The Type 2 Investor

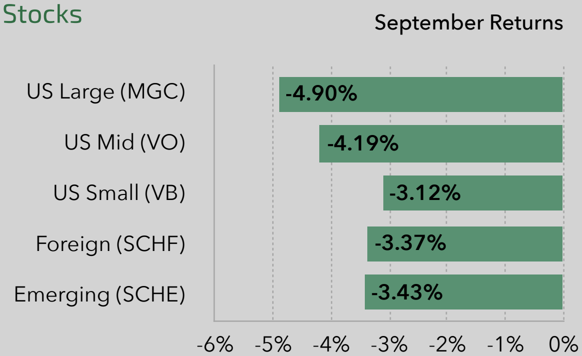
October 14, 2021

September 2021

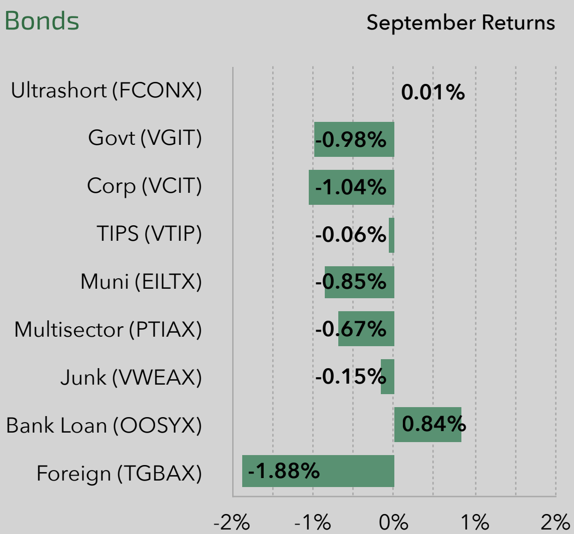
Economic Data

- There was a huge miss for payrolls as just 194,000 jobs were added in September—well below expected; labor force participation is still about 1.5 percentage points below pre-pandemic levels, but the unemployment rate fell to 4.8%
- Retail sales were up 0.7% for the month of August
- Y/y inflation (CPI) is looking less and less "transitory" at 5.3% in August; the fourth month in a row at or above 5%
- Existing home sales declined 2.0% in August; median home price slipped to $356,700

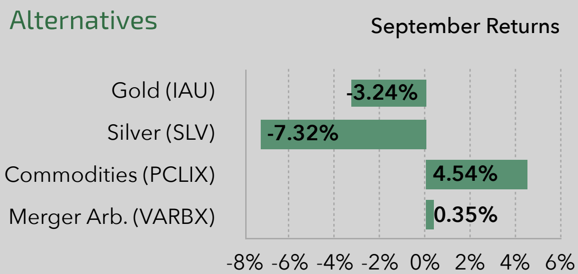
Stocks



Bonds



Alternatives



Performance data provided by Morningstar.

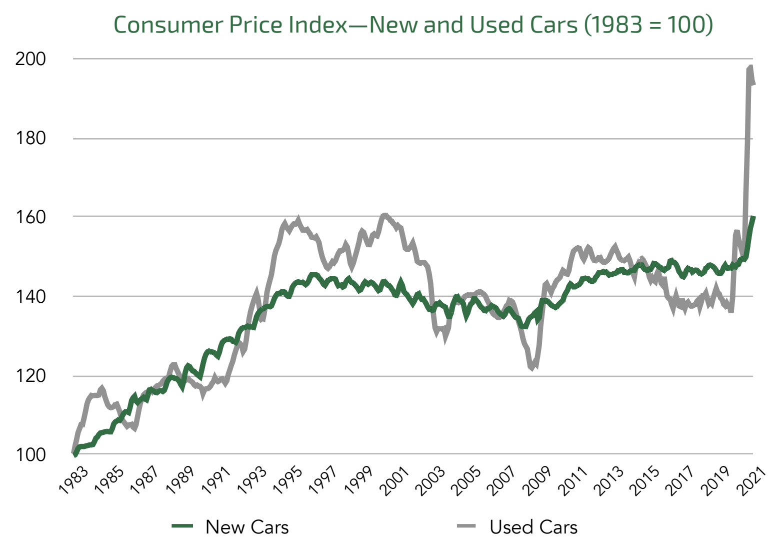
The brain uses two systems to process information. The first type is intuitive but lazy, rapidly forming judgements with no conscious input. The second system is slow, reflective, and is not guided by emotions. It is that second system — type 2 — that we want in control of our investment portfolios.

Inflation Rises, Pictures no Longer Worth a 1,000 Words

"Transitory" is a vague term. It implies something will last only a brief period of time, but that can have many different measures depending on the context. I'm not sure exactly what time frame the Fed had in mind when they kept saying inflation was going to be "transitory," and that was almost certainly their objective when they chose to use that term. If you regularly read this newsletter, you know I have been questioning that narrative since the beginning. It now appears the Fed is finally ditching that fantasy, as well.

