A Double Whammy: Inflation & Invasion

Whammy #1 as reported in Friday's WSJ beginning with the front page's banner headline:

Inflation Speeds to 40-Year High

Price rise of 7.5% tops December's reading as housing and used cars help fuel the surge

BY GWYNN GUILFORD

A relentless surge in U.S. inflation reached another four-decade high last month, accelerating to a 7.5% annual rate as strong consumer demand collided with pandemic-related supply disruptions.

The Labor Department said Thursday that the consumer-price index—which measures what consumers pay for goods and services—reached in January its highest level since February 1982, when compared with the same month a year ago. That put inflation above December's 7% annual rate and well above the 1.8% annual rate for inflation in 2019 ahead of the pandemic.

The so-called core price index, which excludes food and energy, climbed 6% in January from a year earlier. That was a sharper rise than December's 5.5% increase and the highest rate in nearly 40 years.

Prices were up sharply for a number of items, including food, vehicles, shelter and electricity. A sharp uptick in housing rental prices—one of the biggest monthly costs for households—contributed to last month's increase.

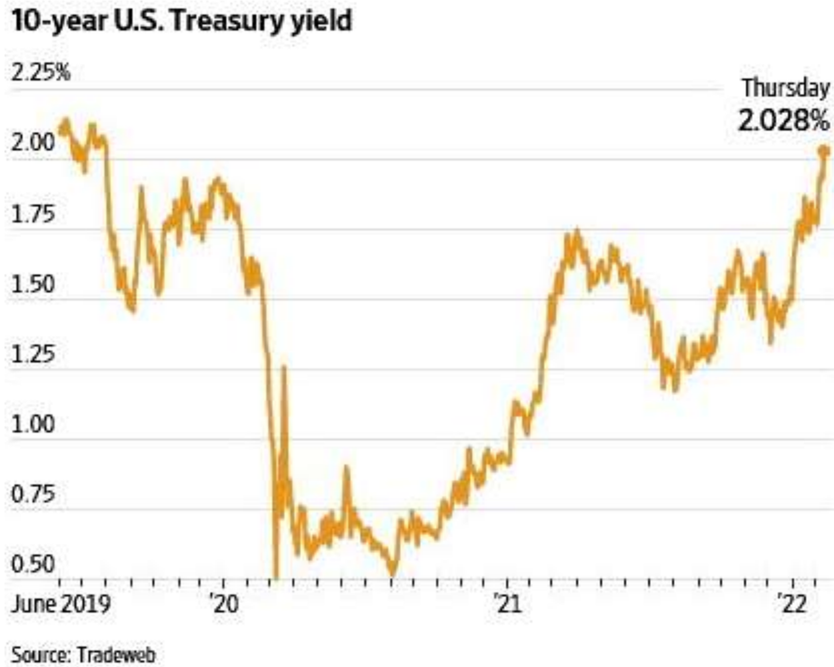
High inflation is the dark side of the unusually strong economy that has been powered in part by government stimulus to counter the pandemic. January's continued acceleration increased the likelihood that Federal Reserve officials could speed up a series of interest-rate increases this spring to ease surging prices and cool the economy.

Stocks dropped Thursday on the prospect of a more aggressive Fed response, with the S& P 500 (-1.8%), Dow Jones Industrial Average (-1.4%) and Nasdaq Composite (-2.1%) all falling ... while a selloff in government bonds drove the yield on 10-year Treasurys above 2% for the first time since mid-2019. (Chart below from **Treasury Yields Top 2% Marker** on page B1.)

Kathy Bostjancic, chief U.S. financial economist at Oxford Economics, said what started as pandemic-specific inflation has now "broadened out across many, many categories both on the goods side of the economy and on the services side."

"It reflects supply constraints both in the goods market and the labor market, but it also is a function of still strong demand, particularly from U.S. consumers," she said. ...

Used-car prices continued to drive overall inflation, rising 40.5% in January from a year ago. ...



Food prices surged 7%, the sharpest rise since 1981. Restaurant prices rose by the most since the early 1980s, pushed up by an 8% jump in fast-food prices from a year earlier. Grocery prices increased 7.4%.

