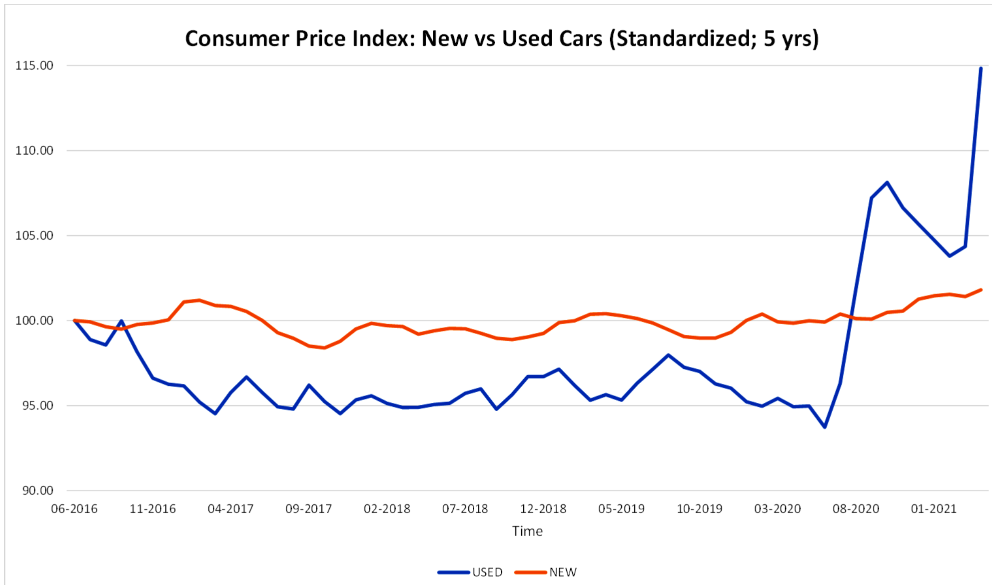
FOUNTAINHEAD INSIGHTS

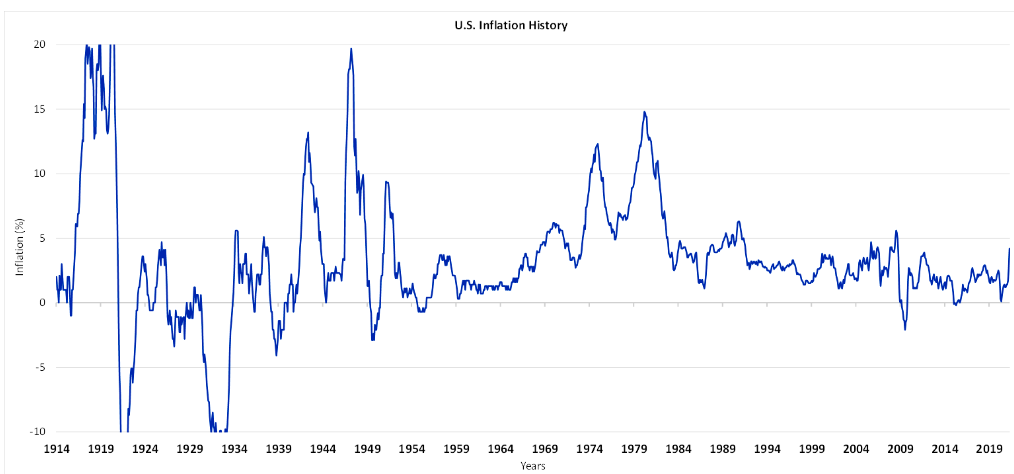
Market Commentary: Is Inflation Transitory? What We Learned from Used Cars
May 2021

Typically, a new car loses one-third to one-half of its value the second you drive it off the lot – it instantly becomes a used car. However, not this season! Used cars are hot (blue line below) with price increases of well over 20% in the past year. Prices are inflated. A brand-new car (orange line) is a touch more expensive compared to a year ago. Relative pricing has gotten to the point where one can sell their used car and buy a brand-new model for a very similar price – if one is willing to wait for delivery. And there perhaps, is the catch. [1]



Inflation has been a concern this year and the big question is whether it is transitory or here to stay. The Fed actively works to keep inflation in a relatively tight range as historically speaking, once inflation gets really hot it has a way of spiraling out of control. The reason for the spiral is logical: If your money buys materially less goods tomorrow, you better buy it today, which simply spikes demand. Unfortunately, deflation can also spiral out of control and is believed to be harder to climb out of – note Japan. In deflation, falling demand leads to business losses followed by falling prices and, well the spiral goes on. Check out a related graphic in our *Money! Explorations* from Q3 2020 for more detail (link in footnote 2).

