RADNOR CAPITAL MANAGEMENT

The Education of Jay Powell, and Other Matters

"We will not raise interest rates preemptively because we fear the possible onset of inflation. We will wait for evidence of actual inflation or other imbalances,"
Fed Chair Jerome Powell, 6/22/2021[1]

The recent surge in inflation has created an unexpected problem for the Fed because inflation has strongly exceeded their targets. *"Inflation is not moderately above 2%. It's well above 2%. It's nothing like 'moderately,"* Mr. Powell said. The question facing the Fed is *"where does this leave us in six months or so when inflation, as we expect, does move down?"*
Fed Chair Jerome Powell, 7/14/21[2]

And the next day:

"We're experiencing a big uptick in inflation, bigger than many expected, bigger certainly than I expected, and we're trying to understand whether it's something that will pass through fairly quickly or whether, in fact, we need to act," Mr. Powell said in response to questioning during a Senate Banking Committee hearing. *"One way or another, we're not going to be going into a period of high inflation for a long period of time, because of course we have tools to address that."*
Fed Chair Jerome Powell 7/15/21[3]

"Yes, I think it is fair to say that it is", Powell responded to the Senate Banking Committee when asked by a lawmaker If the current inflation is more worrying and structural now than it was a few months ago.
"It's also frustrating to see the bottlenecks and supply chain problems not getting better — in fact at the margins apparently getting a little bit worse," he added**.** *"We see that continuing into next year probably, and holding up inflation longer than we had thought."*
Jerome Powell, 9/29/21[4]

"It is becoming increasingly clear that the feature of this episode that has animated price pressures- mainly the intense and widespread supply-chain disruptions- will not be brief.

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[1] 6/22/21, House Banking Panel testimony
[2] House Banking Committee testimony, 7/14/2021, as amended by Bloomberg
[3] Senate Banking Committee testimony, 7/15/2021
https://www.nytimes.com/2021/07/15/business/economy/federal-reserve-inflation.html
[4] https://www.cnbc.com/2021/09/29/fed-chair-powell-calls-inflation-frustrating-and-sees-it-running-into-next-year.html

…by this definition, then, the forces are not transitory.
Longer-run inflation expectations measures have climbed, with many reaching levels we haven't seen in about a decade. These upside risks to the inflation outlook bear watching closely. If high accommodative monetary policy is meant to correct past inflation shortfalls, then we have accomplished that mission."
Atlanta Fed President Raphael Bostic, 10/12/21[5]

"Whether we are living through the beginning of a new inflation is uncertain. What is clear is that we are living through a great inflation debate"
Adam Tooze, Chartbook 42[6]

"And so once again to understand inflation, you have no choice but to understand the fertilizer market, semiconductor shortages, used cars, how many ships are docked at the Port of Los Angeles, what the latest virus variant means for airfares, what the Evergrande crisis will do to the price of iron ore and steel. And so on. Good luck!".
Joseph Weisenthal, Bloomberg[7]

While serving in the Army Air Forces in WW II, Dr. Kenneth Arrow, later a Nobel Prize-winning economist, was tasked with producing long-range weather forecasts. He and his colleagues soon realized that the prevailing techniques were no more accurate than random guessing. His team brought this to the attention of his supervisors, and Dr. Arrow published his first scholarly paper on how optimal flight formulas could be improved. This effort was met with the following reply:
'The commanding general is well aware that the forecasts are no good. However, he needs them for planning purposes.'"[8]

If nothing else, it is becoming increasingly obvious that Powell of the Fed is no longer emphatically pounding the table as much about inflation being "temporary" or "transient". One can assume that the FOMC probably thought at the beginning of the year that post-COVID inflationary impacts would already be abating by now, and yet evidence that definitions of the above terms might include "it'll be over soon" remains scant.

