



April 12, 2022

High Inflation

Dear Investor:

The Fed came through as the market expected and raised rates for the first time in several years at their March meeting. While it was only a quarter point, there's a good chance it might have been a half point if it were not for Russia's brutal invasion of Ukraine. Looking ahead, the Fed is signaling a very strong move to confront inflation. The market is expecting many more rate increases in 2022. Some of this is likely to be front loaded with half point moves starting in May. They have also revealed a possible plan to start shrinking their balance sheet in the next few months. The schedule they are considering could unwind around a trillion dollars a year off their books. I would be very glad to see that. While this sounds good on paper, there's no guarantee they will achieve these goals.

Looking over everything that has happened since the Covid pandemic threw the world into turmoil, it's clear to see now that the Fed kept up their stimulus program way too long. They should have ended their bond purchases much sooner and got in position to move on rates. They are in fact way behind the curve, and it's going to take a lot of work to get inflation under control. In all fairness, hindsight always makes things much easier to see, and it's quite normal to overshoot in the urgency of a major crisis. I think we have to realize they may not be able to bring it down to more comfortable levels for quite a while.

According to the BLS (Bureau of Labor Statistics), here are some of the recent numbers from Feb 2021 to Feb 2022. Please don't think these are based on the Ukraine invasion, these are our numbers. Meat & Poultry +13%, Cereal +7.5%, Gasoline +38%, Air Fares +13%, Used Cars +41%, Fruit & Veggies +7.6%. I can add from other sources, National Home Prices +18% - 20%, and Rents +15%. There are some very hot areas in the country where rents have climbed 30% to 40%. On balance, our inflation is running between 6% and 8% right now, depending on which measure you prefer to use. You may remember it was practically yesterday that the Fed tried for over a decade to hit a 2% average inflation rate and couldn't get there. The majority of this has come from the war on the coronavirus.

One possible outcome of our current situation is stagflation. Stagflation is high inflation, coupled with slow growth and rising unemployment. We could easily get there. As the Fed raises rates, it will begin to slow the economy. The reason is simply that higher interest adds more cost to almost every transaction we do. There are already instances of mortgage rates touching 5%, and the Fed hasn't even warmed up yet. If growth slows as expected, this will most likely lead to some increase in unemployment. The idea here is that the higher interest rates will lead to a stagnant or slowing economy, but not necessarily a recession, while inflation remains high at the same time. Because the Fed is so far behind and rates may have to go much higher, this is a very distinct and undesirable possibility.

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As we have talked about for some time, the Fed's goal is a soft landing. Fed chair Powell recently defined a soft landing at a conference of economists, and I quote from the Wall St. Journal, "The economy achieves a soft landing, with inflation coming down and unemployment holding steady." He also noted at the time that the Fed was successful at this in 1965, 1984, and 1994. I do agree that is the perfect definition of the soft landing. Our current circumstances make this very difficult to achieve. The general outlook right now is that we may be lucky to get inflation down to the 4% to 5% range by the end of the year. Many economists think it will take several years to get back to 2% inflation if we can get there at all. The new normal may end up being a 3% - 4% inflation rate.

Another possible outcome is a recession as the tightening slows things down significantly and we overshoot the soft landing. This will lead to rising unemployment and a lower inflation rate than the stagflation scenario. In that case we would expect earnings to go down and the market to go down also. Investors have been through many recessions, and that does not mean that we would sell our stocks and abandon the market. We would adjust on a case-by-case basis primarily based on client liquidity needs.

I haven't talked with anyone who is not deeply disturbed by the war in Ukraine and the brutal attacks on innocent people going on over there. Considering only the economic implications, the war adds another big layer of uncertainty to the outlook and how all this will play out. Prices in the oil and gas markets have risen dramatically. I've seen graphs of how long it takes to add supply to the market and the range is from one month to one year, depending on the source. There are clearly going to be problems with the food sources overseas. There is a possibility of extreme shortages in some areas. Both issues are already contributing to inflation and may continue for a long time. No one knows how long this war will go on or how it can be resolved. We can only hope that a solution can be found before too many more lives are lost.

We must realize that the enormous programs that were put in place the last few years led to outsized market returns. We have some difficult challenges to overcome right now to get things back in balance. The odds of either the stagflation or recession scenario occurring are high. Some are saying 30% - 50%. You will hear this out there. I want to stress that no one knows the future and I certainly don't. Remember how fast things have changed. Last fall economists were thinking we might have one rate increase in 2022. As investors we must remain focused on the long term and also realize that one of the primary goals of investing is to try and keep up our purchasing power in the face of inflation.

Best Regards



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