



The Fed - An unwitting Participant in the Squid Games

'Squid Game' is a worldwide hit show on Netflix where hundreds of cash-strapped contestants accept an invitation to compete in children's games for a tempting cash prize, but the stakes are 'win or die'. As we watched the initial episodes, we couldn't help thinking the U.S. Federal Reserve might be caught in its own risky game.

Earlier this year, the Fed hoped to 'thread the needle' and achieve their full employment goals without creating longer term inflation. Unfortunately, the slow vaccine adoption rate, along with the spread of the Delta variant exacerbated supply chain issues, shortages of labor and materials, and port congestion. As a result, inflation is now viewed as less transitory than originally expected, and the Fed faces a situation where achieving full employment may cause them to overshoot inflation goals. What does *winning* and *losing* look like in this economic Squid Game?

- **Winning** - the Fed succeeds at achieving full employment while keeping longer term inflation close to their 2% target (not the most likely outcome)
- **Muddling Along** - the Fed gets close to achieving employment goals but sacrifices its ability to keep long term inflation close to 2% (a more likely outcome)
- **Losing** - we get *higher than expected* long term inflation which forces the Fed to Raise interest rates, leading to a recession and higher unemployment (the worst outcome)

What's Behind All the Shortages?

Although some of the current shortages are transitory in nature, they have proven tricky to solve quickly.

Labor Shortages

Worker shortages are prevalent all over the country for a wide variety of reasons.

- Stimulus checks issued during the pandemic meant some workers could be paid more staying at home.
- While at home, workers had time to reflect on their circumstances and decided low pay, long hours and commutes were something they wanted to avoid if possible. Some people pursued self-employment. Fearful of getting Covid or infecting others, some workers were reluctant to look for new jobs.
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- During the pandemic, parents stayed at home to care for children who couldn't attend school. Now, some parents are reluctant to return to work as they are unsure that the schools will stay open.
- The supply of workers was hampered by reduced immigration and unprocessed work visas.
- Laws requiring interstate truck drivers to be 21 exacerbated shortages of truck drivers.

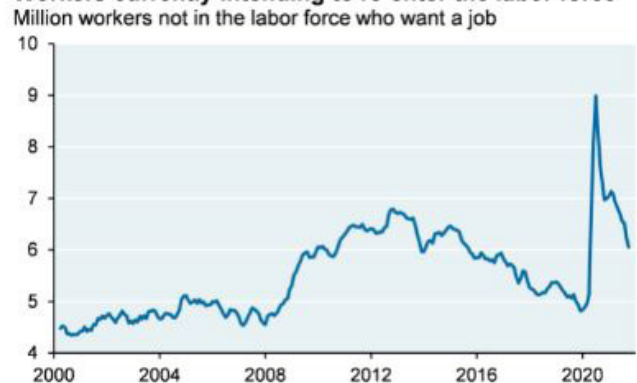
The charts below provide a visual representation of why people have left the labor force and the falling number of people intending to return.

Worker shortages: other departures



Source: BLS, Census, GS, JPMAM. October 2021.

Workers currently intending to re-enter the labor force



Source: BLS. September 2021.

Commodity Shortages

While new trees can be planted to address lumber shortages, and new container ships can be built to transport goods, these activities take time.

Increasing energy production is even trickier. First, the lack of investment in fracking in the U.S. (due to ESG mandates and climate concerns) hampered the shale revolution that was responsible for the last decade of lower energy prices. Second, how much oil is actually in the ground? As we have written previously, many geologists believe that the Ghawar field in Saudi Arabia is in decline, and we haven't found any new shale basins in the U.S. since the Permian discovery (which may be the only U.S. shale play not yet passed its peak). In the short term, strategic oil reserves can be used, and OPEC+ can pump more, but the elephant in the room is longer term supply shortages. Will alternative sources of energy get there soon enough? Many experts think not.

Although demand from China is expected to decline in response to its overbuilt housing sector, the strong demand for copper elsewhere coupled with a dearth of new mine supply, points to a copper bull market for most of this decade. Renewable energy and electric vehicles are both very copper intensive, and many countries need to add copper to their installed base for electricity distribution.

Supply Chain Issues and Port Congestion

- **Covid** reduced the number of available workers in manufacturing plants, and some plants completely closed, making it impossible to keep up with normal demand.
- Many businesses **reduced inventories** over recession concerns in 2020.
- The government put money in people's pockets, and inability to spend money on services such as travel and leisure led to **increased demand for goods**, especially home and garden products. Now we have increased demand, which in combination with reduced supply leads to higher prices.
- There is a **limited worldwide supply of container ships**. During Covid, port workers weren't available to offload containers which slowed down the entire shipping apparatus. Some of the issues are related to labor and scheduling. Further, the California emission standards have exacerbated a truck shortage - disallowing non-compliant trucks from unloading at the major ports of LA or Long Beach. In an effort to solve the problem, transportation companies are using low emission trucks to unload goods and take them to the California state line where they are transferred to non-compliant trucks.

