High inflation is never good, but markets have been overreacting.

ECONOMY & POLICY

April 19, 2024

Chief Economist Eugenio J. Alemán discusses current economic conditions.

The impact of high inflation on individuals' finances is not something to take lightly, especially in the U.S., because for almost 40 years we have had no experience with such an event and have no clue how to deal with it or how to try to minimize its negative impact. In other countries that is not the case, as low inflation has not been part of their experience, and in some of them, people have become accustomed to dealing with high inflation.

For companies, high inflation is not good for business, even if politicians always use firms' price increases as scapegoats for their failure to help keep price increases contained. It is true that, in the short term, some firms may benefit more than others from higher-than-expected inflation, especially as inflation accelerates. However, if firms misprice their goods as inflation comes down, which has been the case for the last year and a half, they could lose market share, something that markets will punish severely.

Of course, each industry is different and competitive pressures, or the lack of them, could temporarily benefit those that try to keep prices higher in a disinflationary environment. And in this vein, what we are seeing from the political system is frightening: an increase in protectionist measures such as higher tariffs on imported goods, etc., that are bound to help firms keep prices higher than they would otherwise be if trade was freer.

We know that many of the 'higher tariffs' arguments espoused by the political system are intended to gain favor with voters while others are predicated on 'national defense' arguments. Some others are lobbied into existence by very powerful industries that benefit from keeping competition 'contained.' Let's face it, in the end, despite the saying "competition is good for business," it is true only for those that win the competitive race because the rest will be out of business sooner or later. In some sense, one of the true regulatory requirements of a capitalist system, we would argue, is to protect and preserve competition between firms, because this typically guarantees the lowest price possible.

But let's say that regulation is not effective in keeping a market competitive and domestic firms abuse their pricing power. What should a government do? The answer is, at least in part, to keep imports as free as possible because that will tend to keep prices of domestic companies contained as they risk a flood of imports that could take away their pricing power.

The only problem with this is that this strategy only works when considering goods which, with few exceptions are 'tradeable,' that is, they can be exported or imported. However, it doesn't work with most services, as services, typically, cannot be transacted across countries. That is, if I want to go to a barber, I have to use a neighborhood barber. I cannot go to another country, or even to another state, to get a haircut at a cheaper price. Although I know that my friends in Buffalo, NY, will disagree with me, as they could easily go to Canada for a cheaper haircut!

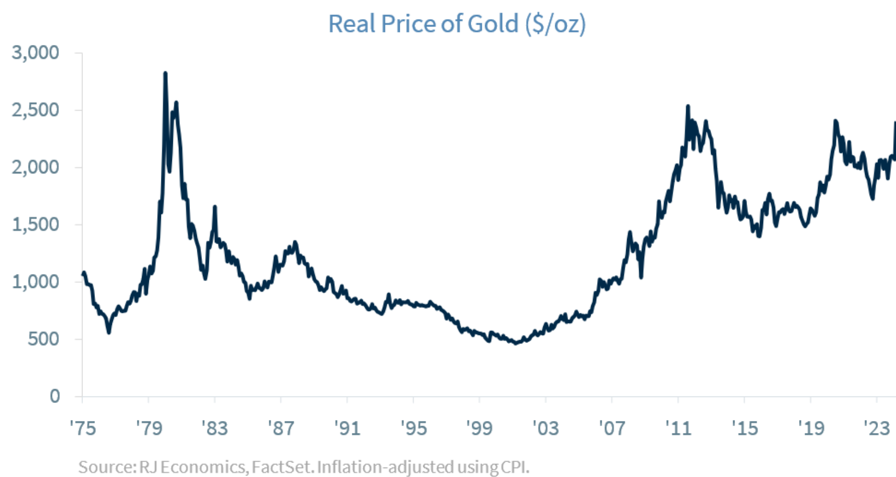
This is the biggest issue the Federal Reserve (Fed) has today, trying to limit price increases in the service sector, which faces little competition from imports. Hopefully, the Fed will not be inclined to increase interest rates further and it can be patient and wait until it is confident that inflation will remain on its disinflationary path. Remember, as we argued last week, the Fed is already expecting to hit the target of 2% not today, or next year, but in 2026.

