

THE QUICK START GUIDE TO
**ECONOMIC
SHIFTS**
A CASE STUDY

J SCOTT



**The
Inflation
Dilemma**

Economic Shifts: A Case Study

By J Scott

The Inflation Dilemma

*In Chapter two of my full-length book, **Recession-Proof Real Estate Investing**, we talked about the role of the Federal Reserve in keeping the economy on track. And while we made it seem like the Fed has a straightforward job, in reality, there's a lot of nuance and guesswork that goes into driving the economy forward without crashing. This is an extended, newly written version of that chapter to comment on the current economic situation!*

Thanks to the current (mid-2022) economic situation, we have a great case study around the complexities of economic shifts and a great example of the difficult position the Fed can find itself in trying to avoid catastrophe.

I'm specifically referring to the high level of inflation we're experiencing, both in the U.S. and worldwide, and what is being done—and will likely have to continue being done—to tackle it.

We discussed earlier that it's typical to see inflation rise after an economic boom; however, what we started to see in 2021 was inflation outside what most economists consider normal or good for the economy. The Fed typically targets about 2 to 3 percent inflation per year, but the U.S. was reaching inflation levels above 8 percent by the spring of 2022.

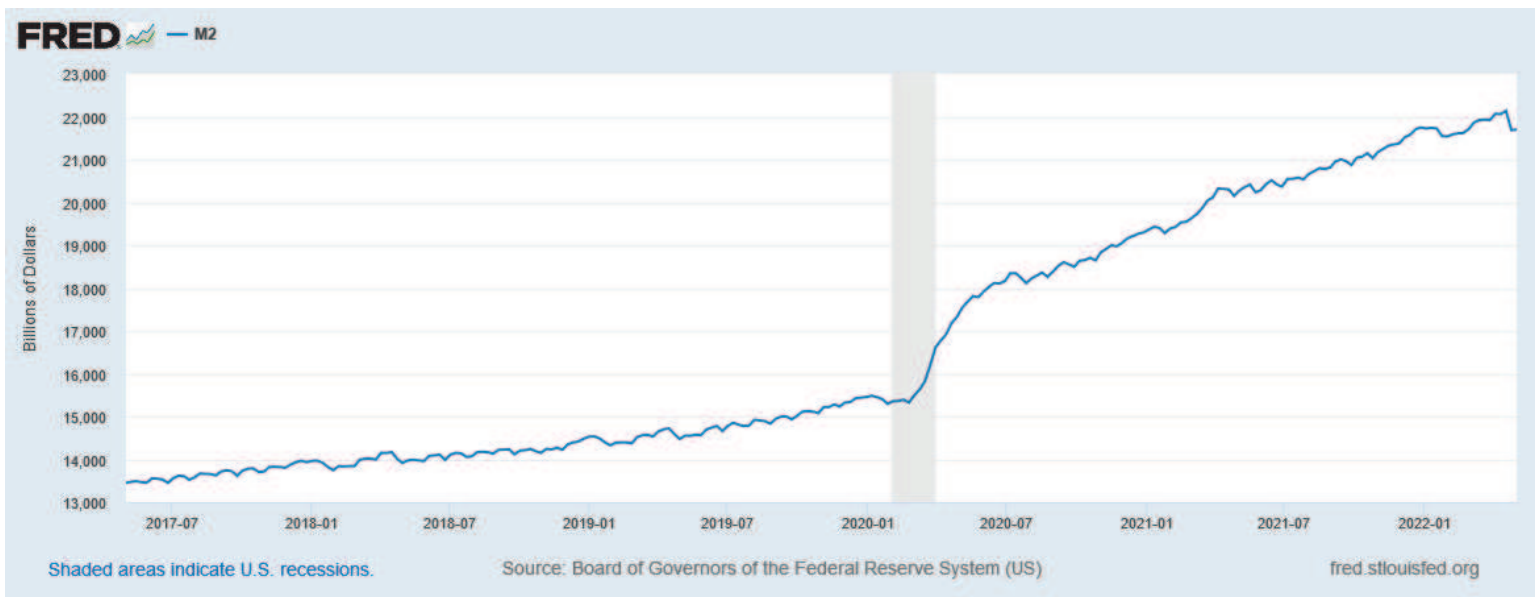
Let's step back and talk about how we got to this point, as well as the challenge the government is facing to fix it (hopefully without creating more problems).

