the current 6.24% inflation rate into some perspective it, if maintained on a constant basis, would be sufficient to double one's cost of living every eleven and one-half years. In contrast, in the prior three years, U.S. inflation had averaged a very modest 1.83%, at which rate it would take over thirty-nine years to double one's cost of living.

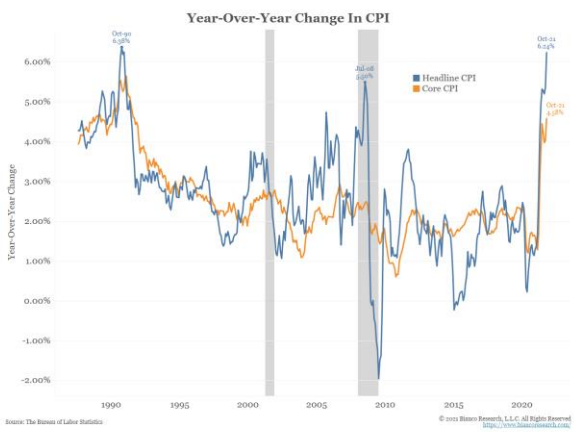
From the earliest days of the current resurgence in inflation, and until just recently, Federal Reserve Chairman Jerome Powell had been consistent in his opinion that this surge in inflation will be "transitory", and that it is being caused by temporary, pandemic-related catalysts, such as supply chain disruptions and disruptions in the labor markets. That said, Powell's most recent comments suggest a change in his perspective. In August, he was still steadfast in his opinion that "these elevated readings [of inflation] are likely to prove temporary" and, in September, he noted that "inflation is expected to drop back towards our longer-run goal".



However, Powell's tone had turned more cautious by late October, when he noted that "The risks are clearly to longer and more persistent bottlenecks and thus to higher inflation".

Indeed, inflation is proving to be anything but "transitory", and appears to be gaining more momentum each and every month. Further, there is a growing risk that inflation could develop into a longer-term problem, as growing expectations for even higher inflation in the future make consumers increasingly willing to pay high prices today, thus opening the door for inflation to become imbedded in the economy.

That said, Chairman Powell's expectations for "transitory" inflation, while overly optimistic, were not entirely unreasonable, as many of the current catalysts for inflation should indeed ultimately prove transitory, which is a good thing, as the last time that we saw such elevated readings, the U.S. was still recovering from a multi-decade period of hyper-inflation, the cure for which was a series of draconian and very unpopular monetary policies pursued by Fed Chairman Paul Volcker.



These included driving short-term interest rates as high as 20% in March of 1980, and ultimately causing two severe recessions. These policies were continued by Alan Greenspan during his first year as Fed Chairman, and are considered to be one of the primary catalysts for the 1987 Stock Market Crash. For the record, and most emphatically, we believe that there is virtually no chance that this will be a repeat of this late 1960s to early 1990s hyperinflationary period!

However, that is not to suggest that inflation does not present an ongoing risk, as both monetary and fiscal stimulus is still continuing, albeit at an increasingly diminished rate, and because today's interest rate environment is one that could not have even been imagined in the 1970s and 1980s. Currently, 17.8% of all of the bonds in the world (representing $12.09 trillion dollars) provide a yield of less than 0%; Japan is the only major country in the world that offers a government bond yield higher than the inflation rate, and the short-term Fed Funds Rate that reached as high as 20% in 1980, is sitting at less than one-quarter of 1% today. Granted, the current 6.24% inflation rate is still less than half of the peak 14.8% level reached in 1980, but this illustrates how dramatically distorted global interest rates are, as a result of years of massive asset purchases (Q.E.) by the global central banks.

"How much of this inflation surge is transitory?" and "How transitory is it?" are probably the two most important questions currently being asked by the world's investors. We hope to use the following pages to shine some light on these most timely issues.

