WORLD BUSINESS ACADEMY
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PERSPECTIVES

by ***Rinaldo S. Brutoco***

Rinaldo S. Brutoco is the Founding President and CEO of the Santa Barbara-based World Business Academy and co-founder of JUST Capital. He's a serial entrepreneur, executive, author, radio host, and futurist who's published on the role of business in relation to pressing moral, environmental, and social concerns for over 35 years.

Inflation, the Economy and More!

A Leviathan Lurking

Most folks are feeling significant pain at the gas pump and the grocery store these days. Remarkably, the cause for that "pain" is the same for both – Inflation. The question is, should we all be worried about that issue in isolation, or should we focus on the economic fundamentals that underly this spurt of inflation and the additional economic challenges lurking beneath the surface?

Worrying about inflation in the abstract is not going to help anyone. We need to look deeper than the headlines and more thoughtfully about the choices we face as a nation, and as a global economy.

First, let's look at the 8.5 percent inflation rate featured in bold headlines last week in every major economic publication. For example, the NY Times reported as follows:

"Inflation hit 8.5 percent…last month, the fastest 12-month pace since 1981, as a surge in gasoline prices tied to Russia's invasion of Ukraine added to sharp increases coming from the collision of strong demand and stubborn pandemic related supply shortages."

That's a correct statement as far as it goes. Eight and a half percent year-over-year inflation is a very high number, but it doesn't tell the full story without putting it all in context.

We need to start by comparing the rapidly growing economy of 2021 to the Covid year that preceded it where we barely escaped a recession, and then only by "printing money". As President Biden correctly reported earlier this year, "Our economy grew at a rate of 5.7 percent last year, the strongest growth in nearly 40 years." Correspondingly, applications to start new small businesses also accelerated in 2021, which was more than a rebound. It was about 30 percent higher than pre-pandemic rates, and much higher than anything in the last decade.

In the first quarter of this year, the research team at Morgan Stanley issued a report concluding that "…a surge in demand coming out of the COVID-19 recession, coupled with lingering supply-chain disruptions and labor shortages, created a perfect storm for price increases." They continued, "the economics team at Morgan Stanley Research forecasts that inflation in major markets will 'peak then retreat' by more than two percentage points over the course of 2022."

Those are the "economic fundamentals" referred to above. And, 3 months ago they looked like solid conclusions.

That was before Russia invaded Ukraine. What that did was provide the excuse for oil companies to engage in their favorite pursuit: price gouging.

Unfortunately, President Biden did too little too late with his initial, paltry release from the oil reserves which further signaled to the oil companies that they would not be restrained in whatever price shenanigans they wanted to pursue. Had President Biden responded immediately when Russia invaded with a two-pronged strategy: 1) starting the 100 million barrel /day release now happening, coupled with 2) the imposition of an excess profits tax that would be repaid to every gas purchaser, the price spike at the pump would have been less than half of what we have sustained.

What could have been will be saved for another day. Suffice it to say, when the oil companies were given free rein to charge American consumers the same prices those same companies could obtain on the global market, the horse was out of the barn and running fast. Unfortunately, prices at the grocery store, already rising from supply chain deficiencies and pent up Covid demand for real goods, rocketed even higher as diesel prices shot up. Virtually everything we eat (and the goods we buy) in the US comes by way of a diesel truck. When diesel goes up, we all pay more.

So, will the inflation ease later in the year as predicted by Morgan Stanley? Not likely without a recession—which is becoming a very real possibility for late 2022 or the first half of 2023. It's a "double whammy", but we need to realize the aggressive stand the Fed will have to take to counter inflation is likely to create far greater inflationary pressures. It's a fine balance and being forced to do too much too fast will lead to unintended consequences.

Already, the increase in interest rates has begun to stall the housing market in several states. You can bet that the entire country will soon see a "buyer's market" taking over from the super-heated seller's market we've seen lately. A $500,000 house with an average down payment now costs an additional $500/month. When you add that to the incredible increases in home prices over the last two years, you have a recipe for bursting the housing bubble. Count on it.

Those same rising interest rates will work to depress consumer spending even as inflation ravages consumer savings, which will be further depressed by the dramatic fall in bond prices that has already begun and will continue well into the future. When the value of bonds fall, people feel it. These are some of the "other economic challenges" alluded to above.

There is one more: the rapidly slowing global GDP. It's unavoidable as China continues the preposterous "zero Covid tolerance" policy that's tied its economy up in knots and reduced its ability to lift Western economies. Japan will also be a drag on global GDP as its economy has been built on excessive debt for years, and the price of that debt is about to get very expensive. This in turn will slow Japan's growth. Morgan's 4.7 percent global GDP growth prediction for 2022 looks more like it will be 3.5 percent at best. Even that may be difficult to achieve in the face of these economic headwinds. Add to that the cost of energy in Europe which will spike further as Russian gas and oil is cut off, and the seeds are there for a serious inflationary spiral.

The potential negative effects of the seriously overvalued stock market also add to this mixture. The high probability of a serious correction being triggered by slowing economic growth (e.g., corporate profits are going to start to fall outside the energy sector), and weakening economic demand also is looming. All accompanied by rapidly rising interest rates.

If all that sounds to you like a potential "perfect storm", you'd be right. In assessing the underlying "fundamentals" there's one more term we must share at this point: stagflation. That's when inflation is rising, and economic growth is simultaneously decreasing. We haven't seen that twin-headed devil since the 1970s, but it is now lurking in the depths. The longer the Ukrainian war goes on the more likely the stagflation scenario becomes. That, unfortunately, is the most dangerous leviathan lurking below the surface.

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