NASHVILLE NOTES

The new normal or just unsettling?

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Every now and then a given week will be odd or unsettling, but last week was both from my perspective. For those of you who live in an area that is highly dependent upon the Colonial pipeline like me, last week demonstrated how fragile our technologically advanced society is becoming. Yes, hoarding was a problem (I filled both cars before the media really picked up on the story); however, we and the "system" may not be as resilient as assumed.

One wonders what happens if the internet ever crashes due to a cyberattack, solar flare, EMP attack or someone accidentally hitting the "off" switch, if such a switch exists.

In 2014, the *Wall Street Journal* broke the story about a precision sniper attack during April 2013 on an electrical substation located near Silicon Valley in which 17 transformers were knocked out. PG&E was able to reroute power in the area, so few knew of the incident at the time. I suspect one reason officials did not inform the public officially at the time it occurred was because it would have been too unsettling to know how fragile the electrical grid is and that someone could pull it off without being discovered.

Last week also saw the government report inflation as measured by the Consumer Price Index and Producer Price Index that was unsettling. Core CPI rose at the fastest rate since 1981, when stagflation was part of the U.S. vernacular. As I pen this post, I have just traveled to the Florida Panhandle. The beach community is packed — it usually is, though now with people from the Northeast and Upper Midwest along with the usual crowd from Mississippi, Georgia, Alabama, Tennessee and Kentucky.

I do not usually pay close attention to prices (gas has gone up and down throughout my life), but rising food costs are out of control. And many restaurants here have limited service because they are not fully staffed based upon my personal experience and what friends have relayed to me.

This weirdness in the economy may prove to be transitory as the Fed and many on Wall Street say. The bond market so far agrees. The yield on the 10-year U.S. Treasury bond was roughly unchanged last week at 1.66% and down from a recent peak of 1.74% on March 31.

If the inflation and/or stagflation of the 1970s is unfolding, the bond market has not recognized it yet. Regime changes in markets are usually about slow turns — a process — rather than a quick reset. The seeds of the 1970s inflation apparently were set in the 1960s when the U.S. pursued a "guns and butter" fiscal policy to finance the Vietnam War and stepped up social spending.

Foreign creditors reacted in time by converting an increasing amount of Treasuries into gold as provided for under the post-World War II Bretton Woods system in which the dollar as the world's reserve currency was anchored to gold. When the pressure became too much, Nixon closed the gold window and instituted a temporary wage and price freeze in 1971. The price freeze was a disaster, and many would argue the same applies to unlinking currencies to gold or other hard assets that limits the ability of politicians to spend.

Back to the present. The absence of a sharp reaction in the bond market to the inflation news is odd if not unsettling. Perhaps the market already priced in this year's "transitory" inflation by pushing the yield on the 10-year U.S. Treasury higher by roughly 100 bps between Sept. 30 and March 31. Markets look forward, not back. Inflation pressures will ease later this year (and service workers will return to their jobs where still available) according to the transitory narrative.

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Alternatively, maybe the bond market is pricing in the potential for a deflationary bust in which asset prices fall but the debt does not. Yields began to fall in the second half of 2007 well before the 2008 bust unfolded. Bank stocks are not in a bubble, but it is hard to argue that SPACs, cryptocurrencies and maybe now housing are not indicative of a wildly speculative market. Unwinds when they occur can be dangerous for the system, not just the most speculative assets.

Or maybe the bond market is not sending a meaningful price signal because it is no longer a true market given the heavy hand of the Fed through setting short-term policy rates near zero and purchasing $120 billion a month of Treasuries and Agency MBS. Distortion, if real, is just another cost to keep the system afloat.

A distorted bond market or not, I do not see how the Fed backs away from its policy of ultra-low policy rates and debt monetization for the U.S. government other than perhaps curtailing Agency MBS purchases. The Fed and the U.S. are not alone; most governments and their central banks in the developed world are doing the same.

There is nothing normal about the government borrowing trillions of dollars it does not have to inject into the economy. We are seeing the first order effects this year in terms of a jump in inflation and worker shortages, though we do not know how long they will last, much less what the second, third and other follow-on derivative effects will be.

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