It's my favorite time of year again where every single day involves celebrating something else for one of our kids. End of school activities, prom, graduation, senior night, school plays, National Participation Trophy Day, etc. Congrats on doing what you were legally required to do!

Our eldest son had a signing day last week – he's going to play college volleyball in San Diego. Super exciting. I left work early, drove almost an hour to his school, and we all watched the signing. Guess who he thanked first in his speech? His buddy on the team. "I'd like to thank Neal for playing volleyball with me since 8th grade." He eventually got around to thanking my wife, but only because *she's been his coach since he was tiny.* That's it. That was his list.

Because coaches were also speaking on behalf of the athletes, when my wife took the stage she actually started with, "I'm sure he also meant to thank his entire family for being so supportive through all his tournaments and long weekends. They're sitting right here…" Thanks, Coach.

Kids…if you show up, they barely acknowledge it. But if you don't, they'll be in therapy forever.

Is this what being a curmudgeon feels like?

Last Week This Morning

- 10 Year Treasury back up to key level of 1.62%
    - German bund up to -0.13%
- 2 Year Treasury unch at 0.145%
- LIBOR at 0.09%
- SOFR at 0.01%
- CPI came in at a 13 year high, 4.2%
- Retail sales came in flat vs an expected 0.8%
- Consumer sentiment actually fell sharply, likely impacted by inflation expectations climbing
- If it was hard for a grocery store worker to pick a fight over masks, imagine how much harder it will be to question whether someone has been vaccinated

Don't Call Me, I'll Call You

April CPI came in at 0.8% vs a forecasted 0.2%. Annual CPI increased from 2.6% to 4.2%.

Core CPI increased 0.9% vs an expected 0.3% - the biggest jump since 1981. Hyperinflation is on the way!

What goes up must come down. The higher inflation gets this year, the more it will pull back next year. Inflation doesn't go up in a nice linear fashion forever!

Nearly 60% of the increase came from just five components – used cars, lodging, rental cars, airfare, and eating out. Used cars and truck prices were up a staggering 10%, comprising almost a third of the total CPI jump. That's not sustainable over the long term. Compared to April 2019 (two years ago), inflation is up 2.2%.

More likely, we are experiencing a temporary shock of re-opening all at once, just like we experienced a temporary shock of shutting down a year ago. Remember when there was a toilet paper shortage? Demand exceeded supply. Same thing is happening now across multiple supply chains. You think Chick-Fil-A won't figure out how to fix its shortage of sauce? These disruptions will be resolved.

If everyone wants to buy a car or hire employees simultaneously, there will be a temporary surge that feels like everything is going to the moon and there's not enough supply to satisfy demand. But we will work our way through that slack and eventually normalize.

It's also likely to be uneven. A spike one month, followed by a down month. For example, I wouldn't be surprised to see a surge in hiring around September when schools open and enhanced unemployment runs out. But you can't take those numbers and extrapolate into perpetuity.

GDP is forecasted to come in north of 10% for both Q2 and Q3, then settle down to 4% by year end. That makes total sense, right? Yet when it comes to inflation, we expect it to rise forever. This cognitive dissonance causes markets to overreact to inflation data.

The Fed isn't going to overreact to these spikes. And Powell has made it clear he is prepared for several months of this. If we're still experiencing higher than expected inflation at year end, *and* if the labor market has recovered faster than expected, we may need to revisit the Fed's timeline to remove accommodation.

Until then, we should be prepared for knee jerk market reactions followed by a "simma down now" response from Powell. The Fed isn't removing accommodation any time soon and will allow the economy to run hot for an extended period of time.

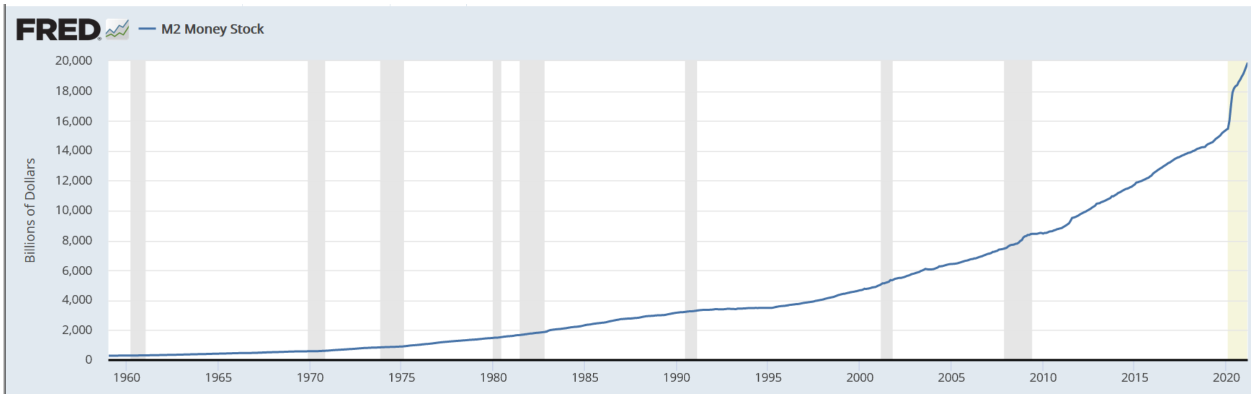
"Don't call me, I'll call you" – Jay Powell to the market.