Advisors ask us if we like gold

We think gold could be part of a diversified portfolio. But, as with any other investment alternative, sometimes stocks or assets are overpriced. Thus, the first question we should ask is, is this asset overvalued? The second question is, is this asset a productive asset? Let's take these questions one at a time.

Is gold overvalued or, better still, is gold overpriced? Who knows! Is there any way to know? Maybe. Let's start with how much it costs, on average, to produce gold. According to an S&P Global report from Q1 2023, the median cost of mining one ounce of gold was $1,239 while the weighted-average mean of mining gold was $1,289.[1] Furthermore, according to a report by West Virginia University, 45% of gold is used in jewelry, 45% in investment and finance, and the rest, 10%, is used in industrial processes, with about 75% of industrial use going into the production of electronics.

We would not try to argue against why humans demand gold, as it has been used in jewelry and coinage for centuries. Today, while it has started to be used in industrial applications, its use in coinage is almost nonexistent for a very good reason: debasing.[2] Clearly, there is a demand for the metal. However, one of the arguments for gold is that it serves as a store of value, which has been hardly the case over the years.



Click here to enlarge

[1] "Large gold miners' all-in sustaining costs rise in Q1 2023," S&P Global Market Intelligence, 13 June, 2023, https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/large-gold-miners-all-in-sustaining-costs-rise-in-q1-2023-76080833

[2] Debasing a coin that contains precious metals means lowering the "precious metal" content of it. This typically happens when the price of the precious metal included in the coin is higher than the extrinsic price of the coin. This is typically called Gresham's Law.

A second argument in favor of gold is that it has historically protected during periods of high inflation. This was true in the late 70s and early 80s but real gold prices started to surge again during the turn of the century when inflation was very low compared to history.

Furthermore, one of the most successful investors of our times argues that gold is not a productive asset. An article called “Warren Buffet explains gold” argues that “Gold is a poor investment because it doesn’t generate returns or contribute to productivity. However, traders can earn profits by speculating on the price movements of gold in active markets. In most markets, gold does little or nothing.”3

In economics, the value of a good/service is not the same thing as the price of a good/service. One way to understand this is by asking the following questions. First, what would happen to the global economy if gold were to evaporate, i.e., disappear from the face of the earth? Probably nothing will happen. Second, what would happen if water disappeared from the face of the earth? Humanity would disappear. That is, the fact that gold has a high price doesn’t mean that it has a high value, while the fact that water has a low price doesn’t mean it has no value. The value of a good/service is given by its usefulness while the price of a good/service is given by the relative scarcity of that good/service.

Our biggest concern with the ‘dollar doom’ prophecies that abound around the U.S., which we have addressed in previous Weekly Economics reports over the last several years, is that those that sell gold are trying to shift the demand for gold to the right to justify higher gold prices under pretenses, i.e., that the U.S. dollar will disappear, and everybody should rush to buy gold to protect themselves from that event. Even some large wholesalers are selling gold bars in their stores!

If this is what they want to do, the risk for less demand for gold once the demand curve reacts to the fact that the U.S. dollar is not going out of existence, is that there is a potential for a large decline in price.

If that is the reason why you are buying gold, don’t. The U.S. dollar is not going anywhere.

Economic and market conditions are subject to change.

Opinions are those of Investment Strategy and not necessarily those of Raymond James and are subject to change without notice. The information has been obtained from sources considered to be reliable, but we do not guarantee that the foregoing material is accurate or complete. There is no assurance any of the trends mentioned will continue or forecasts will occur. Last performance may not be indicative of future results.

Consumer Price Index is a measure of inflation compiled by the US Bureau of Labor Statistics. Currencies investing is generally considered speculative because of the significant potential for investment loss. Their markets are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Consumer Sentiment is a consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in the first quarter of 1966. Each month at least 500 telephone interviews are conducted of a contiguous United States sample.

