Deflation 2022?

We are inundated with news of rapidly rising inflation. I wrote about inflation in this newsletter a few months ago. Now the talk about surging prices is *everywhere*.

That got me thinking. If everyone is talking about inflation, could *deflation* be the problem we ultimately face?

As you may know from reading my book *Unbounded Wealth*, I follow the George Costanza principle. George is a character from the hit TV show *Seinfeld*, and life is best for him when he does the ***opposite*** of what he thinks he should be doing. I like to do the opposite of what *most* people are doing. I believe this approach contributes to over 90% of my success. Right now, most people are freaked out about inflation. Usually, the masses are wrong. I think it pays to look at the contrarian view.

Inflation hurts poor people. Deflation hurts rich people. Therefore, the powers that be will stop at nothing to prevent deflation to a large degree. However, it could be possible that a point is reached where deflation is unavoidable.

If that happens, the market will get punched in the nose hard. That begs the question I asked last week, which is how low it could go?

First, there's a perception that supply chain issues are causing inflation. I'm sure this is true to some extent. However, there's a theory out there that California's laws regarding trucks and emissions are causing a shortage of trucks to move products from ports into the hands of Americans.

That looks to be a bogus claim. Instead of taking what the Internet is saying at face value (always a dangerous strategy), I did some research. About 96% of the trucks in California comply with current regulations. All of the trucks, 100% that enter the port in LA, comply with regulations.

Also, California's law regarding independent contractors doesn't appear to apply as the reason for trucker shortages. The law requires re-classifying independent contractors as employees. This would hurt the trucking industry a lot. There have been court challenges, and the Supreme Court could decide to hear one of the cases. Regardless, it's not being enforced right now, so it cannot be the cause of shortages.

There does appear to be a shortage of truckers, though. Depending on the source of information, the average age of a trucker is 44 to 61 years old. That's a massive difference in average age. However, it does suggest it's not a young person's game. The trucker shortfall is somewhere between 60,000 and 100,000 people. Canada also has a significant shortage of truckers. That number is in the neighborhood of 25,000.

So, what's the cause?

Simple. People are buying more stuff as in ***more*** stuff. And, since human nature never changes, people are likely buying crap they don't need with money they don't have.

According to *Business Insider*, the largest US port has 30% more goods running through it with 28% fewer workers. In 2020, consumers spent $900 billion more online than in previous years globally. That number is up 22% year-over-year through the first half of 2021, a $3.2 trillion increase! In the US, it's the equivalent of 50 million new Americans joining the economy. Infrastructure that was built to handle 40 ships at a time now has to process 150 ships.

Retail goods spending increased 25.7% from January 2019 (pre-pandemic) through August 2021. Meanwhile, spending on services grew by just 7.2%. As usual, collectively, we are accumulating stuff.

For every X-box or flat panel TV, there's a roll of toilet paper stuck on those ships too. Thus, stuff we do need (toilet paper) gets mixed in with a bunch of stuff we don't need (consumer electronics). The result has been a huge bottleneck.

Recently, Jamie Dimon, the CEO of JP Morgan Chase, said that the supply chain issues would be resolved shortly. Typically, I would believe him as his firm has the finger on the pulse of many trends in the economy. However, he did not offer any insight into *why* his statement might be true.

If the infrastructure is not in place to handle the increase in demand from behavioral shifts due to COVID-19, then hoping for a result is just that. It's hope, and it's not a solution.

As a result, it's a bogus claim to suggest that the supply chain will magically unclog itself. The infrastructure cannot handle the increase in demand.

That leads me to deflation.

If the bottlenecks are not resolved from truckers, 24/7 operation of ports, or infrastructure improvements, the equation's demand-side could quickly fix this problem.

There are trillions of dollars sloshing around from government checks handed out during the pandemic. With increased consumption, that money will get burned through, and there are no more checks headed for mailboxes across the US to replenish the shopping spree. That's not happening as long as Joe Manchin is a Senator and the critical 50th vote for Democrats.

You end up with *massive* stimulus to virtually *none* in less than a year or two. Sure, there might be an extension of child tax credits. But taxes might go up too. To whatever extent the $3.5 trillion deal in Congress gets done, it's not helicopter money like it was in 2020 and the early part of 2021.

Where those dollars get consumed from here could be a problem such that the money just goes into a black hole rather than cycle through the economy and benefit more people.

I will give you two examples of how this will shape up starting in 2022. I have worked for myself since 2010. I pay health insurance premiums. Every year these premiums go up, and to some extent, the coverage gets worse (typically, the deductible goes up or what gets covered at specific percentages changes). For 2022, I am going to get hit with a 15% increase in premiums.