COVID-19 hit in March 2020. The economy ground to a halt, and it looked like we were on the verge of an economic depression. So, as is their job, the Fed stepped in to avoid economic catastrophe. I'm not going to argue that the government or the Fed made all the right decisions during this time, but the reality is that the country was in crisis mode, and extreme action was better than no action.

As a reminder, the Fed has two resources at its disposal to control the economy: setting target interest rates and printing money. In 2020, it relied heavily on both of those.

Shortly after COVID-19 hit, the Fed dropped interest rates to near zero percent. This did two things: It encouraged spending (as credit was now cheaper), and it discouraged saving (as bank accounts were essentially paying no interest on deposits).

Additionally, the Fed started to "print money." Now, the Fed doesn't really print money. But it can direct the Treasury Department to print money and then use this newly created currency to start buying things up, putting new money into the economy and spurring growth.



Between 2020 and 2021, the Fed increased the U.S. money supply by over \$6 trillion, a nearly 40 percent increase. In other words, 40 percent of all money circulating through our economy was created in under 24 months.

Unsurprisingly, this did the trick. Between lowering rates and flooding the market with cash, the Fed stimulated tremendous growth. In fact, it stimulated too much growth—driving up housing values, driving up the stock market, driving up other assets like cryptocurrency, and ultimately driving up the cost of everyday goods and services.

INFLATION!

Most people who understand economics wouldn't be surprised to hear that all this money flooding the economy would lead to inflation. It's a fact that growth and spending lead to price increases. However, *a lot* of people were surprised to see inflation spike so quickly and so dramatically in such a short period. Remember, the Fed lowered interest rates and flooded the economy with money after 2008 as well, but we hardly saw inflation over the next decade. What was different this time around?

Why Is 2022 Different Than 2008?

Why was inflation at 2 percent for much of the decade after the Great Recession, and yet it hit 8 percent after the latest round of interest rate drops and money printing? The Fed reacted with the exact same tools in both situations. So what made inflation so much worse this time around?

TWO FORCES DRIVE INFLATION: SUPPLY AND DEMAND.

On the supply side, when the supply of goods and services is low, prices go up. Consumers are fighting over a small number of products, and the sellers of those products recognize that they can raise prices to force competitive buyers to pay more.

On the demand side, when demand for goods and services goes up, so do prices. When millions of people are competing to buy a limited number of products, sellers again recognize their position of strength and raise prices, forcing buyers to compete and pay more.

Thanks to the pandemic, we saw inflationary pressure from both sides. Due to global shutdowns, many bankrupted small businesses, tumult in raw material and transportation pipelines, and a host of other things, supply chains were—and continue to be—a global mess. In 2022, many feel that the worst of the pandemic is behind them and things are approaching normality, so there shouldn't be any more supply chain issues. Right?

Wrong. The United States is a very consumer-centric nation, not a producer-centric nation. We import stuff; we don't produce stuff. Therefore, it didn't matter what we saw in this country in terms of shutdowns and businesses operating. What mattered was what we saw in the countries we import most of our goods from. And in those countries, in 2022, there were still significant lockdowns, as well as war and political unrest.





Shipping logistics were still recovering, energy prices were sky high, chip manufacturing slowed, and global labor faced shortages. Long story short, while the major COVID-19 concerns may have seemed in the rearview, *supply was still constrained*. This was driving prices up.

It was also only half the story. There were also tremendous inflationary pressures on the demand side; demand for everything from commodities to hard assets increased.

WHERE WAS ALL THIS DEMAND COMING FROM?

It came from people, companies, and institutions spending the trillions of dollars that were created and flooded into the market during the pandemic.

But that still doesn't answer the question: Why did we see all this demand post-shutdown when we didn't see it after 2008?

The answer is how the Fed put all this excess capital into the economy.

In 2008, the trillions of dollars created were put indirectly into the economy. The money was mostly given to the banks, allowing them to open their lending to businesses and consumers. That allowed all the extra money to slowly trickle into the economy over the course of months and years. In fact, much of that money never even made it into the economy, instead staying in bank reserves and being loaned back to the government over the next decade.

But COVID-19 was an even more acute event than the 2008 crisis, and trickling money into the economy through the banks wasn't an option. This time around, the Fed needed to get the money out there much more quickly.

The Fed pumped much of those trillions of dollars into the heart of the economy—buying stocks and bonds of American businesses, handing small businesses cash through PPP loans, and sending thousands of dollars directly to Americans.

