FCI ADVISORS

PERSPECTIVES

Third Quarter 2022

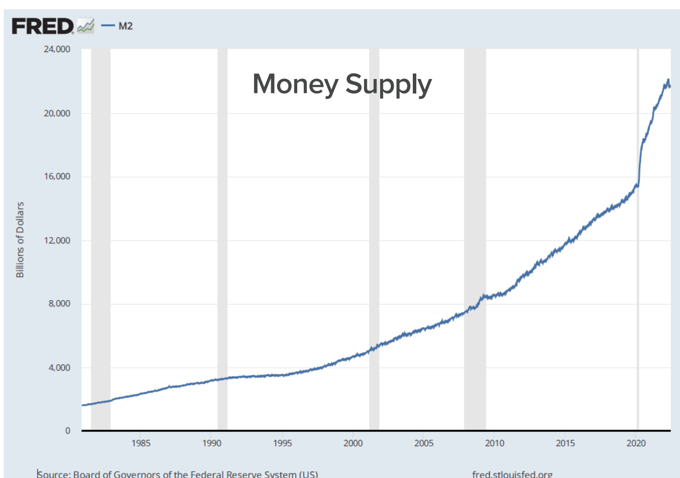
Milton Was Right

By Bill Koehler, CFA, President and CEO

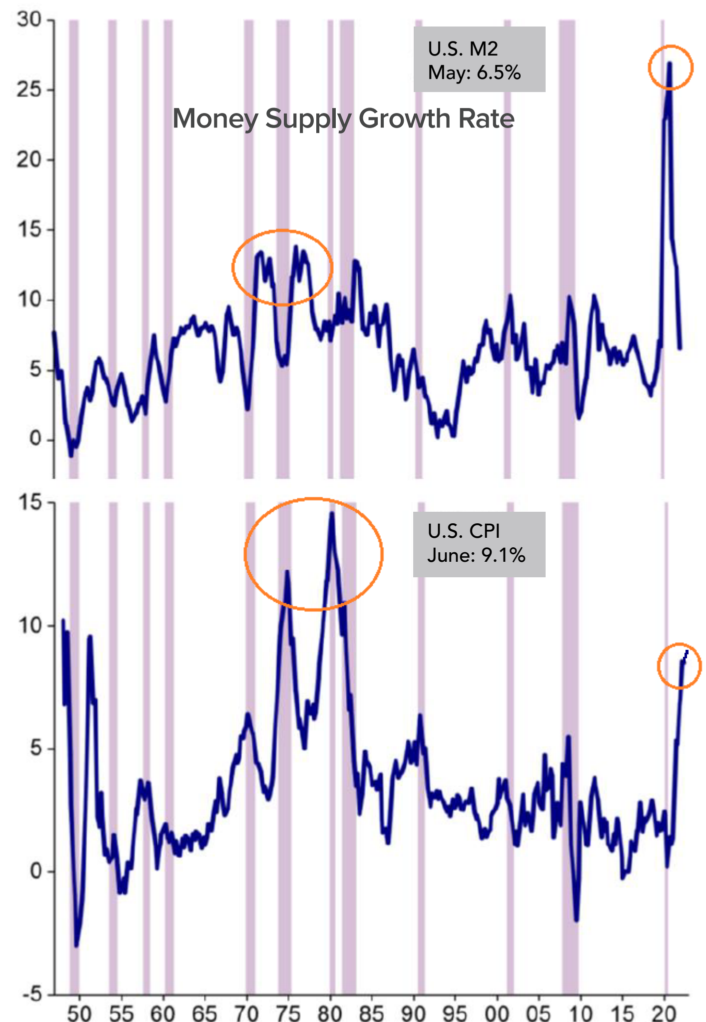
Milton Friedman was a Nobel Prize winning economist and an ardent proponent of free market capitalism. His 1980 PBS television special remains an outstanding tutorial on free market economics that can still, thankfully, be watched today on YouTube.

One of Milton's lasting, memorable tenets was "Inflation is always and everywhere a monetary phenomenon." He was a monetarist, meaning he believed a nation's money supply and its inflation rate were inextricably linked. Milton's research showed inflation "can be produced only by a more rapid increase in the quantity of money than in output."

As the 40-year chart below shows, the U.S. money supply, as defined by M2, has exploded the last two plus years. M2 is a measure of the U.S. money stock comprised of currency and coins held by the non-bank public, checking accounts, savings deposits and shares in retail money market accounts. Each month the Fed releases the data for M2. It totaled $21.7 trillion on June 28. For perspective, it totaled $9 trillion in 2011 and $15.4 trillion in early 2020. Since January 2020 nearly as much money has been created in two and a half years, $6.3 trillion, than was created in the prior nine years. This money supply explosion is unprecedented.