Energy prices rose 27%, easing from November's peak of 33.3%, but a jump in electricity costs was particularly sharp when compared with historical trends. ...

Prices for autos, household furniture and appliances, as well as for other long-lasting goods, continue to drive much of the inflationary surge, fueled by pandemic-related supply-and-demand imbalances. Most economists expect the dynamic to fade as businesses adapt and demand normalizes. But it isn't clear when supply snarls will ease enough to take pressure off prices, particularly because of recent disruptions from the Omicron variant of Covid-19. ..

The economy expanded 5.5% last year, the fastest pace since 1984. That brisk growth is powered by a strong labor market. Employers added 1.6 million jobs over the past three months, putting upward pressure on wages. With inflation well above the Fed's target, the steady gains in hiring leave the Fed on track to raise interest rates next month ....

Mounting wage pressures related to the nation's tight job market also could start feeding into inflation. Annual wage growth was running at 5.1% in January, the fastest pace since 2001, according to the Federal Reserve Bank of Atlanta's wage tracker, which makes adjustments for changes in the composition of workers. However, inflation continues to outpace wage growth for most workers, eroding their spending power. ...

Also from the front page:

Fed Mulls Larger Rate Rise In March

BY NICK TIMIRAOS

The question facing Federal Reserve officials ahead of their policy meeting next month is no longer whether they will raise interest rates but rather by how much.

Another strong inflation report released Thursday is intensifying a debate inside the central bank over how to speed up a series of interest-rate increases this spring to ease surging prices and cool the economy, according to officials' most recent public comments and interviews.

The debate still has weeks to play out but could lead officials to begin lifting interest rates from near zero next month with a larger half-percentage-point increase rather than the standard quarter-percentage-point move. The Fed hasn't raised rates by a half percentage point since 2000.

On Thursday, the yield on the two-year Treasury note, which is especially sensitive to near-term monetary policy, settled at 1.560%, according to Tradeweb, compared with 1.346% on Wednesday, representing the largest such increase since 2009. The 10-year yield climbed above 2% for the first time since mid-2019, closing at 2.028%. ...

Expectations of a larger March rate increase ratcheted higher twice on Thursday, first when the Labor Department reported that consumer prices rose in January by a somewhat larger margin than economists had anticipated and later when a regional Fed president said that the stronger inflation data would justify the larger rate increase. ...

Since Fed Chairman Jerome Powell signaled plans to raise interest rates over the last few months, bond investors have adjusted their expectations, and yields now reflect that the Fed will raise interest rates more aggressively, including at their scheduled meetings in March, May and June.

Until Thursday, Fed officials had largely pushed back against market speculation of a half-point rate rise in March and had signaled they were comfortable with how markets had interpreted the possibility that the Fed might raise rates at their next three meetings.

St. Louis Fed President James Bullard, in an interview on Monday with The Wall Street Journal, said he didn't think the larger rate increase was warranted. "We don't want to be disruptive or surprising markets," Mr. Bullard said. He said he would change his view "if the data went against us here."

But in an interview Thursday with Bloomberg News, Mr. Bullard suggested he was open to a half-point increase in March or to increasing interest rates in between scheduled policy meetings, which are in March, May, and June.

"We are going to have to be far more nimble and far more reactive to data," he told Bloomberg. "There was a time when the committee would have reacted to something like this to having a meeting right now and [raising rates] right now." ...

Interest-rate futures markets showed investors judged a nearly 50% probability of a larger rate increase, up from around 25% on Wednesday, according to CME Group, after the inflation report was released Thursday morning. Those probabilities rose to 90% by the end of the day, after Mr. Bullard's comments. ...

Whammy #2 from the lead story in Saturday's WSJ:

Warning Stepped Up on a Russian Invasion

U.S. says Moscow could move on Ukraine any day now, sending stock markets lower

*By **Gordon Lubold** , **Vivian Salama** and **Michael R. Gordon***

WASHINGTON—The White House said it believes Russia could invade Ukraine at any time with a major military action, and it urged Americans to leave the country as soon as possible.