This direct injection of capital was effective—people had direct access to the cash, without having to work through banks. But this direct cash injection into the heart of the economy caused the heart to beat faster. And that, to continue this analogy, caused our blood pressure to rise.

That high blood pressure was inflation. The dollars flowing directly into the economy led to out-of-control spending by individuals and companies alike, driving up the prices of goods, services, and investment assets. The Fed was successful at avoiding economic collapse. But it over-corrected and didn't let off the gas soon enough. Inflation got out of control.

The Fed Needs to Fix a Tough Problem

The Fed now had to fix the problem it created. If you've read my full-length book, *Recession-Proof Real Estate Investing*, the best way to reduce inflation is to raise interest rates. So, in early 2022, the Fed started doing just that. In fact, it indicated that it would raise rates up to nine times in 2022 alone.

As of this writing, we've seen three of those rate hikes, but there are likely more to come. How many more? Nobody knows. Including the Fed!

While it may sound counterintuitive, even the Fed doesn't know exactly what it will take to fix the inflation problem. Raising interest rates is the solution; but how high do interest rates need to go to calm inflation?

WHILE WE DON'T KNOW THE EXACT ANSWER, HERE IS WHAT WE DO KNOW.

Conventional wisdom says that to reduce inflation, the federal funds interest rate must be higher than the inflation rate. This is because people need to know that they are not losing value by keeping cash, and rates higher than inflation allow people to not lose money by saving.

Interest rates are currently at about 1 percent. Inflation is currently at about 8 percent, according to the government. Does this mean we need to raise interest rates to 8 percent to curb inflation?

Fortunately, that's probably not the case. As rates start to rise, inflation starts to subside. Rates go up while inflation comes down. There will be a point of equalization somewhere between the current 1 percent interest rate and the 8 percent inflation rate where the two cross and inflation drops below interest rates.

Unfortunately, nobody—including the Fed—knows where this equilibrium point is. It may be that raising rates to 2 percent is enough to drop inflation back to 2 percent, a number we should all be comfortable with. But it's also possible that we may need to raise rates to 4 percent, 5 percent, or higher to achieve the desired goal.

Depending on when you're reading this, you most likely already have a good idea of how high rates needed to go to bring down inflation—I won't embarrass myself by venturing a guess. But, in theory, the right move by the Fed would be to raise rates a little at a time until that equilibrium is hit, and then perhaps a little bit more to push inflation down to a comfortable level.

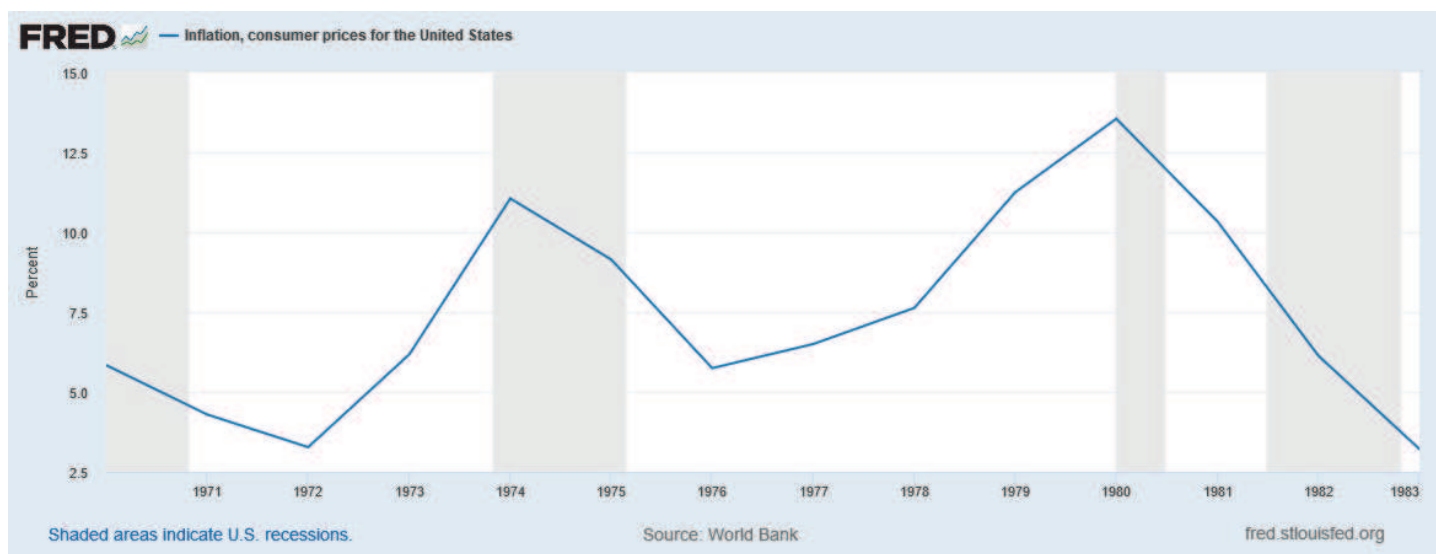
However, controlling a \$25 trillion economy isn't that simple. Raising rates slowly over time poses some risks—the biggest being stagflation.