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[5] Federal Reserve Bank of Atlanta President 2022 (and FOMC voting member) Raphael Bostic in prepared remarks to the Peterson Institute of International Economics, 10/12/2021, as reported by Bloomberg
[6] https://adamtooze.substack.com/p/chartbook-42-the-great-inflation
[7] Bloomberg's 5 Things to Start Your Day, 9/27/2021 /Joseph Weisenthal
[8] From Dr. Arrow's; Obit In The Washington Post; https://www.washingtonpost.com/national/kenneth-arrow-nobel-laureate-and-seminal-economist-with-wide-impact-dies-at-95/2017/02/21/089c3888-f8aa-11e6-be05-1a3817ac21a5_story.html

While it is true that some price accelerations attributable to COVID recovery dynamics have in fact decelerated, we are still dealing with the supply chain and raw material cost aftermaths of the pandemic, price increases which may be "stickier".

Some have characterized the COVID outbreak as a Black Swan event, one which came out of left field in a totally unexpected and unanticipated way. Maybe so, but we have seen pandemics before- the Spanish Flu; SAARs; Swine Flu, & etc.- and in the interconnected world in which we live, it shouldn't have been too surprising that one like COVID might come along eventually; it wasn't at all surprising to specialists in Infectious Disease, at any rate. Once it did come along, and we soldiered through it, and vaccines were at hand last spring, the assumption was that we'd all get the shots (at least those willing), a second half 2021 economic recovery would follow, and we would all get back to "normal " again, if we could remember what that was. The Black Swan here however may be the unexpected number of dents and dings and disconnects inflicted by COVID on the global supply chain. Pre-COVID, that supply chain was an exquisitely calibrated global dance, moving both raw materials and finished goods from low cost far corners of the world (read: China) to manufacturers and end users on a just-in-time basis. That dance is now broken, and the question of the hour is how long it will take to fix it.

Burgeoning supply chain problems have of course been a "thing" since at least the first quarter of this year, and rather than seeing any normalization, it has all mostly gotten worse, per Powell's lament up front. The issue has evolved to being a sort of universal culprit for what ails us, from the White House , to Powell, to corporate managements, to consumers facing empty (actual or digital) shelves when seeking goods for purchase; *"Whoops ! There goes the supply chain again !*".

But why is this happening ?

Per *Slate*:

We are simply buying an enormous amount of things*. When the pandemic began, and Americans found themselves unable to go out, households suddenly shifted their spending to goods from services. With the money they saved skipping restaurant meals, movie trips, and vacations, people spruced up their living rooms with new couches, built out home offices, and bought themselves some exercise equipment. Stimulus checks helped fuel the shopping as many employees who'd kept their jobs splurged on TVs and cars. Economists widely expected that, as the pandemic faded, Americans would revert to their older spending patterns. But that hasn't happened yet, thanks in part to the delta wave. By August, inflation-adjusted spending on goods was up 14.5 percent compared with pre-pandemic, while services were still down more than 2 percent. Part of the issue is that global supply chains are only designed to operate at peak capacity for a few months of year, usually in the lead-up to the holidays. Ports and warehouses can then work through any backlogs during slower seasons. 'The problem is you've essentially had peak season since the onset of the pandemic,'says Phil Levy, Flexport's chief economist. 'As a result, there hasn't been a chance to play catchup after things get clogged, and so delays have simply stacked up'."*[9]

[9] https://slate.com/business/2021/10/supply-chain-shortages-retail-united-states-explained.html

