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INFLATION

A Serious Threat or Not?

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Inflation is defined, by the Dictionary of Finance and Investment Terms, as the “rise in the prices of goods and services, as happens when spending increases relative to the supply of goods on the market – in other words too much money chasing too few goods.” The history of the U.S. inflation rate since 1960 shows a steady moderate to low rate once we got past the early 1980’s (*see graph on page 2*). The 1970’s through the early 1980’s was an aberration when inflation reached 14% and was out-of-control. This is the question we are faced with now: are we entering another inflationary spiral or will this just be a small bump on the long road of controlled inflation?

The Federal Reserve’s Chairman, Jerome Powell, believes and has stated that an increase in inflation will likely be “transitory” meaning temporary.

“The Fed has made it abundantly clear that it is willing to look past any transitory inflationary forces in an almost ‘prove it’ mentality for steady inflation above its 2% average target as the Fed emphasizes full employment,” said Ryan Detrick, chief market strategist for LPL Financial.

“For the Fed, the priority is reassuring investors that high inflation readings are not signaling a return of 1970s era price surges. By talking them down, the Fed hopes to stabilize inflation expectations over the future, which is a major driver of consumption and pricing decisions in the present.”

In the above two quoted paragraphs, there are three important concepts that require more complete explanation. First, the Fed’s target rate of infla-

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tion is 2% annually. This seems to be manageable for the average consumer because it would take about 36 years for prices to double. However, for a senior living on a fixed income, it means a slow but steady decline in standard of living. Retirees who invest in fixed dollar type investments (Certificates of Deposit – CD’s, bonds or money market funds), actually lose money because of the low interest rate environment engineered by the Fed. A retiree earning 2% or less interest with inflation at 2% and taxes having to be paid on the earnings causes the retiree investor to go backward financially.

Second is the concern that the higher inflation numbers might be signaling a return to the 1970s uncontrolled surge in prices of goods and services. Unfortunately, there are similarities in the approach taken then and now. The Fed is creating enormous amounts of money and the government is spending it. Also, regarding the Fed’s dual mandate: control inflation and full employment, the focus (as in the 1970s) is heavily on the side of accommodating full employment. This approach may be compassionate in the short run, but if the inflation genie gets out of the bottle, it will cause much more pain to many more over time.

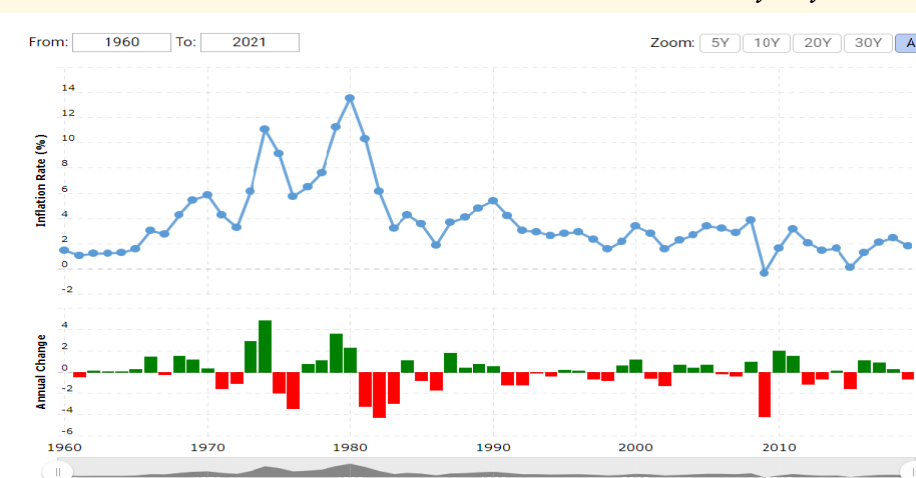
Third is the concern about inflation expectations. The inflation problem is not merely the rise in prices. It is very much a mindset that once established is hard to break. The expectation that prices will be steadily rising causes people to buy now before the item gets more expensive. This becomes a self-fulfilling prophecy because the rising demand and the desire to have it sooner rather than later results in rising prices. Paul Volcker, the Fed Chairman at the time, tamed the inflationary mindset and the very inflation itself but it came at a high cost. The Associated Press (AP) described the scenario and the painful outcome in their December 2019 article about Paul Volcker after his

passing.

“Volcker took charge of the Fed in August 1979 when the U.S. economy was in the grip of runaway inflation. Consumer Prices skyrocketed 13% in 1979 and then by the same pace again in 1980. Working relentlessly to bring prices under control, Volcker raised the Fed’s benchmark interest rate from 11% to a record 20% by late 1980 to try to slow the economy’s growth and thereby shrink inflation.”

