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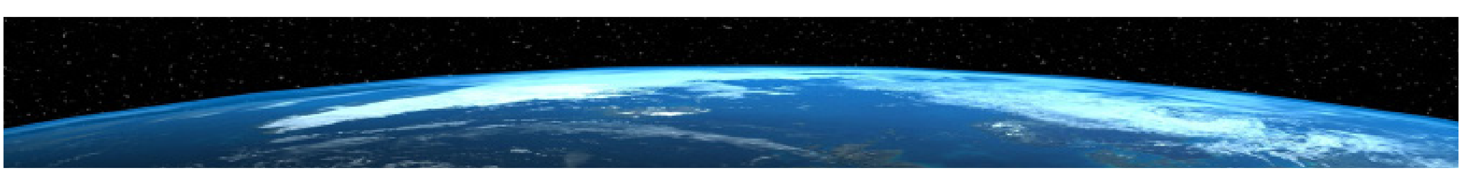
GLOBAL MARKET COMMENTARY



EDITORS

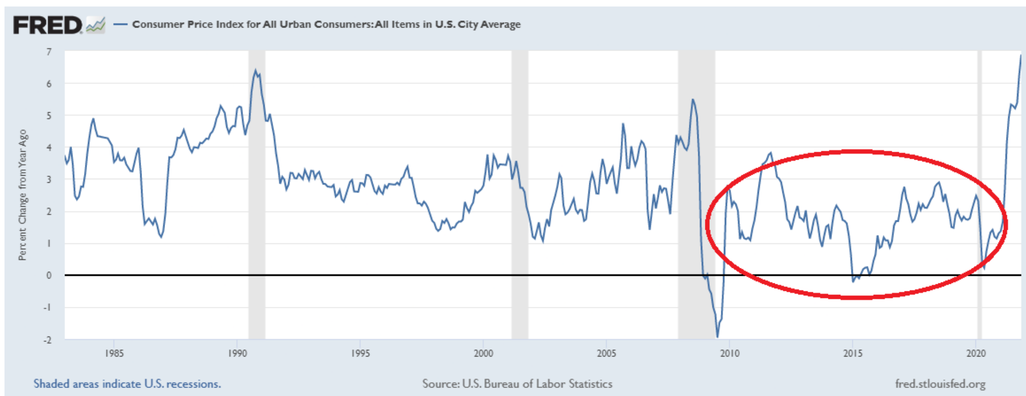
MONTY GUILD
Founder

ANTHONY DANAHER
President

RUDI VON ABELE
Senior Research Analyst

How Inflation Can Persist… Even If Supply Issues Moderate

Inflation remains in the front of everyone's minds -- the Fed, investors, business owners, and consumers. It's interesting to note that inflation was *much less* in everyone's mind during the long period of unusually *low* inflation that followed the Great Financial Crisis. This psychological fact explains a key difficulty faced by the Fed in its critical management of "inflation expectations."



Source: Federal Reserve Bank of St Louis

The fields of behavioral economics and behavioral finance explain some of the psychological features of economic and market behavior. One of these is "rational inattention" -- which means that economic and financial agents are likely to ignore information that would be costly to acquire, but that really doesn't have a very severe negative impact on them.

Even though a decade of inflation undershoot was strange and interesting to professional economists, and prompted all kinds of research and questions in think tanks and government agencies, consumers and businesspeople didn't think much about it on average. (In fact, surveys show that when inflation is low, ordinary people tend not to even know what the prevailing level of inflation is.) On the flip side, though, this means that consumers and businesspeople pay *more* attention than might be objectively warranted when inflation is running in a more painful direction, above trend.

Where this factors into the Fed's quandary is that, contrary to the discoveries of behavioral economics, Fed models sometimes still presuppose that economic agents are purely rational -- while of course we know they are not. The Fed models "inflation expectations" as if consumers, investors, and business owners respond equally to below-trend and above-trend inflation -- assuming that they will look at current inflation, rationally assess that it is "balancing out" the inflation "deficit" accumulated in the post-2008 years, and come to the conclusion that it's all water under the bridge. **Unfortunately, this is not how people's minds work unless they are professional economists.**

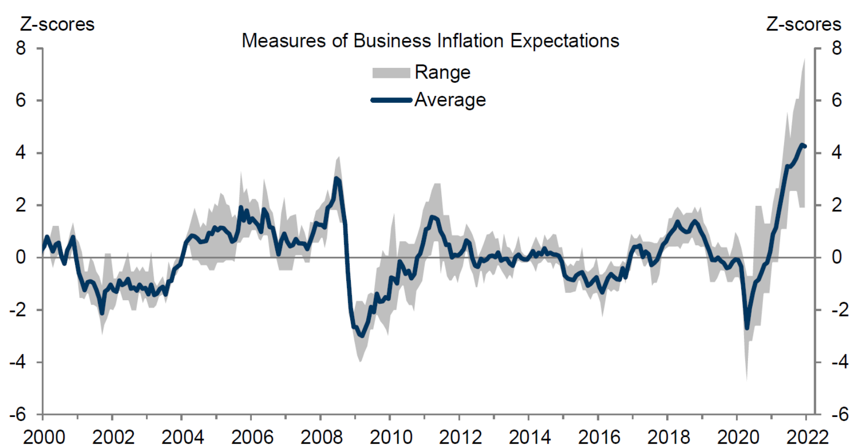
Indeed, research shows that ordinary people are about four times more sensitive to high inflation than to low inflation. **This means that as the current inflation shock continues, it becomes more and more likely that higher inflation expectations will get baked into the economic pie.**