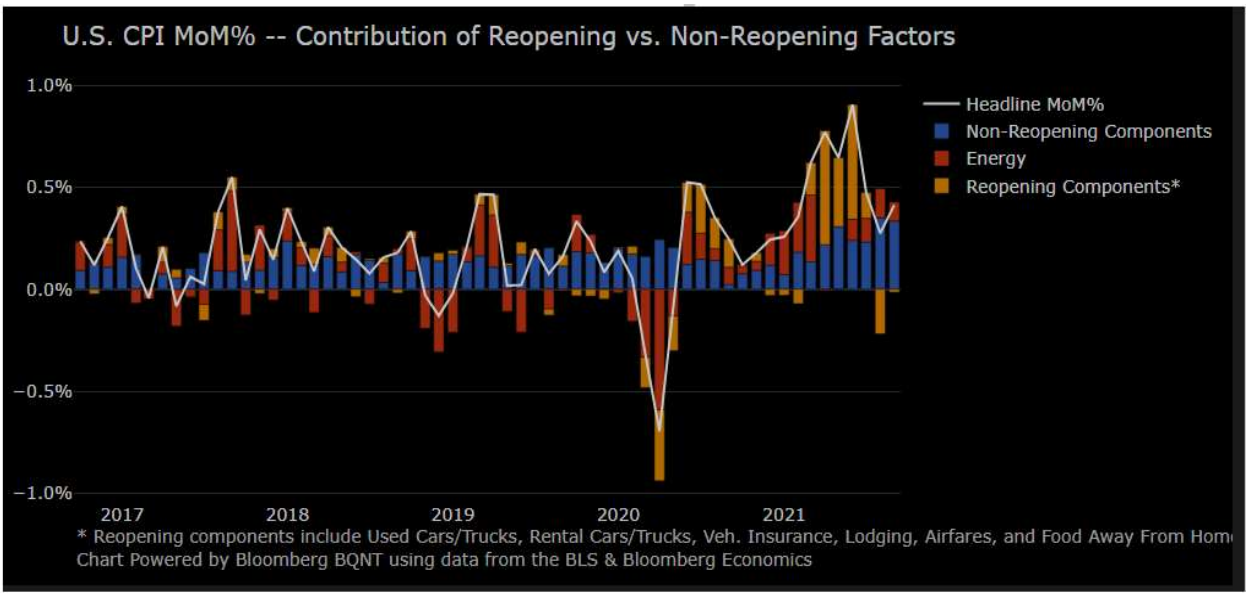
This problem is having an impact of the pricing and availability of many consumer items we normally take for granted, as ports and logistics clog up around the globe. President Biden last week ordered the Port of Los Angeles to operate 24/7 until backlogs are worked down, and maybe it's that simple, and maybe it isn't; if you're offloading containers from trans-Pacific ships, and there are no extra trucks to haul them, then what?

Judging by the amount of media attention these problems are causing, we may well already be at "peak supply chain". In the meantime, we are seeing the impact of all of this in higher prices which may be less temporary. CEO's and CFO's on practically every earnings conference call cite increased input costs, which they will "reluctantly" need to pass on to customers; many have done so via multiple price increases already this year. And that's if they have products to sell to customers; among other things, the current shortage of semiconductors has caused work stoppages across industries from Technology to Auto Manufacturing and even mighty Apple had to talk down iPhone sales projections last week because they can't source some of the chips that go into them. Meanwhile, if you are one of the aforementioned customers, you can't help having noticed that consumer products and packaged foods prices have been ratchetting higher, with the usual games being played with package sizes vs. contents volume. At the same time, even though millions of people in the U.S. are still not driving as much as they did pre-COVID, it costs a dollar more for regular gas at the pump than it did a year ago (more on which below). With kiting fertilizer prices, fresh produce and meat prices are likely to follow. These things add up.

While we do not know when, and owing to what forces, these price trends will abate, they are certainly evident now. Thus, in my last letter I noted that the Consumer Price Index (CPI) showed year-over-year growth of +5.4% in June, up from 5% in May, back when "transient" was the Fed's main refrain.

Last week, CPI was reported for September, with the year-over-year number still a steady-as-she-goes +5.4%, a bit "hotter" than expected prior to the release, and certainly not the "move down" the Fed was looking for.

That's a problem by itself, but what's under the hood is also cause for concern. While the number in June contained pricing factors relating to the post-COVID reopening of the economy, as the chart below shows, non-reopening factors, ie., non-temporary ones (the blue bars), are having an increasing amount of influence on the CPI numbers:



This may be why the Atlanta Fed's Bostic, in the same presentation from which the up-front quote was taken, indicated that he and his staff were now treating "transient" as a "swear word".

A day later, the Producer Price Index PPI report was released. It wasn't as bad as feared, but it was still up half a percent last month, and + 8.6% year-over-year in Sept.