From a big picture standpoint, the world has been fighting deflationary sources for over a decade now. The Fed has noted its inflation target of 2% - 2.5% but hasn't been successful in surpassing a longer-term average of 1.5% over the last decade. We have spoken about some of the main factors behind the inability to increase growth which is one factor that can lead to inflation inclusive of demographics and lower than typical productivity[2].



[1] Source: U.S. Bureau of Labor Statistics via Fred.Stlouisfed.org

[2] [2021_Q1-Explorations.pdf (fountainheadam.com)](); [2020_Q3-Explorations.pdf (fountainheadam.com)](); For all of our insights: [Insights | Fountainhead Asset Management (fountainheadam.com)]()

Covid was a huge deflationary event. It is why the government pumped $4 trillion into the economy. Covid also disrupted supply chains, consumer behaviors and global trade. Purchasing trends in recent history have been relatively slow-moving allowing for real benefit from just-in-time manufacturing[3] and the ability to source the lowest cost inputs globally, further optimized by tech driven analytics. Corporate genius got thrown out the window once everyone needed toilet paper the second Covid came to our shores[4]…

As can be seen below, car sales fell off a cliff when COVID occurred. Once demand came back, however, car companies ran into supply chain issues, such as chip shortages, resulting in a lag of new car production. Noticeably, despite heightened demand, new car prices have been relatively stable as the cost drivers haven't increased significantly; it is just a lack of temporary supply. If you need a car right now, though, you need to get a used car.

Meanwhile, used car inventory was already tight as many lease holders extended their lease during Covid. And that is where there is a perfect storm that has led to demand vastly outpacing supply for used cars. As can be seen from the first chart, the used car market is more volatile than the new car market. Once the new car market solves its supply chain issue one can expect the used car market to come back to earth as a consumer should always prefer a new car over a used one given a similar price point. It feels transitory.

On a shorter-term basis, some of the characteristics that point to a transitory inflation spike (which is fine or even good) include:

- **Faulty year over year comparisons**: Most measurements are standardized by comparing to a year ago period. Any statistic comparing to a year ago is worthless given the disruption Covid wreaked. It is simply a headline number worth catching people's attention with.
- **Supply chain disruptions**: Many economies shut down for a period and others materially restricted flow, resulting in massive disruptions to what was a well-oiled global trade machine. This has been exacerbated further by a couple events, most recently that of the tanker getting stuck in the Suez Canal.

[3] Lean manufacturing - Wikipedia
[4] This is qualitative. Our crack analyst team could not find a graph to illustrate this.

- **Short-term pent-up demand**: For a multitude of reasons, including saved money, travel and leisure will most likely pop over the next year or so. At some point, though, one would expect a return to average consumption.

Longer-term trends that also point to a potential transitory event include:

- **A slack economy**: One really needs to rely on the participation rate rather than the employment rate to understand a true picture of at least employment slack in the system. Note our last Explorations (Footnote 2) for more insight as to why the employment rate is really a relatively bad indicator – though it packs a great headline punch.
- **Poor Demographics**: A maturing population results in lower spends and less growth – note Japan and soon to be China (okay, give China about 10 – 20 years).

While there are many indicators that point to inflation being transitory, there is one big concern, which is that money supply has increased dramatically. After averaging 5% for the years prior to Covid, the money supply as measured by M2[5] rose roughly 27% as can be seen on the chart above. We know the reason. The government bailout of $4 trillion was to counter-act deflation. However, it is hard to get it perfect and ultimately it seems to have created a lot of additional supply in the system, which is inflationary. Did our policy makers get it perfect? We shall see. In the meantime, we are carefully monitoring markets and analyzing ways to position our portfolios in context to this risk.

[5] M2 generally includes cash, deposits, and savings in US denominations. For a more technical definition: [M2 Monetary Aggregate (stlouisfed.org)]