Real Interest Rates in the Developed World (Nominal Minus CPI)

As of 10/21/2021

Country	Inflation Rate	Policy Rate	6-Month	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	30-Year
Switzerland	0.90	-1.65	-1.64	-1.70	-1.66	-1.50	-1.37	-1.28	-1.22	-1.19	-1.09	-1.03	**-0.97**	-0.84	-0.84
Germany	4.10	-4.60	-4.80	-4.79	-4.75	-4.71	-4.63	-4.53	-4.46	-4.38	-4.35	-4.29	**-4.20**	-4.01	-3.83
Netherlands	2.70	-3.20	-3.38		-3.40	-3.31	-3.20	-3.11	-3.02	-2.93	-2.84	-2.75	-2.67	-2.45	-2.36
Denmark	2.20	-2.80	-2.82		-2.82			-2.56			-2.20		-2.04		-2.20
Finland	2.50	-3.00		-3.20	-3.13	-3.06	-2.97	-2.84	-2.77	-2.65	-2.56	-2.46	**-2.38**	-2.16	-1.96
Austria	3.20	-3.70		-3.85	-3.89	-3.80	-3.68	-3.55	-3.49	-3.38	-3.27	-3.17	**-3.08**	-2.78	-2.58
Japan	-0.40	0.30	0.29	0.28	0.28	0.29	0.30	0.32	0.33	0.37	0.39	0.43	**0.49**	0.68	1.09
France	2.20	-2.70	-2.89	-2.83	-2.86	-2.78	-2.67	-2.44	-2.42	-2.28	-2.16	-2.06	**-1.97**	-1.73	-1.30
Belgium	2.86	-3.36	-3.54	-3.50	-3.54	-3.47	-3.36	-3.23	-3.09	-3.03	-2.92	-2.81	**-2.66**	-2.53	-1.99
Ireland	3.70	-4.20		-4.35		-4.30	-4.16	-4.04	-3.92	-3.82		-3.70	**-3.44**	-3.25	-2.83
Spain	4.00	-4.50	-4.59	-4.58	-4.60	-4.41	-4.36	-4.20	-4.01	-3.92	-3.74	-3.62	**-3.48**	-3.05	-2.68
Portugal	1.48	-1.98	-2.21	-2.20	-2.16	-2.13	-1.89	-1.79	-1.59	-1.48	-1.38	-1.22	**-1.07**	-0.79	-0.22
Italy	2.50	-3.00	-3.04	-2.96	-2.93	-2.68	-2.52	-2.33	-2.10	-2.01	-1.84	-1.68	**-1.56**	-1.14	-0.66
United Kingdom	3.10	-3.00	-3.07	-2.51	-2.40	-2.35	-2.31	-2.24	-2.24	-2.17	-2.06	-1.97	**-1.90**	-1.71	-1.66
Australia	3.80	-3.70	-3.79	-3.69	-3.63	-3.08	-2.78	-2.63	-2.47	-2.33	-2.22	-2.08	**-2.01**	-1.61	-1.21
New Zealand	4.90			-4.90	-3.16			-2.81		-2.62			**-2.40**	-2.18	
Canada	4.40	-4.15	-4.19	-3.91	-3.56	-3.49	-3.20	-3.06		-2.94			**-2.72**		-2.32
United States	5.40	-5.28	-5.34	-5.30	-4.98	-4.64		-4.20		-3.90			**-3.73**		-3.28

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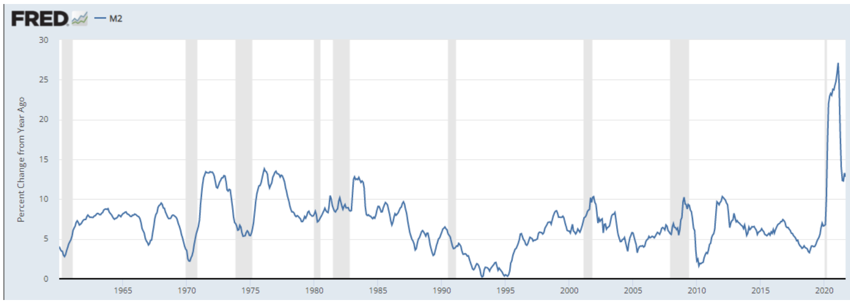
As we have discussed in recent writings, we believe that high inflation is almost always the result of external shocks to the economy. In the 1970s, these shocks included two disruptions in the oil markets (1973 and 1979), the Vietnam War, and the decision to "unpeg" (i.e., disconnect) the value of the dollar from the price of gold. This time, we believe that its catalysts include the aforementioned changes in the Fed's approach to managing inflation, economic disruptions caused by the pandemic, very aggressive monetary policy that ballooned the money supply and kept interest rates too low for too long, and an aggressive fiscal policy that transferred trillions of dollars into the hands of American consumers and created a massive and unprecedented boom in consumer spending.