Inflationary Pressures

- **Labor** – businesses may never fill all their jobs until both wages and workplace environments improve or immigration increases. Amazon is being proactive by paying worker \$22 an hour and improving their lives by sending them to college. And while we applaud this social good, the effect is inflationary and sticky.
- **Commodities** – production of many commodities has long lead times. There will continue to be a gap between increased demand and the arrival of increased supply leading to higher prices for longer. In some cases, the ultimate supply of the commodity may be a limiting factor.
- **Supply chain woes** – seen as likely to reverse over the next year or so. The Biden administration is taking steps to alleviate the port congestion in California and companies are actively working to fix supply issues. As the economy opens up further, there will likely be a shift from buying goods to services, reducing some of the demand pressure.
- **New and existing home prices** have been on a tear, due to low interest rates and lack of supply. Millennials reaching the age of household formation create demand pressure for single family homes, and higher shelter costs aren't easily reversed without a recession.

Mitigating Factors

- **Productivity growth** – businesses turned to technology and other cost savings to produce more with less labor. In fact, 2021 U.S. GDP exceeds that of 2019 while having 5 million fewer workers. Productivity growth is the primary antidote to inflation.
- **Demographics** – aging populations spend less money, reducing demand for goods and services.
- The shift to '**work from anywhere**' may be part of the housing solution as the millennial generation can now move to more affordable locations.
- **International trade**, while shifting, still provides cost efficiencies for companies.

We conclude that although it is still too early to declare higher inflation structural or long lasting, it is prudent to prepare your portfolios for the risk.

3rd Quarter Market Trends

The market constantly grapples with the very issues we present here. Moderate inflation is good because it is associated with economic growth, but too much inflation causes problems and hurts the very growth stocks that shone in the 3rd quarter. Price earnings ratios for faster growing companies often fall as inflation increases because most of their earnings occur further in the future.

Although underlying stock indices such as the S&P 500 were pretty flat for the quarter, a great deal of churning occurred below the surface- with the average stock down 18% from it's high. Only the performance of the largest companies kept the S&P on an even keel.

The Market has been less 'resilient' under the surface

Index	YTD Return	% of members with positive YTD return	% of members with with at least -10% drawdown from YTD high	Average member drawdown from YTD high
S&P 500	16%	81%	91%	-18%
NASDAQ	12%	63%	90%	-38%
Russell 2000	13%	67%	98%	-34%

Source: Charles Schwab, Bloomberg as of 10/12/21

Outlook Into Year End

In equities, we continue to have a barbell approach - growth on one end balancing commodities on the other. In individual stock portfolios, we prefer companies who can benefit from rising prices and protect margins by either growing faster or raising prices. Energy, materials, and financials are our preferred sectors.

The bond market remains unattractive with negative real yields and the threat of rising interest rates. Although history doesn't repeat itself, it often rhymes. If inflation is structural, given the level of U.S. debt, yield curve control is not out of the question. We remind you of what happened in the 1940s when the Federal Reserve placed a 2% cap on interest rates.

Year	3-Month Treasury Bill (%)	10-Year Treasury Yield (%)	Inflation Rate Y/Y Pct. Chg. (%)	Federal Surplus/Deficit As Pct GDP	Corporate Spreads (bps)	S&P Return (%)
1940	0.04	2.20	0.7	-3.0%	64	-9.6
1941	0.13	1.99	5.1	-4.3%	78	-11.6
1942	0.34	2.11	10.9	-13.9%	72	20.1
1943	0.38	2.07	6.0	-29.6%	66	25.6
1944	0.38	2.09	1.6	-22.2%	63	19.5
1945	0.38	1.73	2.3	-21.0%	90	36.3
1946	0.38	1.74	8.5	-7.0%	79	-8.0
1947	0.60	1.85	14.4	1.7%	76	5.6
1948	1.05	2.15	7.7	4.5%	67	5.4
1949	1.12	1.93	-1.0	0.2%	73	23.6
1950	1.20	2.05	1.1	-1.1%	58	32.6

Source: Strategas Research Partners, LLC.

As Netflix contemplates another season of 'Squid Game', the Fed would like the economic Squid Game to come to a successful conclusion.

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