Art Koch's Profit Chain® Market Report
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Inflation: Is it Transitory or a Longer-Term Challenge?

July 22, 2021

I'm excited to announce a welcome addition to my monthly newsletter family. This month we are introducing Art Koch's Profit Chain® Market Report (MR). The MR will be presented in a monthly format in conjunction with Deborah Brown, CEO of DDB Advisory Services. I've known Deborah for over fifteen years and trust that her insights will inspire you. Deborah's prior financial background and handle on the U.S. economy as a bond trader will help guide you as you transform your organization and supply chains during these tumultuous times.

Overall, our goal is to highlight the relevant KPIs in the financial markets within the past 30-days, demonstrate how these factors impact supply chains and recommend measures to diminish those impacts.

Art Koch – AKMC, LLC

Inflation is present everywhere we look. We find it in the price of our streaming subscriptions, at the grocery store, the gas pump, securities asset prices, building materials, real estate values, the cost of used vehicles, and the cost of university education, just to name a few. The big question for 2021 is, will inflation be a temporary condition, or are we looking at higher prices for the longer term? In its simplest form, inflation is the imbalance of supply and demand for goods and services, resulting in too many dollars chasing too few goods and services.

Let's take a close look at the factors that affect inflation. Higher energy prices translate to higher transportation and variable costs for all goods, and those costs are passed on to the consumer. The U.S. had just achieved energy independence for the first time recently, and we were in a position to sell oil to other countries, as well. However, oil pipelines were shut down instead in an attempt to fast-track Green Energy policies, which sent us back into energy dependence on OPEC and rogue nations that are hostile to U.S. interests. It will take years to bring enough renewable energy online to power all of our needs, so we will have to rely on more expensive energy sources in the interim.

Companies are finding it hard to hire employees on the labor front as unemployment benefits continue in some states until September. However, we are starting to see that some states have discontinued those benefits in the last few weeks. Some companies are even turning away new business because they don't have the support staff to take it on. Also contributing to the difficulty in filling 9.2 million job openings is the fear the workers have of contracting COVID-19, childcare issues, and that a considerable segment of the population retired early because the shutdown continued longer than anticipated. We have read about companies offering wage increases, signing bonuses and incentives, even poaching employees from other companies in doing so. These incentives are especially prevalent in the airline industry, where there is a shortage of pilots as travel explodes this summer from Americans who are ripe to go anywhere after being locked down for the past year.

There is much debate among economists and money managers about whether cost savings resulting from technology investment offsets wage increases, ultimately keeping a cap on inflation. Other financial experts argue that inflation is policy-driven. As the government continues to spend trillions, inflation may grow fast enough to force the Federal Reserve to hike rates in 2022, perhaps a year earlier than expected. The Fed now expects PCE inflation (Personal Consumption Expenditures) to be 3.4% for 2021. They also expect that the rate will drop to 2.1% in 2022. Is that reversal next year realistic? According to the Federal Reserve, the optimal inflation rate is 2% at any given time.

The Fed has been flooding the system with liquidity as the economy recovers from COVID-19 through purchases of mortgage-backed and Treasury securities (a policy that inflates the money supply and trickles down to inflated prices). Financial experts are beginning to argue that it's time to shut down the money machine now that the COVID-19 emergency is winding down. At the last Fed meeting, there was a conversation about tapering those purchases at some point in the near future. No agreement has been reached about when is the right time to slow down the flow of funds or close the spigot altogether. Another meeting to address the issue is scheduled for July 28th.

The Federal Reserve watches stock and bond prices very closely in shaping their policy. In the last four months, bond prices have appreciated more than 50 basis points. This appreciation would seem to indicate that the market is not nervous about inflation longer term. Otherwise, higher bond yields would reflect that concern (bond yields and prices are inversely related.)

The Fed walks a tightrope to keep the economy moving while simultaneously attempting to stave off inflation. At this moment, they have to balance the effects of overheated real estate markets, bond markets, and stock markets all occurring at the same time. Suppose the timing of their policy switch (slowing their purchases of mortgage-backed and Treasury securities purchases of $120 trillion per month) is off. In that case, we will see an immediate spike in bond yields as they course correct to keep inflation at bay. We could see a faltering economy instead. It is a tricky balancing act.