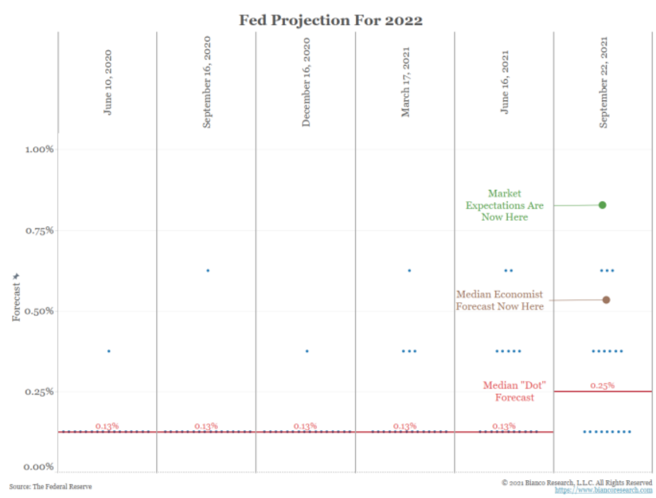
According to renowned economist Milton Friedman, "Inflation is caused by too much money chasing after too few goods", and that is, at its core, what likely initially catalyzed this surge in inflation. The most common measure of money supply is known as M2, which is normally increased on an annual basis by about 1% over the pace of economic growth.



However, in 2020, when the economy actually shrank by 3%, the Federal Reserve ballooned M2 money supply by a massive 27% (i.e., a level 30% greater than the change in the size of the economy). The result was money supply growth far in excess of what could be utilized in the real economy and, as a result, it poured into both the investment markets and consumer spending. The first produced inflation in the prices of financial assets, and the second helped to generate the current surge in consumer spending, which, in turn, helped to catalyze the recent surge in the prices of consumer goods.

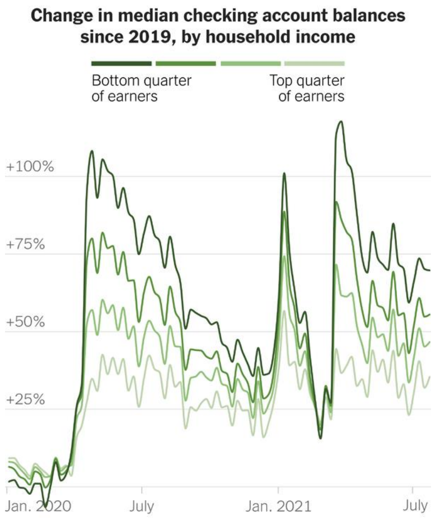
The above chart shows, on a percentage basis, the year-over-year change in money supply, including the explosive growth in 2020 and the considerably slower growth in 2021. While even this slower growth does continue to add to money supply, it should at least mean that money supply will be a less inflationary influence on a going-forward basis.

In addition, the Federal Reserve will start its "tapering" process (under which they are reducing their monthly purchases of financial assets by $15 billion per month) in late November, and they expect to end all asset purchases by next summer. As was the case with money supply growth, these ongoing asset purchases will continue to increase financial liquidity until the program concludes. However, this is yet another catalyst for inflation that should be much less powerful on a going-forward basis.