Companies that cover their employees will pass those price increases on in some fashion. *Everyone* pays.

Since money doesn't grow on trees, that money has to come from somewhere. As a result, I'll cut back on eating out or some other discretionary purchase that directly benefits the local economy. Instead, it goes into a black hole of the insurance company. I highly doubt insurance companies are increasing wages by 15%, so as far as I am concerned, it's primarily dead money and will not flow through the economy.

The 15% hike hurts my local hangout where I go on Monday to have a half-price burger and a beer special (it also hurts my cousin, who is the bartender, and the much greater-than-average tips I leave her).

The other significant expense will be energy costs. Over 40% of Americans fuel their home with natural gas. If it's a cold winter, this will be a *massive* tax on the typical person. While I am not a meteorologist, El Nino suggests early snow and cold weather in the Northeast. Again, money used to pay for heating your house in the winter ultimately will be diverted from some other source of spending or savings. There's a rude awakening about to happen, and again it's another black hole. Wait until people see that 54% increase in their heating bill in the mailbox.

God help them if they filled up their car with gas this past weekend. I did, and I might as well have been mugged.

Demand could start to fall sharply. By April, consumers could be *exhausted* from getting hosed the entire winter on bills they haven't planned for and increases elsewhere. There will be much less discretionary money to buy unneeded crap.

When the demand side of the equation drops, watch out below!

Actually, it's already starting to happen. The cost fatigue hasn't shown up in the numbers yet. After all, GDP is backward-looking. Who cares what it did *last* quarter? What about *next* quarter?

The *University of Michigan Surveys of Consumers* paints a troubling picture.

The Index of Consumer Sentiment is down 12.7% year-over-year and 1.9% month-to-month. The Current Economic Conditions Survey is down 9.3% year-over-year and 2.7% month-over-month. Finally, the Index of Consumer Expectations is down 15.2% year-over-year and 1.3% month-to-month.

According to the University of Michigan's own commentary, the lows have now been reached in sentiment since the shutdown of the economy last year. Furthermore, confidence in government policies has declined during the previous six months. The favorable view of economic conditions is just 19%, and the decline in confidence was recorded across ***all*** age, income, education, and political affiliation groups.

If this dour economic mood persists, it will start to show up in the numbers. Lack of confidence in economic prospects will become a negative self-reinforcing loop. People will cut back their spending. They will become more and more pessimistic. Then they will overshoot like they always do, and that will be the time to apply the Costanza Principle and scoop up assets on the cheap. We are nowhere near the point yet of too much pessimism. The cracks are starting to form, though, as shown in the Michigan numbers.

Another concern is that capacity utilization is below historical averages by several percentage points. And, this metric has been missing expectations recently. A percentage point might not sound like a lot, but it's a huge miss in a massive economy. If demand slows down, there's already a ton of excess capacity in the economy. That means lower prices or lower rates of inflation.

Lastly, remember that an entire generation of people in this country has not seen inflation overtake their lives. The Internet is possibly the most deflationary force in the history of economics. Inflation has been muted for over two decades. Now, these people are all grown up, and they're consumers paying their own bills.

I think we will know for sure where we are headed by spring of next year which means if there's bad news on the horizon, it could start showing up in the fourth-quarter earnings reports that begin to come out in mid-January.