Even if supply chain issues resolve fully, even if labor force dislocations ease, and even if spiking energy prices normalize (as we think is likely), inflation can still become a self-fulfilling prophecy if a wage-price spiral gets psychologically imbedded. This is why many observers are worried that the Fed has missed the boat, and will be forced to taper and hike more quickly than generally anticipated -- with the risk of sparking market and/or economic turmoil as a consequence.

(The question then is whether the Fed will have the backbone to stay the course if markets and the economy connipt. It may well be that the market's thus-far largely copacetic response to tapering and rate hike talk incorporates a view that such backbone will not be visible when push comes to shove.)

The Fed recently began measuring inflation expectations -- but its measurement gives much more weight to long-run than to short-run expectations. This is likely unrealistic. One way or another, higher short-term expectations and lower long-term expectations must converge -- and it is not obvious to us that this will happen by short-term expectations falling. Psychology suggests the opposite could occur. Further, the Fed's modelling does not factor in *businesses'* inflation expectations because of data limitations -- but these might be the most important of all, and they are running at 20+ year highs:

Exhibit 6: Business Inflation Expectations Have Reached the Highest Level in at Least Two Decades



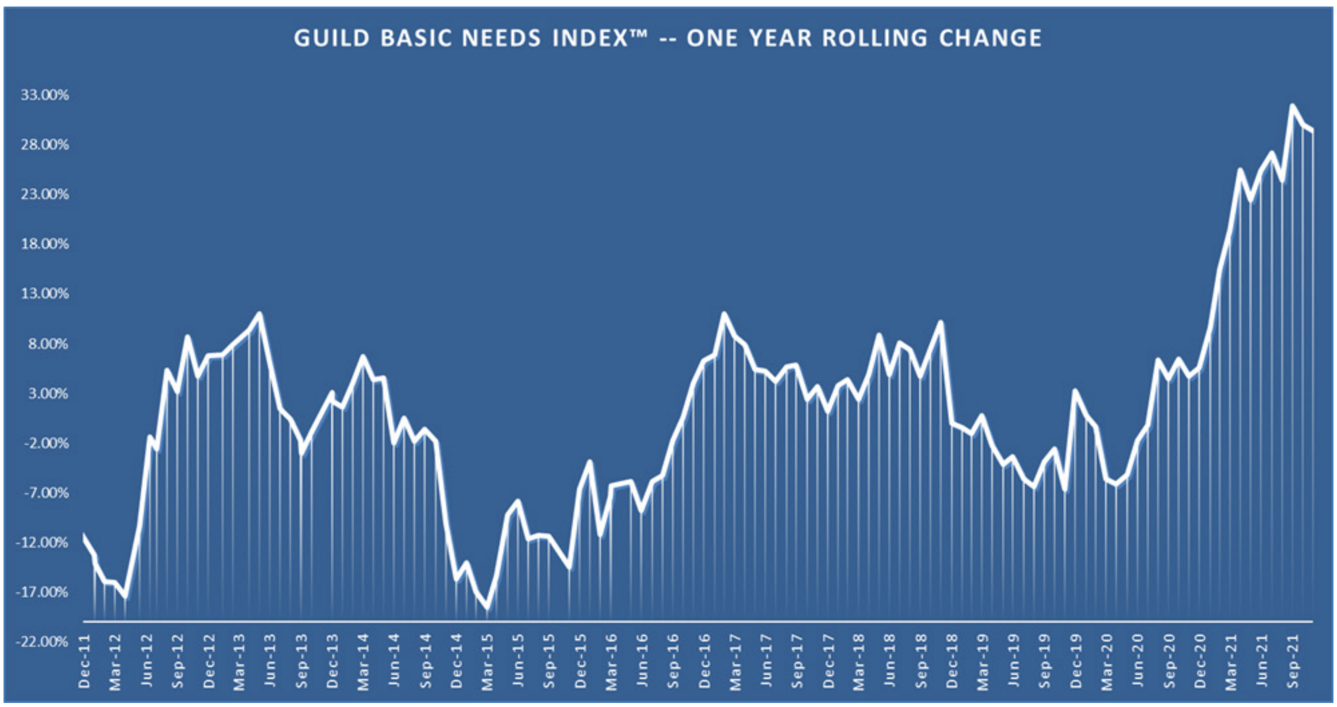
Source: Goldman Sachs Investment Research

The bottom line? The Fed's "rock and a hard place" problem is that the longer it makes the normalization process, the more likely that inflation gets imbedded even if pandemic snarls are untangled -- and the more likely it becomes that precipitous Fed action will result in an "accident" that puts nor-

malization on hold. Factor in the need to appear moderate and non-partisan in a critical election year, and the Fed's window is compressed still further, likely into the first half of 2022.

