



There's No Such Thing As A Free Lunch

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"There is no such thing as a free lunch." It's been attributed to many different people, Milton Friedman and Robert Heinlein, among others. Regardless of who said it, we think it's one of the most basic economic truths.

A lunch has to come from somewhere, and once it is consumed, it's not available for someone else to consume. 'Another way to say it, someone needs to produce what we consume. Supply comes before demand. Without supply – without production – we have nothing to bring to "the market" in exchange for something else. In Venezuela, production has plummeted due to socialist government policies, while inflation and hunger run rampant.

And the US is facing problems as well. Recent reports show a huge gap between supply and demand, a gap that can't go on indefinitely. Retail sales in the US, a measure of demand, fell off a cliff in March and April, bottoming 21.7% below the level in February. Since then, retail sales have rebounded sharply, rising 18.2% in May and 7.5% in June. Amazingly, retail sales are now 1.1% higher than a year ago, during a time where unemployment has climbed from 3.7% to 11.1%.

By contrast, industrial production – one proxy for supply – hasn't done as well. Industrial production fell a combined 16.6% in March and April and has since risen a more modest 6.9% combined in May and June, leaving it down 10.8% from a year ago.

How can Americans go out and buy more when they're making less? The answer: borrowing from the future through government deficits. Government transfer payments in April and May, combined, were up 86.7% from a year ago due to COVID spending on "tax relief" checks that have been sent out by the IRS, as well as a surge in unemployment compensation, mostly because of more people collecting benefits, but also because benefits were increased substantially.

As a result, government transfer payments made up 30.6% of all personal income in April and 26.4% in May. Let's say that again...government made up over 25% of all personal income in May!! From 2015 through February 2020, government transfers averaged roughly 17% of all consumer income. Prior to the Panic of 2008, transfer payments averaged 14%. This year, government transfer payments have been so generous that they've more than offset declines in wages & salaries and small business income.

Normally, the gap between the growth in retail spending and industrial production would be a sign that something is systematically wrong with the economy, and higher inflation is not long to follow. The only way people can spend more without producing more is if they're spending inflationary dollars. That's not a free lunch; it's just that the cost of the lunch is paid for by reducing the value of all the money we use. (Sneaky, sneaky.)

The Federal Reserve has all but promised to remain loose for the foreseeable future. We haven't seen this kind of monetary policy since the 1970s.

Consumer prices rose 0.6% in June, although, given steep price declines in March and April, consumer prices are still up only a modest 0.6% from a year ago. So we don't have deflation, but for now signs of runaway inflation remain scarce.

One reason is that the personal saving rate has surged. The personal saving rate is the share of our after-tax income that we don't spend on consumer goods or services. It hit 32.2% in April, the highest level on record - by far - going back to at least 1959. The next highest level was 17.3% in May 1975, and the average rate last year was 7.9%. The saving rate remained at a still elevated 23.2% in May.

The fact that people are not rushing out all at once to spend their transfer-padded incomes has helped keep inflation in check. The gap between consumer spending and production has also come in the form of big reductions in business inventories, a reduction that can't continue forever (eventually, we'd run out of inventories to reduce).

We aren't looking for hyper-inflation, but we do think the Fed is likely underestimating future price increases. The Fed

expects the PCE deflator to rise 0.8% this year, 1.6% in 2021, and 1.7% in 2022. We'd take the OVER on all three.

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