The Colony Group

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SANTA'S CHALLENGE: INFLATION, SKIMPFLATION, AND ANOTHER COVID VARIANT

The holiday season is generally a good time to reflect on inflation. To that end, this year's Thanksgiving turkey was reportedly more expensive than any year before. Undoubtedly, the Twelve Days of Christmas will cost more too, assuming you can find eight maids-a-milking or ten lords-a-leaping willing to work. Previously, we suggested that the consumer would spend (pun intended) 2021 making up for lost time. Excess savings, the result of stimulus checks and spending austerity, combined with a robust economic recovery enable consumers to plan more elaborate vacations, organize larger family get-togethers, and go on spending sprees. Many felt more comfortable returning to their spending routines than back to their worksite, leading to supply chain challenges. While most of these circumstances were predictable, the magnitude of the inflation spike has exceeded most expectations.

Measures like the Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE), which are at elevated levels by recent standards, don't tell the whole story. Economists and policy makers have long debated the accuracy of the government's official inflation indices. However, even those that once argued that CPI and PCE overstate inflation, now acknowledge that the current environment is different. This camp historically argued that improvements to the quality, usability, service, and speed of delivery of goods and services are enhancements. Therefore, higher prices did not mean higher inflation because consumers received the benefit of these improvements. More recently, however, shoppers are facing a combination of higher prices and an inferior customer experience through reduced services offerings and extended delivery times. This leads to consumers paying more and getting less. The change in service quality has borne a new phrase by economists: **skimpflation.**

In his recent congressional testimony, Federal Reserve Chairman Jerome Powell suggested that it might be time to retire the term "transitory." The statement rocked investors who have anchored around this thesis for the last year. While he suggested that inflationary pressures may extend further into next year, he maintained his view that it is likely to decline. His argument is certainly intuitive. As more of the labor force returns to work, supply chains should normalize. Eventually, consumers will spend their excess savings on goods and experiences. Large retailers are reportedly using this as an opportunity to gain market share from smaller competitors through lower prices, which could drive inflation lower.

We are confident in our belief that the current 6%+ inflation rate is not sustainable, however, it would be reasonable to expect inflation to persist above the sub-2% levels experienced over the recent decade. Importantly, our clients' financial plans incorporate higher inflation in their assumptions. For reference, we use an average 2.5% inflation forecast in our financial plans and believe it remains an appropriate, if not conservative, long-term assumption.

For investors, the scarier story over the last several months has been slowing growth. Following a growth slowdown during the third quarter, recent data shows that the U.S. economy reaccelerating. Unemployment numbers continue to improve. Indeed, the November 24th weekly unemployment claims report was the lowest number of seasonally-adjusted initial claims since 1969. The Federal Reserve Bank of Atlanta's GDPNow estimate for Q4 GDP suggests that the economy may be growing a scorching 8.6%. Equity markets, a reliable barometer of investor sentiment, imply optimism amongst investors, with the S&P 500 rallying more than 6.0% since September.

One of the most significant risks to both inflation and economic growth remains COVID. Last week, the World Health Organization (WHO) designated a new strain, Omicron, a "Variant of Concern." The COVID strain has spread rapidly through southern Africa and shows the highest number of mutations to date. However, it is important to consider this designation within context. There are currently five variants that meet the WHO's definition of a Variant of Concern. Only one of the others, Delta, has proven to be a significant threat. Given Omicron's origins, from a region where less than 25% of the population is fully vaccinated, it is not yet possible to determine ites potential for breakthrough infections. Initial reports suggest that symptoms are milder than previous variants. We are currently much better prepared for the new strain. Higher vaccination rates are evident across the globe. Moderna announced that it would be ready to modify boosters for the new variant in early 2022 and Pfizer should be able to do the same. We also have post-infection treatments on the horizon, though their degree of efficacy against the latest mutation is unknown. While there is uncertainty over the impact of Omicron at the time of writing, the balance of evidence suggests that investors should remain patient rather than attempt to front-run the science.

As the end of the year approaches, there are plenty of stories to share with family at gatherings. Some of these stories may involve spectacular returns garnered from investing in hot stocks or other newfangled asset classes. Often, the story tellers neglect to mention their losers. The patient investor, some of whom have compounded their capital over the years through disciplined and steadfast investing, generally do not resort to bragging.

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