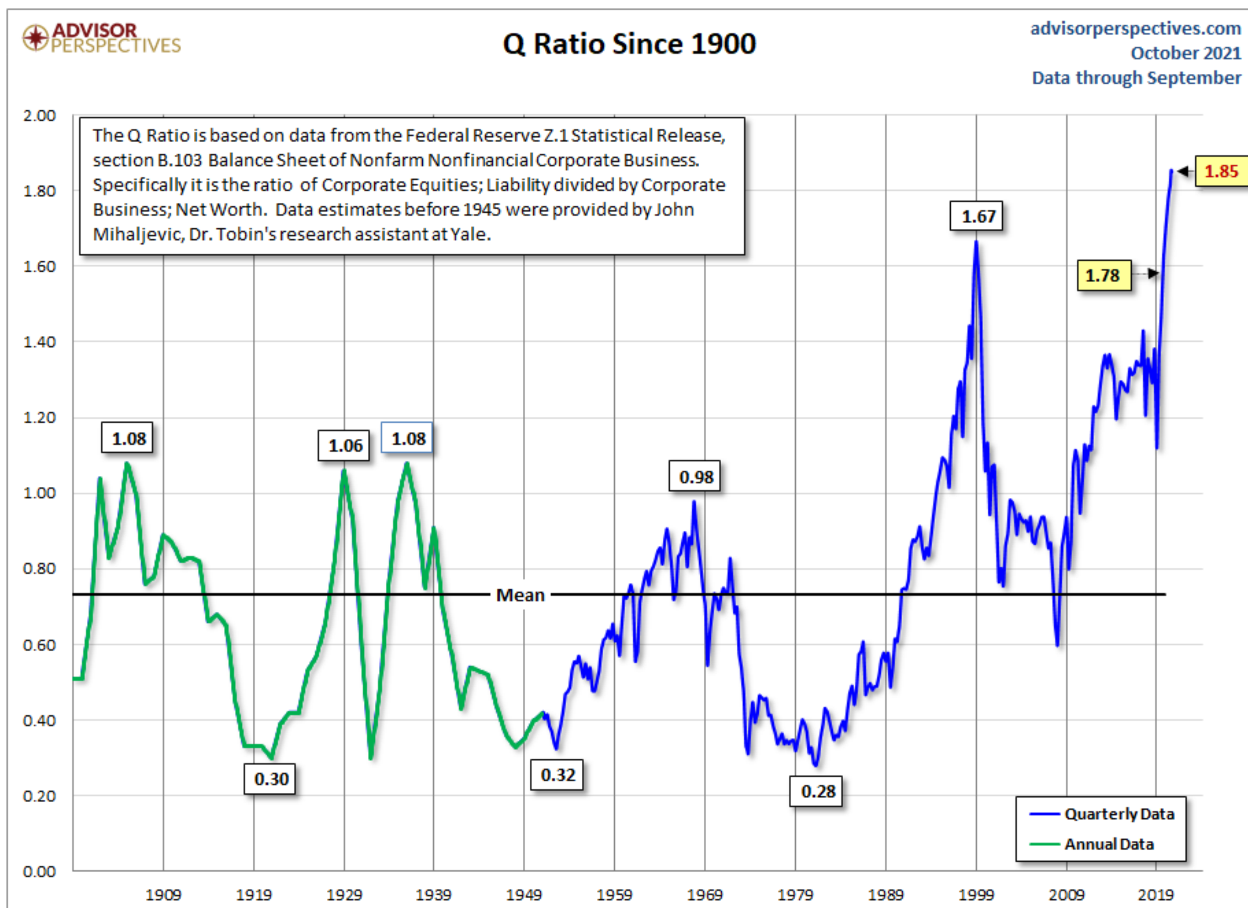
Forward-looking guidance will be a crucial metric to focus on. The forecast might call for April showers!

As a result, the low from here could be *low*. Let's look at two charts!

The first is called Tobin's-Q. You don't see it around much, but Tobin's-Q is my favorite valuation metric. In simple terms, the Q-ratio measures the market value of a company divided by the replacement cost of its assets.

In theory, this should be at equilibrium. That said, we do not live in a classroom. In real life, this won't happen. Historically, the ratio has averaged about 0.79. Valuation is not a science. Don't carry an asset's value to three decimal points. Something is only worth what someone else will pay for it.

That said, the Q ratio is in nosebleed territory. It's much higher than prior peaks of bubbles. It's three times the level of the 2009 lows. It's higher than at any time in the last 120 years and outside the norm of when intangible assets became more prominent within companies.



The most important point to know might be that the Q ratio is three standard deviations above the mean at current levels. Without getting into the math, that's just not a sustainable level. Since markets overshoot both ways, when this ratio "mean reverts," it means a butt-kicking of epic proportions.

The next is a chart from Harry Dent. Last week, when I sat on a panel with Harry, he had the best deck of slides I have ever seen him present. Harry does a lot of work not just in demographics but in market cycles. There's a bunch of issues converging and not in a good way. The culmination of most of Harry's charts is the one below.

Looking at numerous long-term trends and past cycles, which result from human behavior, in the end, Harry projects a downside of about 85%. To put that in perspective, a move like that would wipe out the entire bull market rally from the early 2009 lows as we came out of the mortgage debacle.