Which is not so great by itself, but also has implications for the CPI numbers, since Producer Price changes ultimately find their way into Consumer Prices, assuming that the producers in question want to have any profit margins. Something has to give…

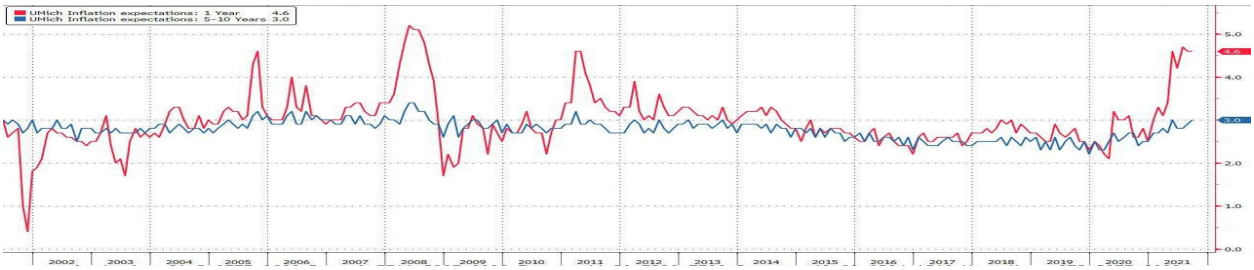
Meanwhile, on October 1st, the Personal Consumption Expenditures (PCE) Deflator (aka "The Fed's favorite inflation indicator") rose 3.6% year-over-year, unchanged from the prior consensus views. Not only is that well above the Fed's 2% inflation target, but it's also a 30-year high in this series.

The Fed's levers are good at stimulating demand, and they have arguably gone overboard in that role by keeping rates low all the way from the Great Financial Crisis to the present; that's 10+ years of interest rate policy essentially in crisis mode. One could certainly credibly assert that the Fed's efforts created or at least contributed significantly to the current inflationary trends, by not only keeping the stimulus pedal to the floor, but also blithely indicating that they'd be OK with inflation exceeding the 2% target for a while, comfortable in the notion that inflation expectations remained "anchored" at reasonable levels. But here's the problem:

As indicated, the current inflation environment is mostly about post-COVID supply disruptions which monetary policy can't really address; hiking rates won't make more shipping containers appear, or break the log- jam in getting semiconductors from Taiwan to international markets…

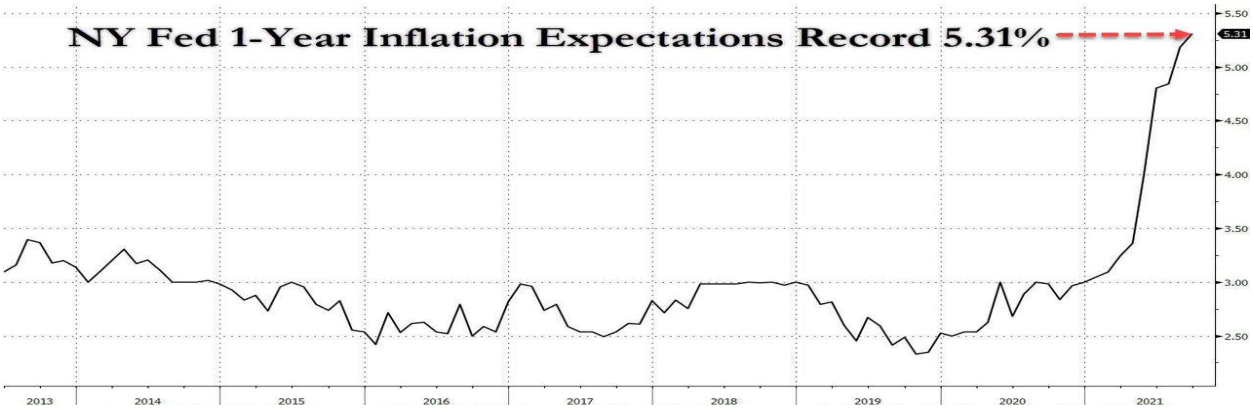
…and yet monetary policy may have to react, with the Fed beginning to raise rates again (with a will or not) sooner than expected, because the longer this goes on, the greater the risk that inflation assumptions become un-anchored. If enough consumers (both business and retail) begin to assume

that inflation is a higher-for-longer thing, then their behavioral adjustments will tend, all else equal, to make a modest inflationary trend (and this one isn't really modest anymore) worse. Back in the 1970's, there was a feedback loop between price inflation, wage inflation, and price expectations which we do not want to repeat, and yet there is already some evidence that the price expectations part is moving higher. Thus, the most recent University of Michigan Consumer survey showed that long term inflation expectations rose unexpectedly to 3%, the highest in a decade (that's the blue line below; the shorter one-year expectation, the red line, is already at +4.6%) :



[10]

Meanwhile, the September installment of the New York Fed's own Survey of Consumer Expectations for the next year hit 5.31%, up from 5.18% in August. This was the eleventh monthly increase, and marks a new series high since the inception of this survey in 2013:



[11]

The longer term (3 year) inflation expectation also hit an all-time high at +4.19% vs. 4.0% in August.