“Those high interest rates made it so expensive for people and companies to borrow that the economy weakened steadily. By January 1980, a recession had begun. It lasted six months. A deeper and more painful downturn took hold in July 1981. It endured for 18 months and sent unemployment up to 10.8% in November and December 1982, the highest level since the Great Depression.”

It is clear that inflation must not be permitted to take hold and get out of control. Those of us who are old enough to remember the 1970s and early 1980s experienced the financial pain of that era. Fortunately, the bitter medicine administered by Paul Volcker was effective and set the stage for the strong economies of the mid to latter 1980s and 1990s. So hopefully the policymakers at the Fed and in the Administration will not repeat the mistakes of their predecessors.



ADV Material Changes

There are no material changes in this brochure from the last annual updating amendment on 03-04-2020 of Southern Capital Services, Inc. Material changes relate to Southern Capital Services, Inc.’s policies, practices, or conflicts.



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As the Chief Compliance Officer of our firm, it is my job to keep you up to date and informed of any material changes to our firm. Please feel free to contact me anytime. My contact information is shown below.

Sincerely,

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OUTLOOK

The first quarter of 2021 was positive, January was flat but February was strong except for NASDAQ (tech stocks) which went through a correction in late February but March finished on a positive note. It was overly optimistic to hope that 2021 would continue the torrid pace of the stock market from April through December 2020.

The balance of 2021 presents a contest between economic and financial tailwinds, which are helpful, and headwinds, which present challenges. In our view the tailwinds have the advantage at least for the next four to six months. Beyond that time frame, it is difficult to evaluate because we do not know what tax policy will be adopted or what new regulatory requirements will be added. Also, there is the possibility of a change in Fed policy although Powell does not believe that is very likely.

We believe that there are five key tailwinds, three key headwinds and two neutrals that potentially will become headwinds. The first tailwind is the almost miraculous development of the vaccines. Under normal circumstances this process takes five or more years. Ending the scourge that is the health and economic suffering caused by the pandemic is probably the most impactful of all positive influences.

Second, resulting from the vaccines, is the re-opening of the economy. As more businesses resume full operations, hire back people that they have laid off and begin to make profits, the economy should really heat up. There are predictions by some economists of seven or eight percent GDP growth in the second and third quarters.

Third, the tremendous amount of money being created by the Fed and spent by the government will stimulate economic activity. The money has to go somewhere. Some of it will wind up in the stock market, some will go to real estate, much of it will be spent by consumers and some of it will go into savings, but it will impact the economy.

Fourth, the low interest rate environment created by the Fed will encourage more leverage in the system which is a boon to the economy. This will also limit the amount that will go into savings.

Fifth, many people who have had jobs during the pandemic lockdowns have accumulated a lot of cash because they have not had anything to spend it on. There is a great deal of pent-up demand to travel, go

out to restaurants, bars, concerts, sporting events, to go places and do things. This activity is starting to become evident in the states that have already re-opened, and it will be on a national level as all states re-open.

The headwinds are more perception than reality at this point in time. The first headwind is the increase in tax rates that is coming. We do not know yet what the new rates will be, but we do know it will be a substantial increase in corporate and individual rates along with others, like gasoline taxes or financial transaction taxes.

Second, is increased government regulation that makes doing business more difficult and more expensive. A good example is the additional regulations on fracking (a method for extracting oil and gas) which will increase energy costs for all Americans and threatens US oil independence.

Third, our political leaders need to curb any anti-business mentality that may exist in Washington. Our companies and small businesses need to have the Government on their side in the competition with foreign competitors that in many cases are aided and even subsidized by their governments. Our elected leaders need to realize that businesses, large and small, are the source of their wealth and power not their enemies.

There are also two factors that are neutral at this time but could become headwinds. First, the fact that the market is fully valued – the bargain prices created by Covid-19 are all pretty much gone. However, this is not negative at this time because the prospect of GDP (Gross Domestic Product) growing at seven percent would produce a lot of earnings to support stock prices.

Second, is the inflation that has been discussed in this newsletter. The initial stages of inflation are beneficial for stock prices because companies can charge more for their goods and services and their assets (inventory, real estate and plant and equipment) increase in value. The later stages is where the problems occur when stagflation takes over and the Fed begins to fight it with higher interest rates and reducing the money supply.

To conclude: the tailwinds should carry us through the next few months barring unforeseen geopolitical events. Although gains should be more modest than in the last three quarters of 2020. Beyond the next two quarters, we will have to wait and see what the tax and regulatory policies look like.