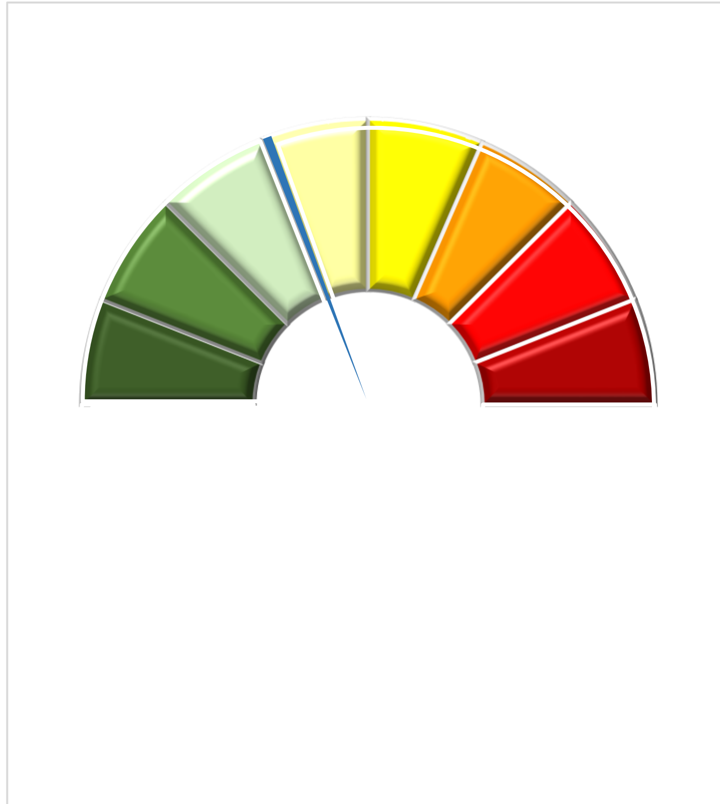
In my own mind, I have oddly always thought we'd test that low in a deflationary bust. My target is just 4 points lower on the S&P 500 than Harry's. Maybe great minds think alike?

I don't analyze cycles or long-term timeframes, but I think about what happens in a bear market. The indexes tend to hold up okay for a while, but the average stock goes down way more than the index. In a deflationary bust, the bankruptcies will be epic. The whole system is built on funny money and leverage. The implosion will be like we have never seen.

The only thing that might hold everything together would be a massive policy response. This happened in the COVID panic, making it easy to see a bottom was in place and stocks should be bought. However, what could be in store is a more prolonged, drawn-out mess. Furthermore, if the confidence in the government is eroded, and it's already there, a massive policy response might not matter as much.

In the meantime, while we wait for that significant decline and the buying opportunity of a generation, the *Risk-O-Meter* is still on a buy. Risks reduced slightly over the week, and we have still been in the rally mode I suggested was likely to occur a couple of weeks ago. Breadth in the market has improved. Volatility is in the green zone. The credit markets have flipped back to the "all is good" and suggest being aggressively long stocks or staying long stocks. Market sentiment is on a sell signal.

That said, the market is overbought. And, with individual companies reporting earnings, there will be increased volatility when those companies report.

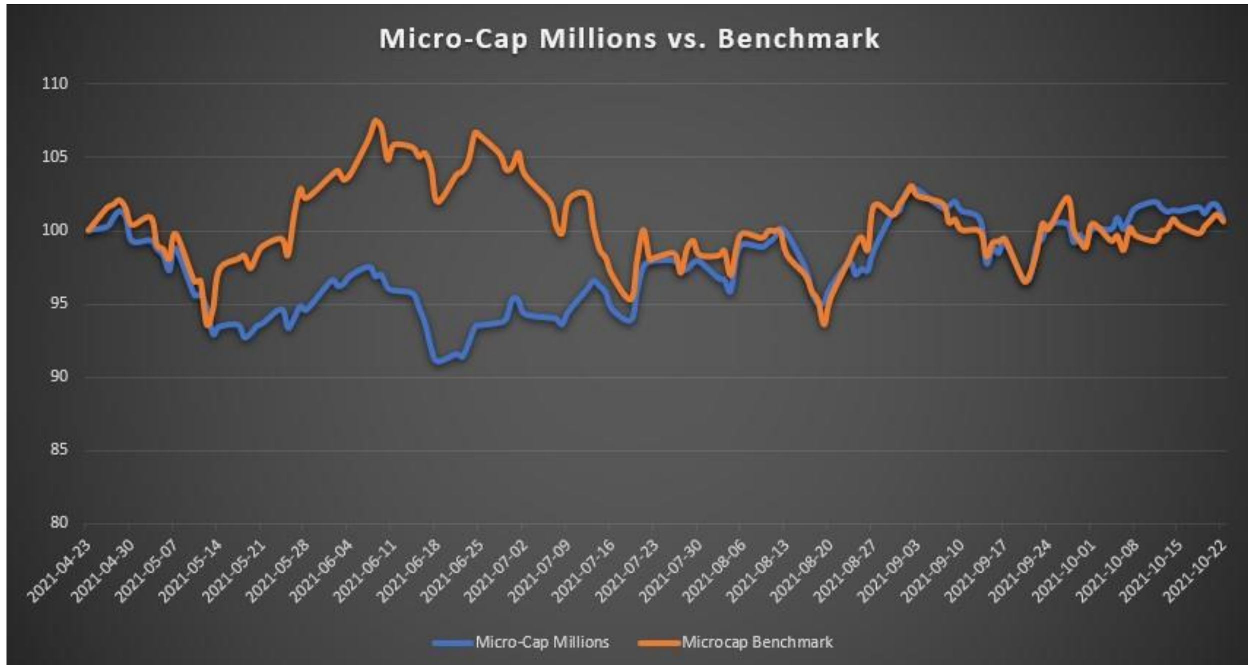


Happy trading!