In the end, is inflation just temporary as the U.S. economy recovers, or will it last for a more extended period? Here are the critical factors to consider:

1. Will the Fed move fast enough to implement the anti-inflation tool at their disposal by reducing securities purchases and/or raising interest rates? Continuing to pump liquidity into the system post-pandemic keeps inflation alive and growing.
2. How long will it take the supply chain to return to normal levels? I would argue it will take several years, prolonging the imbalance between demand and supply.
3. Will the labor market remain tight and continue to drive up wages? That picture is uncertain at this time.
4. Globalization policies that had kept prices low for decades through cheap labor have reversed over the last few years.
5. Baby boomers own one-half of the wealth in the U.S. – and they are much better consumers than producers.

6. Online purchases used to generate cost savings for the consumer. However, E-commerce has matured, and now these lower prices are no longer the case post-pandemic. Online prices have risen 2% since March of 2020, according to Adobe data.
7. Will the coronavirus Delta variant spread be a factor in slowing the economic recovery?

When considering all these factors, the case for longer-term inflation is the more solid argument. The U.S. economy works most efficiently when left to its natural market cycles of supply and demand. If the Fed continues to interfere with that process by artificially stimulating the economy, asset prices will remain artificially inflated.

Sources: Wall Street Journal, Tradingeconomics.com, MarketWatch, Fox Business News, CNBC

Deborah Brown – C.E.O. DDB Advisory Services

In any enterprise, it's critical to stay ahead of demand, financial markets, and the competition. If you weren't addressing the potential for inflation and a tight labor market three to six months ago, you are likely behind the competitive curve and will need to play catch-up.

Here are a few essential actions you can take to catch up to the competition. Always remember, raw material purchases typically account for 50%+ of cost-of-goods-sold, and direct labor costs are between five and seven percent.

- Rising materials prices can quickly erode profit margins. Be sure that long-term agreements (LTA) with customers have built-in clauses that pass along raw materials price increases.
- Use resources such as the London Metals Exchange (LME) to secure futures prices for raw materials like steel, aluminum, copper, lithium, etc.
- Establish long-term partnerships with key suppliers in the supply base that give you a competitive advantage.
- Use lean manufacturing methodologies to improve processes to reduce non-value-added steps. Refocus on bottlenecks, eliminate downtime, and avoid producing scrap and rework. Become zealots for making only quality parts and what is needed right now!

Remember, a crisis is a terrible thing to waste, and always play to win!

Art Koch, AKMC, LLC

Art Koch's Profit Chain®
Create dramatic improvements to inventory velocity, customer service, and corporate profits.

If you have any questions or concerns about your operations and supply chain business strategy, please contact me by e-mail or at +1 (336) 260-9441.

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Self-Ranking - Pick one of the four questions below and then fill in your comments in the space provided.

1. Don't think this applies to your business or enterprise? (Write three to four reasons why it might not.)
2. This is a new idea and strategy; it's something we need to work toward. (Brainstorm the first steps.)
3. We can do better, modify our strategy, and now we are moving in the right direction. (What are the next steps to ensure success?)
4. Our team gets the necessary time to keep their minds fresh, and we have plans to live our dreams. (Comment on how you're ready.)

- ____.
- ____.
- ____.
- ____.

Don't be afraid to call with any questions or comments.

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in·ven·to·ry / ˈin-vən-ˌtȯr-ē / noun
Inventory is the term for the goods available for sale and raw materials used to produce goods available for sale.

in·ven·to·ry is evil! / ˈin-vən-ˌtȯr-ē is ˈē-vəl / phrase
"Left unchecked inventory has many negative unintended consequences to profitability. It hides problems; therefore, it delays fixing problems!"

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Thanks in advance for your time and for being a loyal client. Looking forward to helping you and your team again soon.

Carpe diem,

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