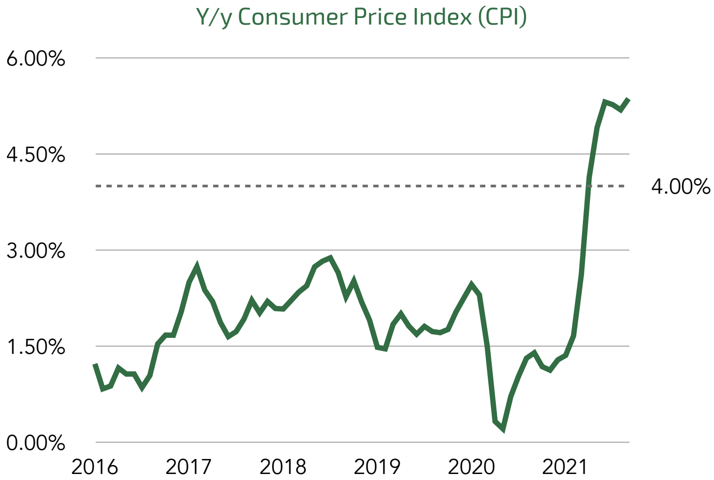
"Transitory is a dirty word," Federal Reserve Bank of Atlanta President Raphael Bostic said in a virtual speech on Tuesday. He kept a glass jar labeled "transitory" at his side, depositing $1 each time he used the "swear word." He went on to say, "It is becoming increasingly clear that the feature of this episode that has animated price pressures — mainly the intense and widespread supply-chain disruptions — will not be brief…By this definition, then, the forces are not transitory." U.S. Transportation Secretary Pete Buttigieg echoed this during a recent interview with Bloomberg, admitting that some of the supply chain problems that we are currently facing could last for "years and years"

A few price increases will certainly prove to be transient. Take used cars, for example. The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. Used cars and new cars are both subcomponents of this index. The price of used cars has gone up 24.41% over the past year. Meanwhile, new car prices are only 8.74% higher. It's probably unlikely that the US consumer all of a sudden prefers used cars to new cars. It is more plausible that demand has skyrocketed and the supply of new cars wasn't enough to meet it. I expect the rise in new car prices will be sticky, while the bulk of the increase in used car prices will dissipate. Not in the next few months, mind you, but perhaps in the next few years. I see larger price increases on the horizon for other components, however.



Source: U.S. Bureau of Labor Statistics

The September CPI report was the first to finally show a potential breakout in shelter costs, with owner-equivalent rent rising 0.43% for the month and rent of primary residence up 0.45%. With median existing home prices up 14.9% y/y, according to the National Association of Realtors, and national median rents up a staggering 16.4% since January, according to Apartment List, it was only a matter of time before this had to start showing up in CPI.



Source: U.S. Bureau of Labor Statistics

In June I talked about the 4% level often being cited as the line above which inflation is considered high. It is around here where the relationship between equities and inflation tends to break down and equities no longer function as a reliable hedge against rising prices. I expect the headline inflation rate as measured by the CPI to remain above 4% through at least February 2022, and likely longer.

If you look to other measures of inflation, the situation looks even more severe. The Producer Price Index (PPI) has exploded 18.40% higher from pre-pandemic levels (February 2020) and is up 19.87% year-over-year through August, according to the Bureau of Labor Statistics. The PPI measures the change in the selling prices received by domestic producers for their output before reaching the consumer level. These are the prices from the first commercial transaction for many products and services, and so it gives us a glimpse into the rising costs that businesses will either have to eat or pass on to their customers. Kraft Heinz, the food giant, recently warned consumers around the globe to get ready for higher prices due to supply shortages and higher transportation costs. Kraft Heinz chief executive,

Binge Box

The Chair (Netflix)

The Chair is actress Amanda Peet's first effort working behind the scenes instead of in front of the camera, and it does not disappoint. The series is produced by D.B. Weiss and David Benioff of Game of Thrones fame, and stars Sandra Oh and Jay Duplass. *The Chair* is a romantic comedy, but it tackles so many more important things that it is hard to think of it as simply that. Set at Pembroke, a fictional liberal arts college, the show covers topics such as ageism, sexism, and political correctness, but also—and most importantly, in my opinion—cancel culture. And it does so in a manner that examines both sides of the argument in a humanizing way. At six episodes it's a quick binge.

Tactical Asset Allocation

Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Fixed Income		●			
Duration	●				
Inflation				●	
Credit	●				
Foreign				●	
Equities		●			
Large Cap	●				
Mid Cap		●			
Small Cap	●				
Developed Intl.		●			
Emerging			●		
Alternatives					●
Commodities					●
Hedging					●

Miguel Patricio said "Specifically in the UK, with the lack of truck drivers. In [the] US logistic costs also increased substantially, and there's a shortage of labour in certain areas of the economy."

Last month we hit an all-time-high 73 container ships in the queue in San Pedro Bay, according to the Marine Exchange of Southern California. They were all waiting for entry into the Ports of Los Angeles and Long Beach where 40% of containers enter the US. Many of the ships are still being forced to drift because anchorages are full. The White House issued a memo saying the Port of Los Angeles will begin to operate 24/7 in an effort to work through the backlog. Bottlenecks like these—which appear to be getting worse rather than better—are just part of a much larger number of disruptions that are cascading throughout the entire supply chain. Freighter shipping costs are 3 to 4 times what they were just a year ago, according to some measures. This leads to shortages and higher prices for the goods that do make it onto shelves.

The energy shortage is also a factor in rising prices. The whole of Lebanon went dark for 24 hours last week when the country's two main power stations ran out of fuel. Shortages may become more common if there is little appetite for investment in developing new oil and gas supplies in an industry that some–perhaps mistakenly–believe is in its twilight.

The 5-year breakeven inflation rate is currently 2.64%, which implies that the market expects the rate of inflation to average that number over the next five years. If inflation ends up being higher, which I forecast it will be, TIPS will be the better investment relative to a regular old 5-year treasury note. Broad commodities, like the exposure we get through PCLIX, should also continue to do well in this environment.

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About EmeraldSpark

EmeraldSpark Investments, LLC is a Registered Investment Adviser based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide personalized financial planning and fiduciary investment management services to select clients. Our investment process blends the foundations of Modern Portfolio Theory with the latest research in the field of behavioral finance. We specialize in asset allocation and investment due diligence to help provide our clients with investment strategies personalized to match their specific goals and risk comfort zone.