Personal Consumption Expenditures Price Index (PCE): The PCE is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The change in the PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

The Consumer Confidence Index (CCI) is a survey, administered by The Conference Board, that measures how optimistic or pessimistic consumers are regarding their expected financial situation. A value above 100 signals a boost in the consumers’ confidence towards the future economic situation, as a consequence of which they are less prone to save, and more inclined to consume. The opposite applies to values under 100.

Certified Financial Planner Board of Standards Inc. owns the certification marks CFP®, CERTIFIED FINANCIAL PLANNER™, CFP® (with plaque design) and CFP® (with flame design) in the U.S., which it awards to individuals who successfully complete CFP Board's initial and ongoing certification requirements.

Links are being provided for information purposes only. Raymond James is not affiliated with and does not endorse, authorize or sponsor any of the listed websites or their respective sponsors. Raymond James is not responsible for the content of any website or the collection or use of information regarding any website's users and/or members.

GDP Price Index: A measure of inflation in the prices of goods and services produced in the United States. The gross domestic product price index includes the prices of U.S. goods and services exported to other countries. The prices that Americans pay for imports aren't part of this index.

The Conference Board Leading Economic Index: Intended to forecast future economic activity, it is calculated from the values of ten key variables.

The Conference Board Coincident Economic Index: An index published by the Conference Board that provides a broad-based measurement of current economic conditions.

The Conference Board lagging Economic Index: an index published monthly by the Conference Board, used to confirm and assess the direction of the economy's movements over recent months.

The U.S. Dollar Index is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies. The Index goes up when the U.S. dollar gains "strength" when compared to other currencies.

The FHFA House Price Index (FHFA HPI®) is a comprehensive collection of public, freely available house price indexes that measure changes in single-family home values based on data from all 50 states and over 400 American cities that extend back to the mid-1970s.

Import Price Index: The import price index measure price changes in goods or services purchased from abroad by U.S. residents (imports) and sold to foreign buyers (exports). The indexes are updated once a month by the Bureau of Labor Statistics (BLS) International Price Program (IPP).

ISM New Orders Index: ISM New Order Index shows the number of new orders from customers of manufacturing firms reported by survey respondents compared to the previous month. ISM Employment Index: The ISM Manufacturing Employment Index is a component of the Manufacturing Purchasing Managers Index and reflects employment changes from industrial companies.

ISM Inventories Index: The ISM manufacturing index is a composite index that gives equal weighting to new orders, production, employment, supplier deliveries, and inventories.

ISM Production Index: The ISM manufacturing index or PMI measures the change in production levels across the U.S. economy from month to month.

ISM Services PMI Index: The Institute of Supply Management (ISM) Non-Manufacturing Purchasing Managers' Index (PMI) (also known as the ISM Services PMI) report on Business, a composite index is calculated as an indicator of the overall economic condition for the non-manufacturing sector.

Consumer Price Index (CPI) A consumer price index is a price index, the price of a weighted average market basket of consumer goods and services purchased by households. Changes in measured CPI track changes in prices over time.

Producer Price Index: A producer price index (PPI) is a price index that measures the average changes in prices received by domestic producers for their output.

Industrial production: Industrial production is a measure of output of the industrial sector of the economy. The industrial sector includes manufacturing, mining, and utilities. Although these sectors contribute only a small portion of gross domestic product, they are highly sensitive to interest rates and consumer demand.

The NAHB/Wells Fargo Housing Opportunity Index (HOI) for a given area is defined as the share of homes sold in that area that would have been affordable to a family earning the local median income, based on standard mortgage underwriting criteria.

The S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index measures the change in the value of the U.S. residential housing market by tracking the purchase prices of single-family homes.

The S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index seeks to measures the value of residential real estate in 20 major U.S. metropolitan.

Source: FactSet, data as of 7/7/2023