Moreover, the Federal Reserve is expected to start raising interest rates, which has traditionally been the Fed's best tool for battling inflation, as soon as they conclude their tapering of asset purchases, and we are expecting **<u>at least</u>** two rate increases in 2022. Indeed, as you can see from the above chart, both most Wall Street economists, and the markets themselves believe that the Federal Reserve is being way too conservative in its expected pace of monetary tightening, and that the Fed is ultimately going to need to move more aggressively. While not necessarily good news for the economy, a more aggressive tightening on the part of the Fed should help to further dampen inflationary pressures, although it should be emphasized that it traditionally takes 12-18 months before a change in interest rates has a tangible impact on the real economy, which is why the Fed had pursued a very proactive approach to monetary policy over the prior several decades.

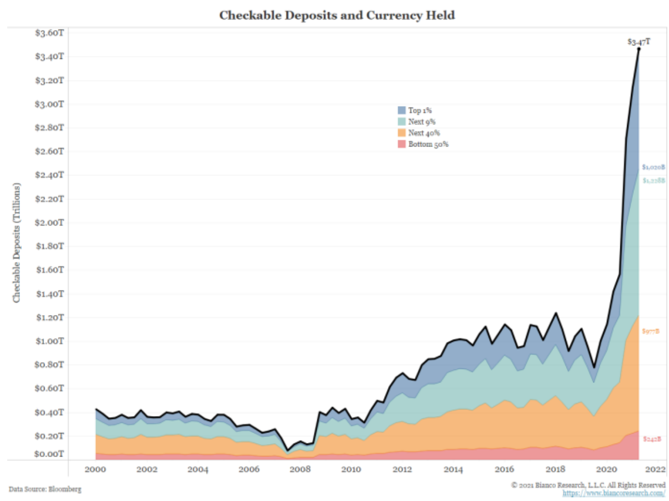
Also exacerbating inflation has been the trillions of dollars that the government has transferred into the hands of American consumers, the largest impact of which has been on the lower-earning half of the population, which tends to spend the vast majority of dollars that it receives.



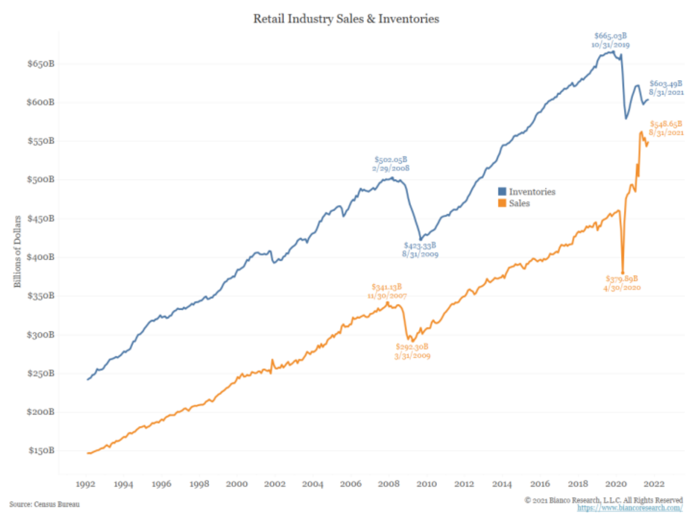
These payments were very important in helping the economy to recover from its self-imposed recession (caused by the government-mandated shut-down), and both dramatically increased the level of saving enjoyed by most Americans, and even helped to level the playing field between America's "haves" and "have-nots".

The impact on the spending power of American consumers was nothing short of massive, as you can see in the chart below, which illustrates levels of cash and checking account balances.

Of note, this injection of income may not have been so inflationary in a more normal environment. However, it took place at a time when the pandemic had simultaneously caused major supply chain and labor disruptions, which depressed the supply of goods just as the demand for goods was exploding to the upside. As was noted in the previous discussion of money supply, the combination of a large and growing demand for goods and a reduced and falling supply of those goods is a recipe for high inflation, which is exactly what we are seeing.