What is Stagflation?

Stagflation is an economic situation characterized by simultaneous inflation and recession. Inflation is typically a sign of a strong economy, but inflation alongside increasing unemployment and slowing economic growth can create a downward spiral. Stagflation can destroy the economy for years or decades. This is because all the tools the Fed has available to curb inflation will risk deepening the recession, and vice versa.

The U.S. last saw stagflation back in the 1970s, when regulation around wages and consumer prices, along with rising oil and energy prices, drove annual inflation to over 13 percent. At the same time, a weak economy and high unemployment meant low economic growth—and financial struggles for the average American.

From 1970 through 1982, the U.S. saw four recessions, with both inflation and unemployment consistently above 5 percent.



How do we avoid stagflation?

Again, we look to conventional wisdom, which says that to avoid stagflation, we need to raise rates quickly to shock the system, quash inflation, and get things back into the normal rhythm. While theoretically effective, raising rates slowly may be less effective—and riskier—than raising rates quickly and decisively.

Even if a quick spike in rates plunges the economy into recession, many people believe that it's better than risking a spiral into stagflation, which could cause a much worse and longer-lasting economic downturn.

As usual, though, it's not that simple. Raising rates quickly and drastically has an additional side effect that must be considered.

As we've seen over the previous four decades, the government is not very good at spending less money. In the case of quickly rising interest rates, the government would likely have to start issuing more debt to its interest payments, which would increase those interest payments, forcing even more debt to be created, leading to more money printing, which...

You get the idea. The national debt spins out of control, and we risk defaulting or restructuring all that debt.

As you can see, the Federal Reserve is in a major dilemma!

It was forced to act after the pandemic drove inflation, and now it is in a catch-22 situation where it risks stagflation or a debt crisis to alleviate that inflation.

Of course, as the reader, you are in a better position to know how this turned out (or is turning out), but it's likely a safe prediction that the Fed's actions will lead to some other circumstances that will require hard decisions and trade-offs to be made. It is these decisions, actions, and reactions that ultimately drive the economy up and down in repeating cycles.



Risk of Debt Crisis

RAISING RATES TOO HIGH TOO FAST COULD CAUSE AN IRREVERSIBLE DEBT CRISIS.

When interest rates rise, bond yields (the interest paid to bond holders) also rise. Because treasury bonds are simply the debt that the U.S. has created, increasing interest rates means the government needs to pay more interest on the national debt. It's no different than taking a mortgage on a rental property: The higher the interest rate, the higher the interest payments, and the harder it is to cash flow.

When interest rates rise, bond yields rise, and the government must now spend more money on interest payments. This means the government either has to borrow more money (again at the higher interest rate) to pay all that interest, or the government needs to spend less money on everything it wants to pay for.



Negative Interest Rates

Finally, I want to touch on a topic that isn't being talked about much these days, although it was a big topic of conversation back in 2018 when the full-length version of my book (*Recession-Proof Real Estate Investing*) was originally written. Depending on the trajectory of interest rates over the next several years, it could be a hot-button issue again.

When the economy overheats, the Fed will hike rates to slow inflation, the economy will slow, and the Fed then drops rates to get the economy back on track. Historically, this cycle of raising and lowering interest rates lasts about two years. And, on average, the top-to-bottom decrease in interest rates to drive us out of recession is about 5 percent.

During the next recession, if interest rates are below 5 percent, there's a possibility that lowering rates back to 0 percent won't generate enough economic growth to get things back on track. If the Fed needed more firepower to spur economic growth, one option is to take interest rates into the negative. This is uncharted territory, so we don't know exactly how this would play out. But, we can theorize.