Meanwhile, In the Guild Basic Needs Index

Our in-house, real-world inflation measure, the Guild Basic Needs Index [GBNI], is comprised of a basket of consumer essentials: food, clothing, energy, and housing -- and thus captures a faster-moving snapshot of the "volatile" elements excluded from such measures as "core" CPI. (We've been compiling it since the 1980s, and so have watched it through many cycles -- you can find a more detailed description here.) November GBNI data show our index slightly off its high of two months ago, **currently running at 29.4% year-over-year.** Below is a ten-year chart of the one-year rolling change in the GBNI.



Index Comparisons For The Period Ending: 11/30/2021

	1 year	5 years	Since 1/1/2000
Guild Basic Needs Index ™			
Estimated Total Change For The Period:	29.4%	44.5%	131.2%
Annualized Change:	29.4%	7.6%	3.9%
U.S. Consumer Price Index			
Estimated Total Change For The Period:	6.8%	15.2%	65.2%
Annualized Change:	6.8%	2.9%	2.3%

The GBNI is volatile, as it is comprised of a basket of items with volatile prices. Given the asymmetry of the psychological effect of above-trend inflation on consumer and business psychology, the current elevated GBNI trend suggests that concern about the "unanchoring of inflation expectations" is warranted.

Investment implications: Because businesses and consumers pay more attention to unusually high inflation than to unusually low inflation, the current bout of elevated inflation is making it more and more likely that inflation expectations will become unanchored from the quiescent assumptions of the post-2008 era. To forestall this unachoring, the Fed is pivoting to more hawkish language and policy forecasting. Their window for action is restricted in part by political pressure, and some market participants may be pricing in the risk that they act too fast, and will be forced by resultant volatility to delay further policy normalization. Watch out for inflation and policy-driven volatility and rotations, especially in the first half of 2022.

Market Summary

With all the reflection and analysis we've been offering about inflation over the past year, we should emphasize again that **we do not believe the U.S. is headed for hyperinflation or any imminent financial catastrophe.** While we think the very long-term trends of spending, unfunded liabilities, and corporate and government indebtedness are troubling and are likely to lead eventually to cathartic events, we do not believe such events are likely in the near future.

Right now, in the big picture, U.S. stocks remain in a credit-led bull market, underpinned by massive liquidity. In the nearer term, as we noted in our "year-ahead" reflections, we think current events are likely to create a more volatile environment in the coming year, offering tactically minded investors the opportunity to sell ramps, buy dips, and rotate among sectors -- though all of these movements have become more rapid and difficult to navigate successfully.

In December 2019, U.S. bank deposits (earning virtually no return) totaled about $14.5 trillion; **at the end of June 2021, that stood at about $18.7 trillion.** This is far from the only potential source of "cash on the sidelines" that can step in to "buy the dips" as they occur (money market funds are another). We believe this reality will help to constrain the depth and duration of corrections. **The pool of capital earmarked for risk assets is growing, and the hunger for yield of the biggest institutional market participants (pension funds and insurance companies) is as high as ever.**

Major analysts are beginning to ratchet back their GDP growth projections for 2022, largely because of the failure of the current administration's push for their

Build Back Better spending bill. We think it is likely that a smaller version of this plan will be passed next year; West Virginia Senator Joe Manchin is said to have been positive on a more conservative bill.

Turkey

Ongoing monetary chaos in Turkey continues to illustrate several points for us, beyond the point that demagogues and would-be despots are unlikely to be sources of groundbreaking new monetary and economic theory. (Turkey's Prime Minister seems to believe he has discovered an economic Holy Grail, to wit: the way to combat hyperinflation is to cut interest rates.)

The first point is that the global use case for cryptos is enhanced by the policies of despotic and destructive governments. As we noted last week, we think that the first sidelining of a formal financial system by crypto is likely to occur in a state with failed financial infrastructure. Unfortunately such failure is typically accompanied by political repression.

The second point is that even in situations of monetary intransigence, locals who have no recourse to foreign currencies, cryptos, or hard assets, can have recourse to local stocks. Albeit with great volatility, stocks in countries like Venezuela, and now Turkey, have kept some kind of pace with inflation, permitting some value to be maintained.

American investors for whom our qualitatively different inflation dynamics are a concern would do well to note this as well: **stocks can perform well in an inflationary environment -- you just have to adjust your portfolio to manage inflationary risk.**

We are attentive to the opportunities that will be created by expected market volatility. We believe that cryptocurrencies, gold, some commodities, growth stocks at a reasonable price, and certain large-cap growth stocks are going to be attractive buys when volatility occurs. Don't hesitate to call our office if you have questions on strategy.

Thanks for listening; we welcome your calls and questions.

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