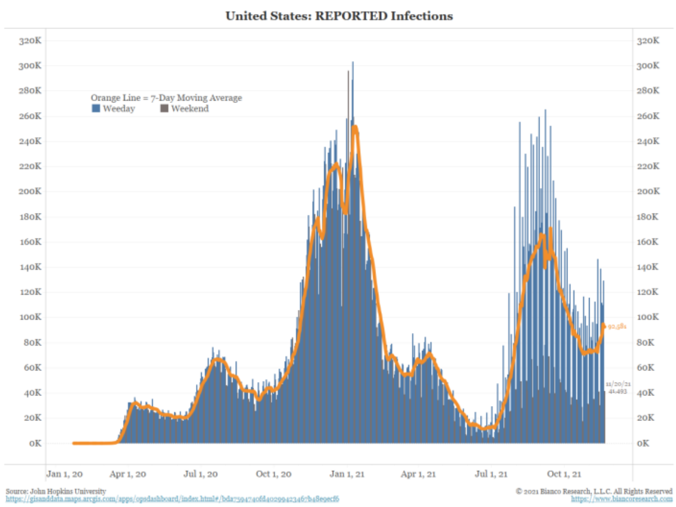


The good news is that there seems to be little appetite among most in Congress to pass yet another massive fiscal stimulus package, and even the potential passage of Biden's "Build Back Better" package should not provide a big and/or inflationary boost to consumer spending, as it would be spread out over a decade, and would not include direct transfer payments to American consumers.

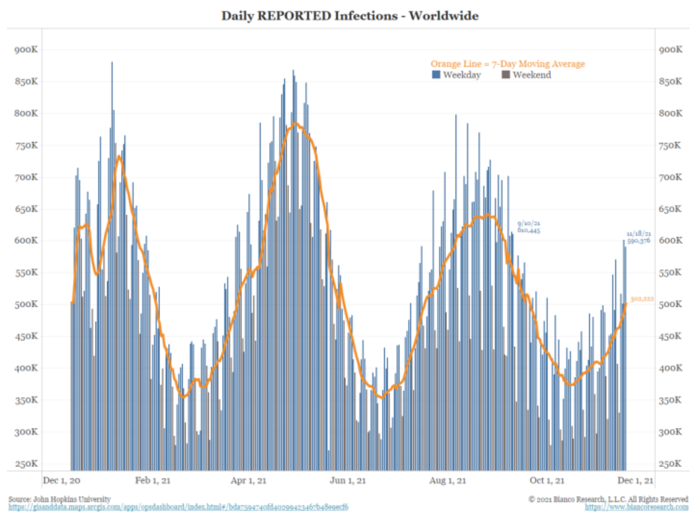


In short, just as is the case with monetary policy, fiscal policy should also become a much less powerful impetus for inflation on a going-forward basis.

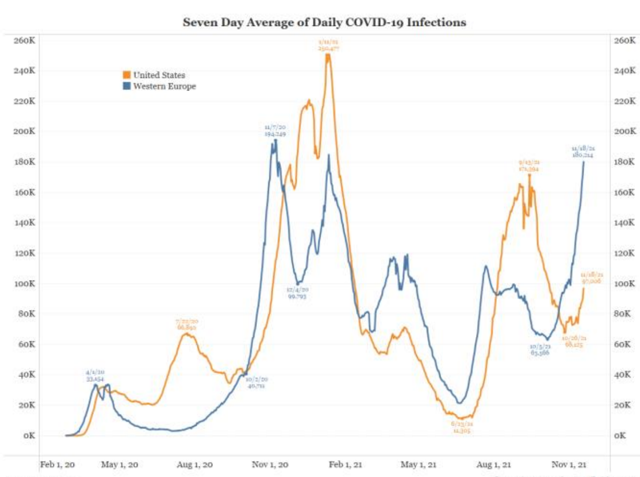
Also encouraging are recent indications that some of the highly-inflationary supply chain snafus have started working themselves out, which could be great news on the inflation front. For example, there is evidence that we may have, at least temporarily, seen both a reduction in shipping containers sitting idly at U.S. ports and a decline in the cost of moving goods around the world by ship.



Unfortunately, however, any continued improvement in the supply chain, and therefore the availability and cost of goods, will likely be dependent on continued improvement in the pandemic and, while there is better and better news on the clinical front, as boosters and new therapeutics continue to make the COVID virus less lethal, the spread of new cases is once again moving higher at a very disturbing rate. If this continues apace, it will almost certainly exacerbate supply chain snafus and further elevate supply chain-related inflation.