The escalation of tensions sent U.S. stocks lower Friday afternoon, as investors sought the safety of government bonds, sending their yields lower. Oil prices jumped to fresh eight-year highs on the prospect of supply disruptions.

At the White House Friday, national security adviser Jake Sullivan said the U.S. wouldn't conduct a military evacuation of citizens from a war zone. He said Americans should leave Ukraine on their own in the next 24 to 48 hours while land, rail and air routes out of the country remain open, in the most pointed directive yet from the White House.

"We are in the window when an invasion could begin at any time should [Russian President] Vladimir Putin decide to order it," Mr. Sullivan said. If the Russians attack Ukraine, it will begin with aerial bombing and missile attacks that could kill civilians, he added.

"A subsequent ground invasion would involve the onslaught of a massive force," he said. "With virtually no notice, communications to arrange a departure could be severed and commercial transit halted."

Mr. Sullivan said an invasion could occur during the Winter Olympics. Until Friday, many U.S. officials and outside analysts believed that if Mr. Putin were to order an invasion, he might await the end of the Games on Feb. 20 out of deference to Chinese President Xi Jinping, whom he would be disinclined to upstage with a military incursion.

The U.S. wasn't closing the door on diplomacy, however, and President Biden, who is at the presidential retreat Camp David in rural Maryland this weekend, was expected to speak with Mr. Putin on Saturday, after Mr. Putin requested a phone call, officials said.

German Chancellor Olaf Scholz is also scheduled to visit Kyiv Monday and to meet in Moscow with Mr. Putin Tuesday.

In a call with European leaders on Friday, Mr. Biden said the U.S. now believes Mr. Putin has made a decision to go ahead with an invasion of Ukraine and named specific dates when Washington believed it might happen, according to a senior European source, briefed on the call.

While U.S. officials declined to detail the new intelligence, some of it appears to consist of fresh signs that Moscow is preparing a pretext to invade its neighbor. The intelligence, officials said, has pushed forward the Biden administration's understanding of Mr. Putin's timeline.

"The level of concern is increasing on the imminence" of an invasion, one official said.

All three major U.S. stock indexes finished Friday lower, capping another volatile week on Wall Street. Friday's retreat from stocks extended a selloff that began Thursday ....

The S& P 500 tumbled ... 1.9%, in Friday trading .... Its combined two-day loss over Thursday and Friday amounted to 3.7%, the index's largest two-day percentage decline since October 2020.

The technology-heavy Nasdaq Composite slid ... 2.8% .... The Dow Jones Industrial Average lost ... 1.4% ....

Oil prices surged Friday, with Brent crude jumping 3.3% to $94.44 a barrel, its highest settle since September 2014.

In the bond market, the yield on the benchmark 10-year Treasury note retreated. The yield, which settled Thursday at 2.028%, fell to 1.951% Friday. ...

U.S. officials have said that an invasion could result in 25,000 to 50,000 civilians killed or wounded if Russia mounted an all-out attack and sought to occupy the entire country. ...

Meanwhile, the Pentagon said Friday that it would deploy an additional 3,000 troops to bolster the defenses of NATO allies that could house and support Americans evacuating from Ukraine. U.S. officials said this week that hundreds of U.S. troops would be deployed inside Poland along its border with Ukraine to help facilitate the safe evacuation of Americans and others from inside Ukraine.

The U.S. troops aren't authorized to enter Ukraine, nor will any evacuations involve U.S. aircraft, officials said.

In warning of the Russian buildup, Mr. Sullivan was referring to the deployment by Moscow of more than 100,000 troops to the border with Ukraine, the movement toward Ukraine of heavy weaponry from bases in the Russian Far East, and the movement of Russian troops and missile batteries into Belarus. ...

Invasion continued to dominate the WSJ's front page on Monday:

Biden Pledges Swift Reaction To an Invasion

U.S. says it is prepared for possibility Russia will soon launch major assault against Ukraine

BY ALEX LEARY AND LAURENCE NORMAN

President Biden on Sunday told Ukraine's leader the U.S. and its allies would respond "swiftly and decisively" to any further Russian aggression against his country, the White House said, even as Russia deployed some of its most powerful weapons and best-trained battalions around Ukraine.