Given the enormity of the increase in M2, I suspect Milton Friedman would not be surprised by our current inflation rate of 9.1%, the highest since 1981. Some will rightfully suggest supply chain disruptions and Russia related price increases in energy and other commodities have contributed to inflationary pressures. However, history suggests surging demand driven by excessive money creation is the primary culprit of rising prices. As the charts below indicate, money supply and inflation rates do correlate.



Source: Ed Hyman - EverCore ISI

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History Does Not Repeat, but It Rhymes

The last time money supply grew this quickly was in the 1970s. Fifty years later, pandemic related government spending and an accomodative Fed caused the bulge in the money supply. The most recent two administrations have both contributed to today's expansive money supply. An early clue to the Biden administration's attitude toward government spending and money supply growth occurred in April 2020. When arguing for a much larger pandemic related spending package than the initial $2 trillion bill being debated at the time, then candidate Biden said, "Milton Friedman isn't running the show anymore." This was said even though Milton never officially "ran" anything as an academic at the University of Chicago and passed away at age 94 in 2006.

Inflation is impacting every American. A five pound brisket at the local grocery store is $75. An FCI colleague was planning to vacation at a resort near Branson, Missouri this fall. She reported a favorite vacation getaway is now renting for four times what it cost in 2019. So, she and her husband are simply not going to that particular property. This will happen hundreds of millions of times as consumers walk away from many discretionary purchases simply because prices are too high. This type of consumer behavior and declining demand will ultimately drive some prices back down, albeit perhaps not as quickly as they rose. A time tested economic adage is, "The cure for high prices is high prices."

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What goes up....

The good news is the *growth rate* of the money supply is declining rapidly. As can also be seen in the charts, M2 growth is indeed starting to decline. Frankly, it needed to decelerate. Inflation expectations, as measured by breakeven inflation rates in the 5-year treasury market, are now beginning to moderate. A March expectation of 3.57% has declined to a 2.53% level as of July 7. This value implies what market participants expect inflation to be in the next five years, on average.

Monetary policy works with a lag. Money takes a while to circulate and recirculate through an economy. With this in mind, it is not outside the realm of possibility that core inflation rates are back under 3% in the next 12-18 months. This current bout of inflation will be remembered as positive if it serves as a warning for what may occur longer term, if more fiscal discipline is not enacted by our policy makers.

A Message to the Fed

If we could offer our advice to the Fed it would consist of the same message we delivered to clients in our May Capital Market Commentary......Resist Overreacting. The Fed may not have to raise rates as much as they have indicated they may raise them. Let the economy and the rate of money growth get in better balance, naturally. Don't raise rates too quickly and throw the economy into an unnecessary recession. Inflation was not going to be transitory in 2021 with the unprecedented amount of stimulus and money creation we have witnessed the last two and a half years. Keep an extra eye on the money supply. Have some faith that if we can keep the money supply from running too far ahead of output (GDP) or too far behind, we can skirt a "hard landing" or recession. Do this and the inflation we have all been living through the last 12 months may well be subsiding over the next 12 months and we can again have a growing economy with low inflation.

Recession Perspective

Over the ensuing weeks (and possibly months) there will be much discussion in the markets and media about the anticipation of, or reaction to, news of the second quarter real GDP being negative, as was the case in the first quarter. We have no special insight into what the number, to be released in late-July, will be. However, we must keep in mind the reality that recessions are normal. They have happened on average every 6.5 years since 1945. Sometimes they are more severe like the Great Recession of 2008-2009 that was deeper and longer. Sometimes they are less severe as was the Covid-19 Recession of 2020 when the pandemic first struck.

If we do experience a recession, barring an overreaction by the Fed, we feel it may well be brief and shallow. As one of our FCI colleagues stated at a recent internal meeting, our economy has witnessed jobless recoveries in the past, so why couldn't we also have a full employment recession? In this unusual environment, that outcome seems plausible. If a recession does come to pass, the stock market will likely rise well in advance of the official end of the recession as it discounts the future recovery, just as it has over the last 12 recessions since WWII.

Patience and Milton's Lessons

If the Fed can be a little patient and let the economy adjust, it looks like inflation may be in the process of easing. Looking within the latest 9.1% Consumer Price Index (CPI) report, the sequential year-over-year rate of change in the core CPI (excluding food and energy) declined for the third consecutive month. The June reading of 5.9% declined from 6.0% in May, 6.2% in April and 6.5% in March. In the spirit of it is always darkest before the dawn, we may be past the worst of the inflation. We do not think we are going to experience a repeat of the 1970s where a prolonged inflationary environment dominated the decade.

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We believe the U.S. economy will emerge from this current inflationary environment with lower long-term inflation if we simply recall some of Milton Friedman's lessons and apply them in our fiscal and monetary policies. A fellow FCI colleague is fond of saying, "Human beings need reminders." If this bout of inflation causes our policy makers to remember and apply some of Milton's lessons in the future, it will have been a positive, though somewhat painful, episode in our economic history.

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