While we're at it, at least one branch of the U.S. Government sees inflation in even higher terms; it was announced last Wednesday by the Labor Department – which uses slightly difficult stats than those used

[10] https://www.zerohedge.com/markets/fed-losing-control-consumers-inflation-expectations-hit-new-all-time-high

[11] https://www.zerohedge.com/markets/fed-losing-control-consumers-inflation-expectations-hit-new-all-time-high

to measure the CPI - that the cost -of-living adjustment for Social Security payments will be a 5.9% increase for 2022, the highest jump in almost 40 years. So there's that.

To be sure, the Fed has acted already in a behind-the-scenes way; as noted in my last letter, money supply growth has slowed markedly since the beginning of the year. Meanwhile, the FOMC minutes released last week indicated that the Fed is resolved to start tapering its open market purchases of bonds next month, or maybe in December, intending to conclude the program by mid-2022. That's about $120 Billion a month (created out of thin air by the U.S. Treasury) which will cease to be injected into the U.S. economy over the course of the next six months or so, independent of any rate moves; those still appear to be on the shelf for the moment. However, the mere fact that the Fed has decided to kinda/almost/probably/soon start tapering may well be responsible for some of the backing and filling characterizing market action since the beginning of September.

In the meantime, none of these inflation headlines are particularly good news for the economy; corporate revenues could continue to be impacted, while margins already are, and neither of those spells good news for earnings. US GDP is still about 70% Consumer, and if higher prices constrain discretionary spending, and/or persistent supply chain problems limit that which is available to be consumed, that spells potential trouble too.

Lumped on top of all this of course is the factor briefly alluded to earlier, Energy, and if you don't think those costs can put a dent on your economic outlook, then you haven't filled your car up lately. A month or two ago, I saw no mention of the term, but now it's hard to avoid tripping over references to "the world energy crisis" , or related labels. Some of this is related to "supply chain", as in transportation logistics, and some sort of it is a supply shock, with modest global storage/production cushions not being able to catch up with post-COVID recovery demand. Some of it is just…circumstances. As David Rosenberg put it in a piece last week:

It is not one development in particular but rather a combination of things that has led to the ongoing world energy crisis. Demand for energy has risen thanks to a recovering global economy, as well as temperature extremes, which caused a spike in usage of electricity-run air conditioning this past summer in North America and Europe. A negative shock to the supply side, courtesy of weather events, has also contributed to the crisis. For instance, droughts in Brazil have caused water levels to drop enough as to reduce hydroelectric capacity, while the wind stopped blowing in the North Sea hammering wind generation, particularly in the U.K. In both cases, that led to increased demand for fossil fuels such as natural gas and coal to plug in the gap in power generation —further pushing up the price of those commodities.