John

Micro-Cap Millions

Still no new trades in the strategy again this week. Here is the performance chart and current portfolio below.

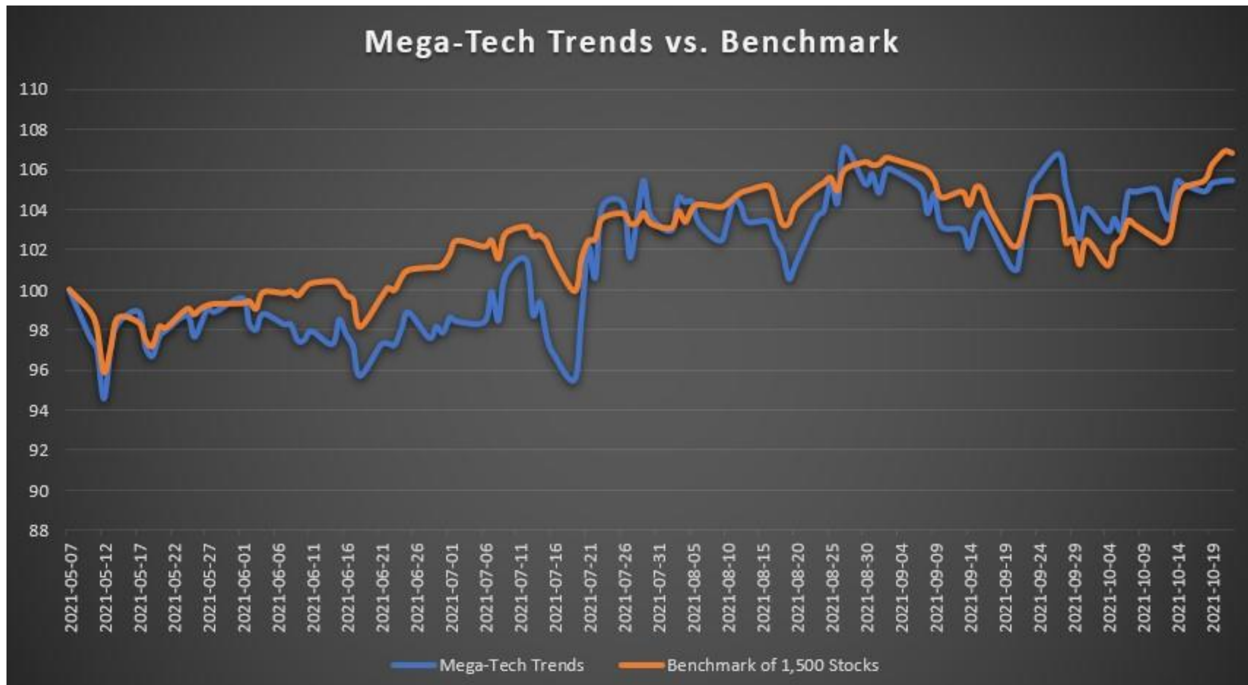


Current portfolio:

BBSI	Barrett Business Services, Inc.
EVC	Entravision Communications Corp.
HSII	Heidrick and Struggles International, Inc.
IHC	Independence Holding Company
MNDC	MIND CTI Ltd.
NAII	Natural Alternatives International, Inc.
PCOM	Points International Ltd.
PMD	Psychemedics Corp.
SGA	Saga Communications
TSQ	Town Square Media

Mega-Tech Trends

There is one new trade in the strategy again this week. Here is the performance chart with the trade below.



Buy Interpublic Group of Companies, Inc. (NYSE: IPG)

Sell Baxter International, Inc. (NYSE: BAX)

Here is the current portfolio:

ABC	AmerisourceBergen Corp.
ACLS	Axcelis Technologies, Inc.
APH	Amphenol Corp.
BDC	Belden, Inc.
CNXC	Concentrix Corp.
DFIN	Donnolley Financial Solutions, Inc.
FORR	Forrester Research, Inc.
IPG	Interpublic Group of Companies, Inc
JBL	Jabil, Inc.
PLAB	Photronics, Inc.

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