A day earlier, Mr. Biden's warning to Russian President Vladimir Putin of "swift and severe costs" if Russia moves against Ukraine yielded no change in the Russian stance, U.S. officials said. Meanwhile, the fear of conflict has led to canceled flights to Ukraine and heightened volatility in energy and financial markets. ...

Before Mr. Biden's hourlong telephone call with Mr. Zelensky, U.S. national security adviser Jake Sullivan renewed on Sunday the Biden administration's warnings of a possibly imminent Russian invasion of Ukraine as Russia continued to insist it has no such plans and European leaders embarked on further diplomatic attempts to ward off military conflict.

By Monday all diplomatic personnel will have left the U.S. Embassy in Kyiv, according to State Department officials, leaving only security personnel in the Ukrainian capital. A core staff of diplomatic and consular officials have set up operations in the city of Lviv, which is considered safer because it lies further west near the Polish border. ...

Mr. Sullivan reiterated calls for any U.S. citizens still in Ukraine to "move out by air or rail or road as rapidly as possible." Seeking to dispel any notion that there would be U.S. military action to extract anyone in the case of

Russian action, he said there was a “ big difference” between the U.S. deployment of soldiers to Afghanistan last summer to end a 20-year U.S. presence there and its current effort to prevent a war in Ukraine. ...

Chancellor Olaf Scholz of Germany, who has tried to balance his country’s membership in NATO with its close economic ties to Russia, is scheduled to meet with Mr. Zelensky in Kyiv on Monday and with Mr. Putin in Moscow on Tuesday. Earlier this month, Mr. Biden pushed the German leader to support tough sanctions on Russia should Moscow invade its smaller neighbor, including closing Nord Stream 2, a pipeline that is awaiting certification to start pumping natural gas from Russia to Germany. Mr. Scholz on Sunday warned Mr. Putin of “ hard reactions” in the event of a Ukraine invasion but hasn’t explicitly put Nord Stream 2 in play.

Mr. Scholz’s trip east follows one by President Emmanuel Macron of France, who recently traveled to Moscow for talks and spoke Saturday with Mr. Putin, telling the Russian leader that sincere dialogue was incompatible with an escalation, according to Mr. Macron’s office. ...

and on Tuesday:

Russia Accelerates Military Buildup

German leader tries to mediate peace in Ukraine visit; Putin leaves room for talks

*By **Michael R. Gordon** in Washington,**Thomas Grove** and **Yaroslav Trofimov** in Kyiv, Ukraine, and **Bojan Pancevski** in Berlin*

Russia moved ahead with its massive military buildup near Ukraine as Chancellor Olaf Scholz of Germany began shuttling between the two nations seeking to stave off a conflict and Moscow left the door open for continued talks. U.S. officials said that the Russian forces near Ukraine had grown to 105 battalion tactical groups, up from 83 groups earlier this month. Russia has also moved about 500 combat aircraft within range of Ukraine, and has 40 combat ships in the Black Sea, U.S. officials familiar with intelligence reports said.

In a carefully choreographed scene broadcast on Russian television, Russian Foreign Minister Sergei Lavrov told President Vladimir Putin that the West was ignoring the Kremlin’s core security demands. But he nonetheless suggested that Moscow continue negotiations to resolve tensions around Ukraine.