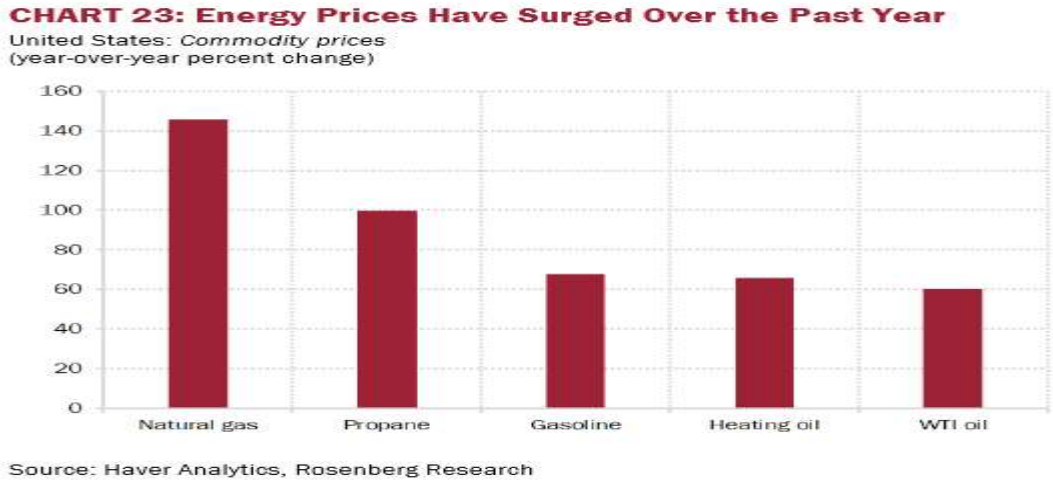
…and the problem is that higher demand for conventional energy sources "to plug the gap in power generation" is running headlong into an environment where supply, and financing for finding more of same, looks to be increasingly constrained, courtesy the move- maybe too quickly , in hindsight.- towards the wholesale embrace of "green" power. No less an authority than the International Energy Agency recently called on oil and gas producers to cease downstream investment "since no new oil and gas fields are needed in the net zero pathway"[12] Well, maybe, and maybe not, but they may well be

[12] Grant's Interest Rate Observer, 10/15, 24

getting their wish in any case. Per the Wall Street Journal, drilling permits on Federal Land have crashed to 171 in August from 671 in April, while the stalled $3.5 Trillion "infrastructure" plan would raise royalties and fees high enough on U.S. Energy producers that it would render them globally uncompetitive.[13]

U.S. Energy Independence, we hardly knew ye!

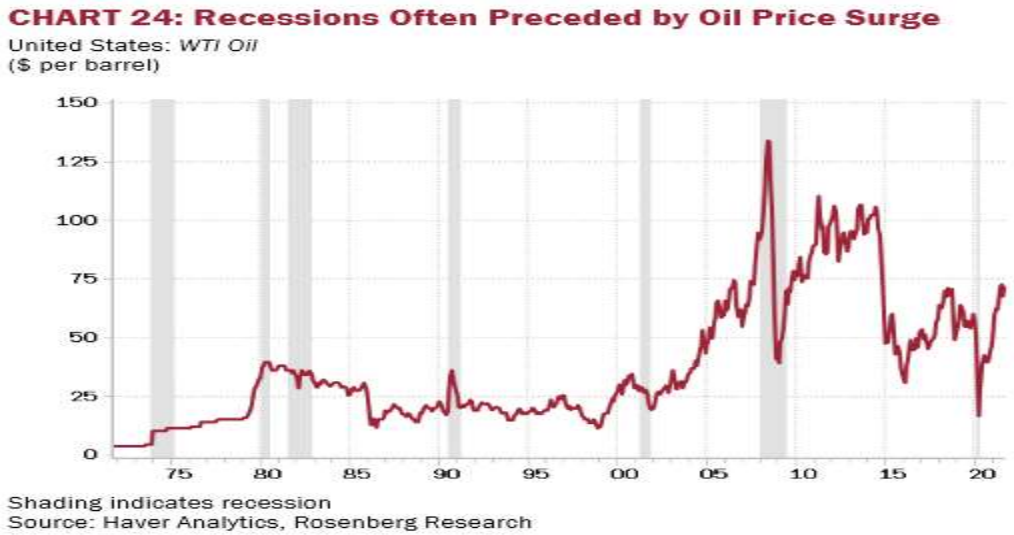
The current supply/demand environment has led to some rather startling price increases on these shores, with West Texas Intermediate Crude Oil up 60% being the laggard this year:



While that makes us happy as owners of conventional oil and gas companies, the economic "tax" of these extra oil and gas costs, whether as a source of fuel or heat, or as petrochemical feed stocks for manufactured items, has already been felt, and will continue to be so; Rosenberg estimates that this leg of the current Energy supply crisis could knock up to two percentage points off of Global GDP in the next year, independent of everything else. Thus while analysts have been raising earnings estimates with an eye to the continuing post-COVID recovery, all of the above has conspired to cause forward estimates of U.S. GDP to decline materially, with the Atlanta Fed's GDP Now estimate for the third quarter now at +.5%, vs. +6% as late as the end of July. Earnings estimates are likely to follow.