Mo' Money, Mo' Inflationary Problems

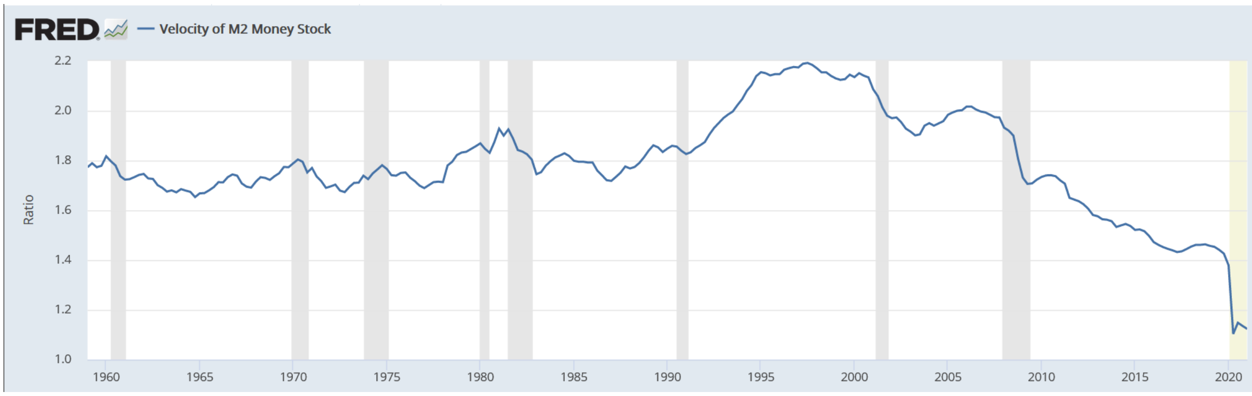
One interesting thing to watch is inflation expectations. We've described inflation as a self-fulfilling prophecy. If you think prices are going up, you buy now. That increases demand and pushes prices up.

The University of Michigan 1 Year Inflation survey came in at 4.6% vs expected 3.5% - expectations are rising. There's an element of psychology to that. I wonder how surging home prices, lines at the pump, employee shortages, etc. are all factoring into the *perception* of inflation, even if that inflation ultimately fails to materialize?

One of the most commonly cited catalysts for inflation is money supply, which is at an all-time high thanks to accommodative policies and stimulus. Intuitively, this makes sense. Mo' money, mo' inflationary problems.



But money needs to exchange hands in order for inflation to materialize. The speed at which money changes hands is called the velocity of money supply. Velocity has collapsed. All that money being printed is sitting on balance sheets, not exchanging hands.



I know I know, readers of this newsletter are experiencing inflation. But just because *we* are experiencing inflation doesn't mean *everyone* is. We're able to absorb higher prices because we are using leverage, and that leverage is costing us basically 0%. Plus, we've had a solid decade long-run aided by ZIRP and multiple rounds of QE. Our industry is not representative of the typical middle class.

Deal volume would cool immediately if rates went to 5%. Subcontractors would be begging for work, lumber prices would collapse, etc.

The Fed says it can cut off inflation if needed. If the Fed hiked Fed Funds to 5% overnight, what would the resultant impact be on our industry?

I think it would be severe and that concerns about inflation would evaporate. Powell can throw a bucket off cold water on inflation if need be, but it's way harder to create it.

Week Ahead

The Atlanta Fed's Financial Markets Conference on Monday and Tuesday may give Vice Chair Clarida an opportunity to clarify the Fed's reaction to the inflation data last week.

Dallas Fed President Kaplan has four speeches, which is notable because he is leading the charge on "we should begin discussing tapering".

We also get the minutes from the April FOMC meeting, but I don't expect much to come from it. That pre-dated the recent spike in inflation data, so the Fed thinking may feel stale to markets.

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