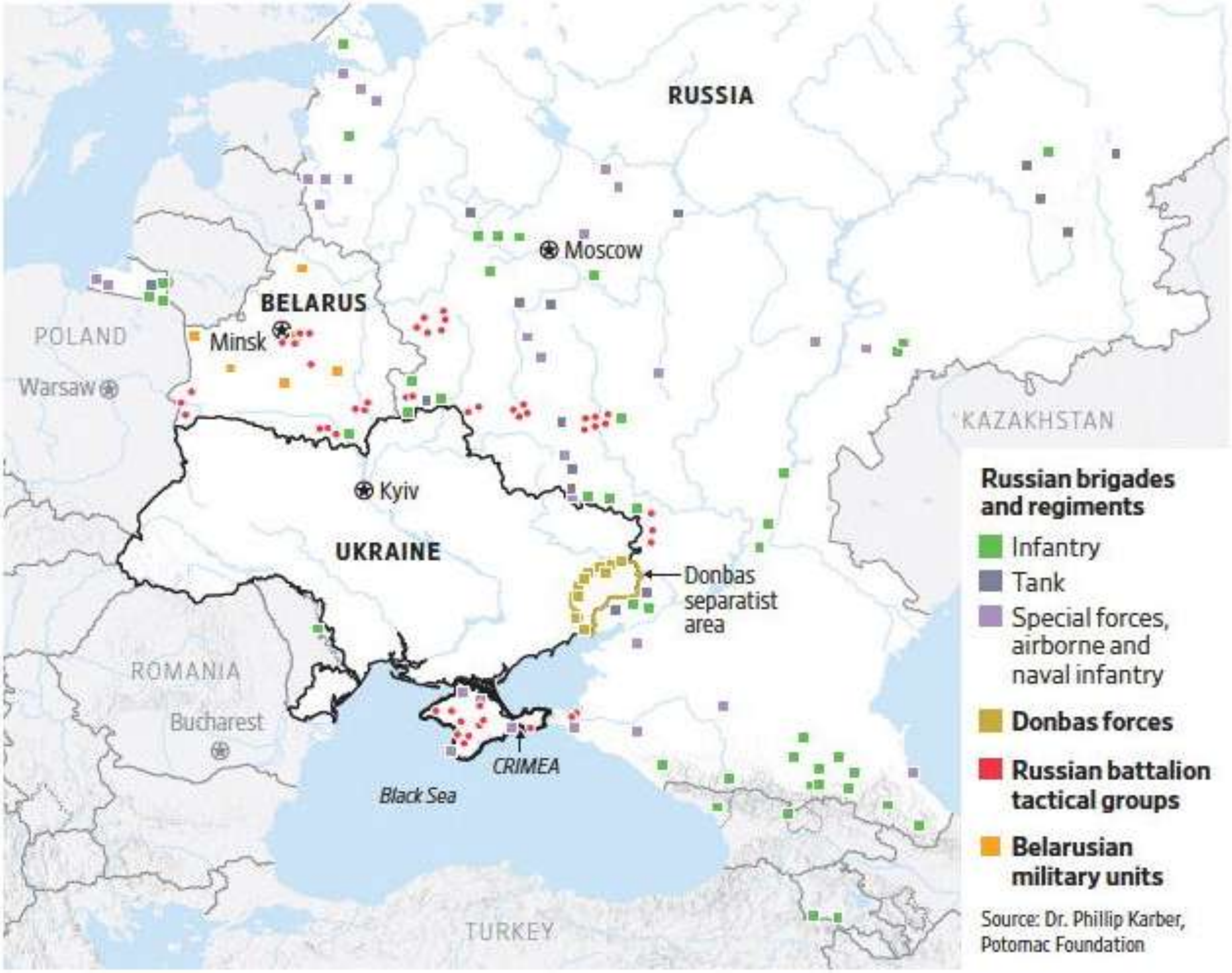
“It seems to me that our possibilities are far from exhausted,” Mr. Lavrov told the Russian leader. “I would propose continuing and intensifying them.”

“Good,” Mr. Putin replied. ...

Mr. Scholz met with Mr. Zelensky Monday in Kyiv, and is expected to meet Mr. Putin in Moscow on Tuesday.

“There are no sensible reasons for such a military deployment,” Mr. Scholz said at a joint news conference with the Ukrainian leader. “The sovereignty and territorial integrity of Ukraine is not negotiable. We expect Russia to take clear steps to resolve the situation.” ...

Russia, which has massed some 140,000 troops along Ukraine’s borders, has denied that it seeks war. But in recent months it made a number of demands on the North Atlantic Treaty Organization. Among other elements, Moscow has demanded NATO never accept Ukraine as a member and curtail troop deployments on the alliance’s eastern flank.