The recovery is starting to look more like a grind. Rosenberg goes on to note that the last seven U.S. recessions were proceeded by an energy price surge:

[13] https://blog.evergreengavekal.com/green-energy-a-bubble-in-unrealistic-expectations-part-ii/



…and who was thinking six months ago that such a thing as an "energy price surge" was even possible?

As you probably figured out long ago, my ability to predict where we go from here is no better than Dr. Arrow's in the up-front quote, and is likely worse; he went on to win the Nobel Prize in Economics, after all. In light of which, I will merely observe that Mr. Powell (or his successor; he has not yet been appointed to another term) and his team at the Fed have the proverbial tiger by the tail at the moment.

As Bill Blain put it this morning:

" Financial assets remain seriously distorted by the consequences of the last 10 years of QE and ultra-low interest rates. It would be a policy mistake *not to unravel the multiple negative market consequences of bad policy. However, doing so – by tapering QE purchases, raising interest rates, and causing investors to question the implicit put they think Central Banks have given markets – will likely trigger a market tumble, and thus be a* ***policy mistake*** *".*[14]

The post-COVID economic recovery seems to be running out of gas, and higher inflation generally and higher energy prices in particular will not be constructive. On the other hand, the current rate policy regime is way past it's "sell by" date, and the current trend of inflation could give the Fed some cover to begin to raise rates again. However, higher rates would not necessarily be a positive for the economy; whether we end up eight-for -eight with higher oil prices and recessions or not, a combination of higher inflationary pressures and economic softness - a possible reprise of Stagflation? - would not be constructive for stocks or bonds. And yet at the moment we find ourselves with stock market indexes at all-time highs and at similar valuations (the cyclically adjusted P/E ratio for the S&P 500 now sits at 38.3X, up from 36.7 in the last 3 months, a level only exceeded in the past by the DotCom bubble in 1999- 2000) with perhaps less certainty that earnings will continue to "grow into" those valuations, and with bond yields about as low as they have ever traded in recorded history. As in, a very low margin for error, or unexpected outcomes, all the way around.

Continued caution, along with retaining plenty of financial flexibility, would seem to be prudent, and that is how we are looking at the markets on your behalf.

[14] Blain's Morning Porridge, 10/19/21

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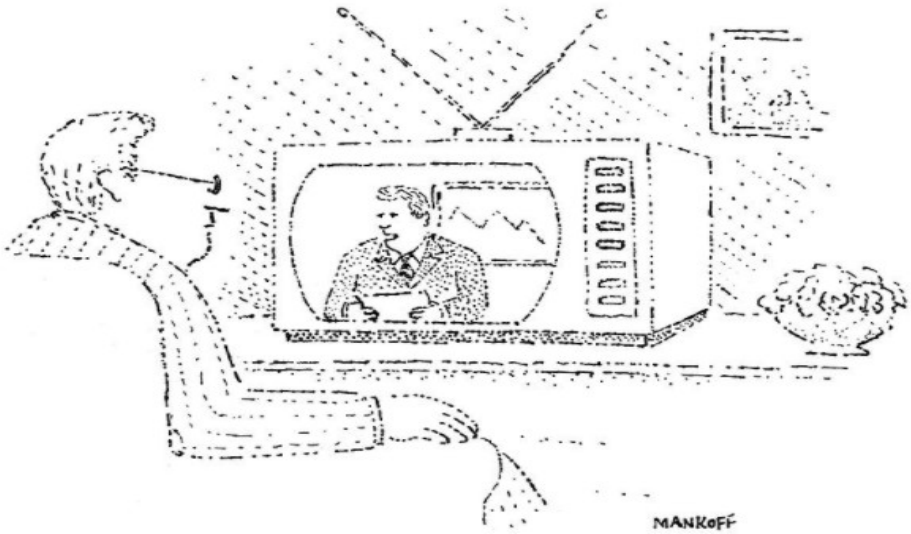
Finally, as a proof statement for "there is nothing new under the sun on Wall Street", I tender the following cartoon by Robert Mankoff, which appeared in the New Yorker in the 1980's, but seems entirely up-to-date (except for the TV "rabbit ears" antenna) for the current market environment:



"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."

Pierce Archer
10/20/2021