FIRST, LET'S LOOK AT HOW NEGATIVE INTEREST RATES WORK.

Remember, when you borrow money, you pay back the amount you borrow plus a little more. That "little more" is based on the interest rate—the lower the rate, the less the "little more" you need to pay back. When the interest rate is zero, that "little more" is zero. In other words, you pay back \$1 for every \$1 you borrow—no interest!

With negative interest rates, however, not only does the borrower not have to pay back the "little more," but the borrower actually repays *less* than they borrowed (ignoring fees and such). For example, if I borrow \$100 at a negative interest rate, I may only have to repay the lender \$98 instead of the full \$100!

You might be asking, why would a lender loan money in a situation where they aren't even going to get the full amount back? The answer is that the lender may not have a better option. If they put that money in the bank, and the bank is paying negative interest, that means that the bank isn't going to return the full amount of the deposit. That's right—negative rates mean you're paying the bank to hold your money. A lender may be happier loaning money at negative 0.5 percent than putting that money in a bank account or bonds earning negative 0.75 percent. They lose less money that way.

So far, that doesn't sound too bad. Negative rates help us as investors, because not only do we borrow money cheaply but we also don't have to pay back the full amount!

In reality, it's not all good. In fact, negative rates have the potential to hurt all aspects of the economy, from individual investors to big companies, banks, and Wall Street. Let's look at some of the ways negative rates can have a huge negative impact on nearly everything.

First, successful investors tend to have a lot of cash, and they need someplace to put that cash. As real estate investors, if we want to take advantage of borrowing at negative interest rates, we need to put our cash somewhere other than the houses we're buying. Unfortunately, just like we're getting negative interest on the money we're borrowing, many investments are paying negative interest as well. It costs money to keep our cash in the bank; it costs money to put that cash in government or corporate bonds; it costs money to lend, etc.

While there will still be investments that pay returns above zero percent, those investments will be in such high demand that they will skew riskier than the return they provide. Overall, those other investments may not be worth the risk, and mathematically, it may be better just to put our money in the bank and pay them to hold it.

For poorer people, negative rates are even worse. They see their savings eroded away, and the small negative interest they are paying to the bank could be enough to drive them to insolvency. One big effect of very low or negative interest rates is that it drives the inequality gap, hurting poorer people more than it hurts wealthier people. Low rates have already exacerbated the wealth gap over the past decade—that would get much, much worse with negative rates.

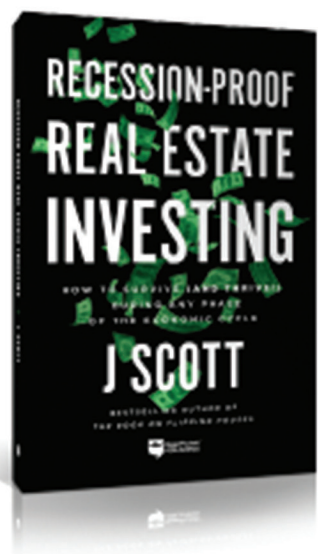
Next, think about how negative rates would affect big companies in the United States. Berkshire Hathaway has more than \$120 billion in cash, Apple has more than \$200 billion, and Facebook has about \$50 billion. How do you think their shareholders would feel about losing money on those cash reserves quarter over quarter? And when corporate balance sheets get ugly, our equities markets (i.e., the stock market) start to get ugly. Negative interest rates could have a massive impact on equity/stock prices.

Negative interest rates also run the risk of destroying bank profits. Sure, they get to pay back less than you deposit—but people are much less likely to deposit money at negative interest rates and much more likely to stash it under their mattress or in a hole in their backyard. Negative interest rates are typically very bad for banks, which causes issues that can trickle into the broader economy.

Lastly, negative interest rates in one country encourage citizens to ship their money to another country or another currency that might be paying a bit more (or that is less negative). This hurts the local currency and the local economy. It can also impact the country that's receiving that money, as it pushes down the returns for all investors in that market and hurts demand for domestic manufacturing, because imports are so much cheaper.

Again, much of this is just theory. Nobody knows exactly how negative interest rates would affect the economy long-term. That said, many economists speculate that things wouldn't end well.

This is one reason why a lot of economists suggest that the Fed raise rates as high as possible now, to avoid the risk of having to drop rates into negative territory during a future economic downturn.



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