While a NATO summit said in 2008 that Ukraine and Georgia will eventually become members of the alliance, they have not begun membership talks and prospects are low for either nation joining soon. Mr. Scholz repeated Monday that Ukraine's membership in NATO isn't on the agenda. ...

In Kyiv, Mr. Zelensky said that, if it were up to him, Ukraine would already be in NATO. "We won't give up on our path to NATO," he said following talks with Mr. Scholz. ...

and today, despite running out of anything newsworthy to report:

Russia Offers Mixed Signals On Crisis

Putin says Moscow has withdrawn troops from Ukraine border; Biden warns attack is possible

*By **Ann M. Simmons** in Moscow, **Yaroslav Trofimov** in Kyiv, Ukraine, and **Catherine Lucey** in Washington*

President Vladimir Putin of Russia said Moscow had withdrawn some troops from the Ukrainian border and was open to renewed talks to end a standoff with the West, but President Biden said an invasion remained "distinctly possible."

Mr. Putin's comments on Tuesday were part of a recent string of mixed messages from the Kremlin and capped a day of diplomacy and military maneuvering that left Western leaders unsure of his intentions. ...

At a news conference after a meeting with Chancellor Olaf Scholz of Germany, Mr. Putin said, “There is nothing to comment on here. A decision was made to partially withdraw troops.”

The Russian leader said Moscow was “ready to follow the negotiation track” but that the implementation of Russian demands, including a halt to expansion of the North Atlantic Treaty Organization, are “an unconditional priority for us.” ...

Before Mr. Putin spoke on Tuesday, Russia’s parliament urged him (obviously a complete surprise to Putin) to recognize two Russian-backed separatist republics in eastern Ukraine as independent states. ...

The NYT's David Leonhardt provided a good summary this morning of where the **Invasion** stands:

Three explanations

Vladimir Putin may still order an invasion of Ukraine, as President Biden said yesterday. Putin has long been obsessed with Ukraine, viewing it as part of Russia’s immediate orbit. And more than 150,000 Russian troops remain ready to pour over the border if Putin gives the order.

Yet Putin and his top deputies have taken several high-profile steps over the past 48 hours that seem to signal a de-escalation of the crisis. Why? Nobody knows for sure because Putin often shrouds his motives and his plans. But with help from our colleagues in Washington, Moscow and Kyiv, today’s newsletter looks at three possible explanations.

1. Always been a bluff

Putin, after meeting with Chancellor Olaf Scholz of Germany yesterday, said that Russia had decided “to partially pull back troops” from the border. That announcement followed other signs of de-escalation since Monday, including encouraging comments from Russia’s top diplomatic officials about negotiations.

There does not seem to be any immediate cause for Moscow’s change in tone, which suggests that perhaps Putin never planned to invade, despite the huge buildup of troops. “Putin might have been bluffing all along,” Edward Wong, a Times correspondent in Washington, told me, “so seeking a diplomatic resolution where he can wring guarantees, however small, from Ukraine, the United States and Western European nations might be the best outcome for him.”

Putin certainly has reasons not to invade. The sanctions imposed by the U.S. and its allies could damage Russia’s economy. The majority of Russians don’t want an invasion, the Levada Center, a pollster, says. A war would also likely involve large casualties on both sides — including among Ukrainian civilians, many of whom have relatives in Russia, notes Anton Troianovski, the Times’s Moscow bureau chief.

Notably, several prominent experts in Russia, including some who are close to the Kremlin, have been expressing skepticism for weeks about an invasion. Andrew Kramer, a Times correspondent who’s been reporting from Ukraine since November, has noticed similar skepticism in Kyiv and among Ukrainian soldiers at the border. “You would expect more nervousness than you actually see,” Andrew said, “and part of the bigger story here is that the Ukrainians have been less worried on an official level and in society than the U.S. government about the Russian buildup.”

One former Russian official told The Economist that the Kremlin believed it had more to gain from the threat of war than from war itself. That threat may already have won Putin some concessions: Ukraine's president, Volodymyr Zelensky, suggested this week that he might abandon Ukraine's effort to join NATO, which would meet one of Putin's demands. Speaking at the White House yesterday, Biden also showed a willingness to negotiate, saying the U.S. was open to new arms-control agreements with Russia.

