Key Questions

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What Will Fix Inflation?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

In short, there is no immediate fix and while we don't believe another "Volcker moment" is upon us, we need to be mindful that the economic landscape is changing.

In October 1979, Pope John Paul II made his first papal pilgrimage to the United States. His weeklong visit was historic. The popular pontiff made nearly 70 public appearances throughout the country, including stops in Boston, New York, Philadelphia, Chicago, and Des Moines, Iowa.

Most noteworthy, perhaps, was John Paul's visit to Washington, punctuated by a meeting with President Jimmy Carter at the White House – the first time a pope set foot in America's most recognizable residence. Given the country's attitude at the time of keeping church and state separate, the visit was, as Time magazine noted, "a happening that would have been inconceivable just two decades ago."

Nevertheless, the pope's visit was, for a moment, upstaged by a far lesser known individual, Paul Volcker, the new chair of the Federal Reserve (the position now occupied by Jay Powell). On Saturday, October 6, 1979, the same day the pope visited the president, Volcker held an unexpected and unprecedented evening news conference less than a mile from the White House. It was the first time that a Fed chairman addressed the media directly.

Volcker felt it was imperative that the American public hear from him firsthand. When told by one national TV network representative that they were too busy covering John Paul's visit with President Carter, Volcker barked: "Send your crew here. Long after the pope is gone, you'll remember this one."

Indeed we do. That evening, Volcker declared that the Fed would "slay the inflationary dragon."

In the mid/late 1960s, inflationary pressures were building as a result of accommodative monetary policies (i.e. low interest rates) coupled with major spending programs encompassing a broad array of social initiatives at a time when the U.S. was already spending substantial dollars on the Vietnam War. Then, in 1973 and again in 1979, the U.S. was beset by a series of energy crises further fueling the inflation situation. Some numbers: In 1964, inflation was 1%; when Volcker was appointed chair of the Fed in the summer of 1979, it was near 12%.

Volcker sought to arrest inflation by altering the Fed's approach to managing the economy.

Previously, the Fed used interest rates – the price of money – to control economic activity. But Volcker declared that the Fed would instead dictate the *supply of money* and allow markets to determine the price.

When Volcker simultaneously announced that the Fed would restrict the supply of money in order to tame inflation, interest rates soared to over 20%, sending the economy into a recession in early 1980.

At that point, the Fed relaxed the supply of money, but inflation quickly reaccelerated, prompting Volcker to reverse course and again reduce the supply of money. And for the next several years, the money supply was kept relatively tight. That led to a loud chorus of critics as the U.S. entered another recession in July 1981, which lasted until November 1982, far longer than the 1980 recession. Ultimately, however, Volcker's medicine worked – in 1983, inflation fell below 4% and Volcker's critics were transformed into admirers. The dragon had been slayed.

Fast forward to today

In January, inflation rose over 7.5%, the fastest year-over-year growth since 1982. More worrisome, inflation appears to be rising at an accelerating rate and is broadening, inviting the question: "What will fix inflation?"

In short, there is no immediate fix. In its simplest form, inflation occurs when supply and demand are out of sync. For inflation to be "fixed," an equilibrium needs to exist. Managing the supply of money can alter demand, but the impact is not immediate, and it does little to directly influence supply.

The seeds of today's inflation were first planted when policymakers acted aggressively as the economy was shut down to limit the spread of COVID-19. Massive amounts of stimulus were injected into the economy, which ultimately sparked an explosion in demand. At the same time, supply – principally the supply of labor – struggled to keep up, something we foreshadowed in our 2021 Outlook and again discussed in our 2022 Outlook, and addressed throughout the year as well.

To address the supply shortage, companies have raised wages, new manufacturing capabilities have been added, and policymakers are beginning to respond. Moreover, demand for some goods is beginning to wane, which will also help restore the needed equilibrium.

Two risks should be acknowledged:

1. Policymakers' response could miss the mark. Already viewed as "being behind the curve," the Fed could overly constrict liquidity and trigger a recession. Similarly, policymakers could institute wage or price controls as was done in the 1970s. Such measures temporarily slowed the rise in prices; however, they exacerbated shortages and also triggered higher unemployment, an unwelcomed side effect.

2. Inflation could become a self-fulfilling prophecy. Raising wages in an attempt to address labor supply shortages could lead workers to demand even higher wages. The notion that higher prices bring about higher prices could cause expectations for higher inflation to become entrenched.

The outlook for inflation

Positively, while short-term expectations for inflation have risen sharply, longer-term expectations for inflation have remained at around 3%. Additionally, while risks of a policy error have increased, there is a possibility that some inflationary pressures will cool later this year, effectively taking some pressure off the shoulders of Powell and his colleagues at the Fed.

Nevertheless, the outlook for inflation remains highly uncertain. We encourage investors to remain disciplined and take steps to ensure their portfolios are well diversified. This would include a slight tilt toward high-quality cyclical/value stocks and bonds, a balanced view with respect to international markets that are currently holding up better than their U.S. peers, and incorporating real assets and other portfolio diversifiers where appropriate.

In short, we don't believe another "Volcker moment" is upon us. But we need to be mindful that the economic landscape is changing and investment portfolios should be positioned appropriately.

For more information, please contact your advisor.

About the Author

As Chief Investment Officer, George Mateyo is responsible for establishing sound investment strategies for private and institutional clients, expanding internal and external research capabilities, and managing the delivery of solid risk-adjusted investment performance.

In previous roles, George spent more than 15 years in investment management and investment consulting, where he acquired firsthand knowledge and insights into the capital markets and the stewardship of investment portfolios for institutional and high net-worth investors.

George received his MBA from the Weatherhead School of Management at Case Western Reserve University and completed additional studies at the London School of Economics.

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