

ECONOMY

Credibility
in Peril

THINK STRATEGICALLY:

How did the Fed Get Inflation so Wrong?

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The Basic Basket

The basic basket is the set of goods and services essential for a person or a family to meet their basic needs; in other words, a basic basket has all the necessary products for a healthy life both physically and mentally. Analyzing the basic basket and its cost per month in Puerto Rico reveals it is \$161.26 versus a \$2,111 average salary, representing 7.63 percent of total compensation.

As high as it may seem when we look at other economies in Latin America, Argentina has the highest percentage of basic basket cost to per capita income with a basic basket of \$71.82 versus a per capita income of \$215, which represents 32.4 percent of the total salary to meet the basic basket. The second highest is Colombia, with a basic basket of \$58.58 to per capita income of \$258, or 22.7 percent of the average salary. As we begin our discussion about inflation,

we emphasize that these increases affect everyone, with the lowest earners suffering the worst impact.

The U.S. economy has two inflation readings that determine the rise of inflation:

1. U.S. Consumer Price Index, or CPI: Measures the average change from time to time of the prices paid by urban consumers for a market basket of consumer goods and services. The CPI is now at 7.04 percent, compared with 1.36 percent last year, a 417.6 percent rise.

2. U.S. Personal Consumption Expenditures Price Index, or (PCE): Measures the prices that people who live in the United States pay for goods and services. The index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. The PCE is now at 5.79 percent,

compared with 1.29 percent last year, a 348.83 percent rise.

To present the proper perspective, the Federal Reserve has indicated that its target inflation reading is 2 percent, and the preferred index for this reading is the PCE. Well, since April, the CPI and PCE have been above the 2 percent target rate; the CPI rose to 2.96 percent, and PCE rose to 3.58 percent. At the time, the Fed maintained that the increases would prove to be temporary in nature and maintained the same stance all through the year, even when evidence was building that inflation would prove to be persistent. In a non-pandemic situation, the Fed would have swiftly raised rates to begin to curb the inflation readings; what changed this time?

For one, COVID-19, with the expressed intention of the Fed to wait until the United States reached full employment before acting so that the economic recovery would not be affected.

While we understand these issues, we do not comprehend why the Fed maintains its asset purchase program when all indications are it must be eliminated at once. So, that correctly positions the market for four or five interest rate increases; not doing so continues to affect the Fed credibility.

Another item that needs explanation is how the Fed allowed itself to react wrong and so late to the inflation increases, with eight months of continuous CPI and PCE readings that were double or triple its desired target rate, another reason for suffering a loss of credibility.

If the Fed chooses to regain its credibility and control the economic narrative again, it must explain these mishugas and act decisively.

In October, the PCE reached 4.58 percent, or 129 percent above its target rate of 2 percent; by then, unemployment had fallen to 4.6 percent, well below the long-term average of 5.76 percent, with claims for unemployment way down.

Our point is that all the available data used directly by the Fed suggested quite strongly that monetary policy had to change from accommodating to stimulative. Instead, it maintained the pedal

to the metal longer than it should have.

During a November release by Fed Chair Jerome Powell, he removed the transitory inflation label, accepting that the Fed had been wrong for most of 2021 about inflation pressures and missed vital opportunities to curb it. In our view, the Fed has no other option than to raise rates in March; however, to restore its damaged credibility, it must explain in great detail how it fumbled the inflation numbers so severely and for at least eight months. Whatever the outcome, this Federal Reserve and its members shall be remembered as the worst inflation preparedness in history.

After having grown even with dramatic supply chain limitations at a rate of 6.9 percent, the economy will absorb at least four rate increases easily.

The Week in Markets: The Fed's loss of control alters investor sentiment; volatility takes over.

The U.S. stock markets ended the week recovering some of the ground lost during one of the most volatile weeks in recent history, which was fueled by the stock and asset rotation out of growth and into value driving the market. The negative sentiment is so strong that neither Apple nor Microsoft's outside earnings have stabilized the tech stocks or the broader U.S. markets.

The Fed is expected to begin raising rates by March. When that happens, it will be the first time the Fed raises rates since 2018; it is forced to do so to curb inflation that is spiraling out of its control.

We had one of the most volatile weeks in some time. It ended with a solid rally, and while the Fed plays a part, the most significant is the stock and asset rotation that has been happening for some time now.

Again, the other issue of importance for markets has been the Fed's credibility loss because of its "temporary inflation" stance. It lost total control of inflation—the last straw being the report this week of the preferred Fed inflation index, the U.S. PCE Price Index, which

rose to 5.79 percent, a whopping 136.32 percent since March last year. Our view is that to curb inflation, the Fed will be forced to raise rates, in my opinion, 4 or 5 times in 2022, if not more.

Wall Street summary for the week of January 28:

- Dow Jones Industrial Average: closed at 34,725.47, up 460.1 points, for a year-to-date (YTD) return of -4.44 percent.
- Standard & Poor's 500: closed at 4,431.85, up 33.91, or 0.77 percent, for a YTD return of -7.01 percent.
- Nasdaq Composite Index: closed at 13,770.57, up 1.65 points, or 0.01 percent, for a YTD return of -11.98 percent.
- Birling Capital Puerto Rico Stock Index: closed at 3,053.46, down 17.2 points, or -0.56 percent, for a YTD return of 0.53 percent
- The U.S. Treasury 10-year note closed at 1.78 percent.
- The U.S. Treasury 2-year note closed at 1.15 percent.

The Final Word: Corporate Earnings Parade

Fourth-quarter (4Q) earnings are expected to rise 23 percent, and full-year earnings are expected to increase 50 percent for most S&P 500 companies; below, we share three companies that hit it out of the park with their quarterly earnings and full-year numbers.

- Apple, Inc. (AAPL): 1Q22 earnings beat expectations with revenues of \$123.9 billion, up 11 percent, and net income of \$34.6 billion, up 20.43 percent. The stock closed at \$170.33, up 6.98 percent.

- Microsoft (MSFT): 2Q22 earnings beat estimates with total revenues of \$51.7 billion, up 20 percent, and net income of \$18.8 billion, up 21 percent. The stock closed at \$308.26, up 2.81 percent.

- Popular Inc. (BPOP): 4Q21 earnings saw net income of \$206.1 million, while full-year 2021 net income was \$934.9 million, an 84.54 percent increase. The stock closed at \$88.15, up 2.12 percent.

Francisco Rodríguez-Castro is president and CEO of Birling Capital LLC. Think Strategically© is a publication by Birling Capital LLC that summarizes recent geopolitical, economic, market and other developments. This report is intended for general information purposes only and does not represent investment, legal, regulatory, or tax advice. Recipients are cautioned to seek appropriate professional counsel regarding any of the matters discussed.

Weekly Market Close Comparison	1/28/22	1/21/22	Return	YTD
Dow Jones Industrial Average	34,725.47	34,265.37	1.34%	-5.70%
Standard & Poor's 500	4,431.85	4,397.94	0.77%	-7.73%
Nasdaq Composite	13,770.57	13,768.92	0.01%	-11.99%
Birling Puerto Rico Stock Index	3,053.46	3,070.66	-0.56%	1.08%
U.S. Treasury 10-Year Note	1.78%	1.75%	1.71%	1.15%
U.S. Treasury 2-Year Note	1.15%	1.01%	13.86%	15.00%