Even more concerning, from an American perspective, is the trend towards explosively higher case counts in Western Europe, particularly in the Netherlands, Germany and Austria, as there has been, throughout most of the pandemic, a very close correlation between what happens in Europe, and what ultimately happens in the United States.



In conclusion, while it is clearly taking longer than Chairman Powell had anticipated for inflation to prove transitory, we suspect that he will, in many regards, ultimately be proven correct. That said, we believe that inflation will only subside once the global economy and supply chains start to normalize, and that still seems to be largely dependent on progress regarding the pandemic, the prospects for which, unfortunately, seem nowhere as promising as they seemed only a few short weeks ago.

CHART 5: COVID-19 Sensitive/Insensitive Core PCE Inflation

United States: *FRB San Francisco*
(red line; COVID-19 sensitive inflation; year-over-year percent change)
(blue line; COVID-19 insensitive inflation; year-over-year percent change)

Shading indicates recession
Source: Haver Analytics, Rosenberg Research

The good news is that the current inflationary experience is very unlikely to be a repeat of the 1970s and 1980s.

The bad news is that the course of inflation is likely to remain very closely tied to the outlook for the pandemic, and that the course of the pandemic is both very unpredictable, and something over which neither monetary nor fiscal policy is likely to have any influence.

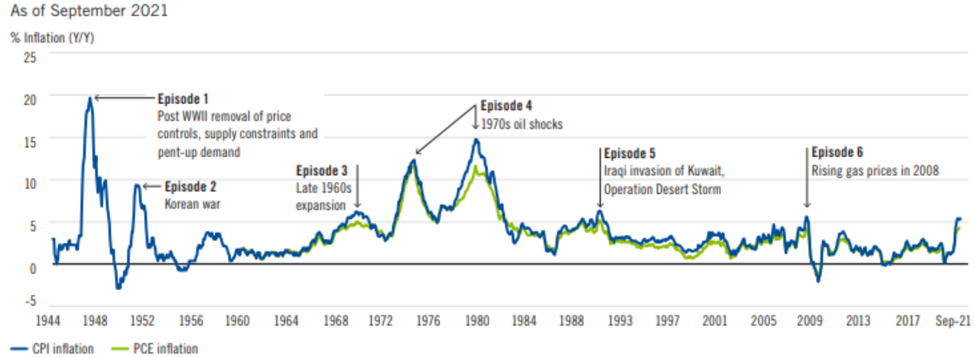
In regard to monetary policy, there is significant evidence that the Fed is "behind the curve" (i.e., that they have already waited too long to start raising short-term interest rates and reducing their asset purchases). Even so, we believe that the Fed would prefer not to accelerate tightening from what it has already suggested, particularly since many Fed economists still believe in the premise that inflation is largely transitory.

That said, we believe that the Fed is ultimately likely to take its cues from the financial markets, and that means accelerating its tightening of monetary policy if sustained volatility and/or losses in either the stock or bond markets send the message that the Fed is letting inflation get out of hand.

SUPPLY AND DEMAND IMBALANCES IN THE 1940S ARE THE CLOSEST COMPARISON TO CURRENT INFLATIONARY DYNAMICS

Exhibit 12: Six episodes of elevated inflation since WWII

As of September 2021



Sources: BLS, Bureau of Economic Analysis (BEA).

If you want to know what the Fed is likely to do, just watch the markets, and the markets are currently pricing in the first rate hike for June of next year, the second hike in September and a third hike in December. Markets are even starting to discount the possibility of the first hike taking place as soon as May of next year, which would suggest that the Fed either accelerates the reduction in its asset purchases or starts raising rates while it is still in the process of tapering, which it previously stated that it did not want to do.

In any event, the markets are expecting the Federal Reserve to get progressively more aggressive in restricting monetary policy, which should eventually put an end to the current high levels of inflation. After all, the Fed almost always ultimately gets what it wants.

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