Other analysts believe Putin may soon launch smaller attacks against Ukraine, which would help give him influence over the country while also seeming almost like a compromise relative to the threat of a full-scale invasion. One potential smaller attack: stepped-up military assaults by Russia in the Donbas region, a disputed part of Ukraine.

"His main goals — including less of a Western military presence in the region and a guarantee that Ukraine won't join NATO — have not changed," Anton told my colleague Claire Moses.

2. Just timing

On Friday, the Biden administration took the unusual step of telling reporters that its intelligence suggested Putin might invade as soon as Wednesday, Feb. 16 — today, that is. The announcement was part of a broader U.S. campaign to release information about Putin's apparent intentions, partly to make it harder for him to justify an invasion with a false pretext.

Given that announcement, what might be the one day that Putin would least want to invade? "Everyone was talking about the 16th as invasion day," Anton said. "So what better day than the 15th to announce you're pulling your troops back?"

One thing to watch: Will Russia truly withdraw large numbers of troops in coming days, or did the comments by Putin and his aides over the past two days exaggerate those plans?

"I take the news that Russia announced it begins to withdraw troops from the Ukrainian border with extreme caution," Olga Tokariuk, a Kyiv-based journalist, tweeted yesterday. "Let's see if they actually do it." Biden, in his remarks, said, "We have not yet verified that Russian military units are returning to their home bases."

As Edward Wong put it, "Putin likes to cultivate an aura of unpredictability, and the physical signs of de-escalation are minor at best."

3. An effective pushback

Edward spent last week traveling with Secretary of State Antony Blinken on a trip around the Pacific and said he was struck by how synchronized the messages from the U.S. and its allies in Asia and Europe sounded. Earlier in the Ukraine standoff, such coordination was not a given. Germany, in particular, seemed hesitant to stand up to Russia.

"There's also a strong argument that Putin has overplayed his hand," Edward explained. "The Biden administration and European governments have stayed in lock step on pushing back."

The public response inside Ukraine may also have reminded Putin how costly a war would be. Many citizens seem ready to take up arms if Russia invades, and Ukrainian nationalists have been pressuring Zelensky to remain strong.

From today's **Insiders Forum Portfolio Update**:

Investors were treated to a significant relief rally yesterday as we saw the first signs of a possible de-escalation between Ukraine and Russia. The NASDAQ was up two and a half percent for the day and the S&P 500 was up 1.6%. ...

The news around the Ukrainian situation overshadowed another key reading showing inflation remains out of control. The Producer Price Index rose one percent for the month and 9.7% on a year-over-year basis. Core PPI rose .8%. All readings came in significantly above the consensus. The prior readings were also slightly revised higher. This is the latest economic report showing inflation is nowhere near to being contained. There seems to be more and more chatter calling for a 50-basis point hike to start off the Federal Reserve's coming monetary tightening effort.

This is the key reason I believe yesterday's trading action was no more than a relief rally. The market still trades for north of 20 times S&P 500 forward earnings just as the central bank is about to take away the 'punch bowl'. The 10-year treasury yield just crossed the two percent threshold. This is already having an impact on the housing market where the average 30-year mortgage rate has risen beyond three and three quarters percent after spending most of the past two years under the three percent level. It is hardly surprising to see mortgage application volume start to fall.

In addition, consumer sentiment is at decade lows and flashing at least a yellow light. I came across an interesting set of data points the other day. A professor at Dartmouth noted that every economic slump in the United States since the 1980s has been foreshadowed by at least 10-point drops in consumer indices from the Conference Board and University of Michigan. The former dropped over 25 points in 2021 while the latter was off slightly more than 18. These are eerily similar readings to what occurred before the financial crisis in 2008.

With inflation running approximately two percent ahead of average wage gains over the past year and costs for staples like rent and gas soaring, it is hard to blame the consumer for being in an increasing cautious stance when it comes to confidence. This is especially true on the lower end of the income scale which has less disposable income to deal with these cost increases.

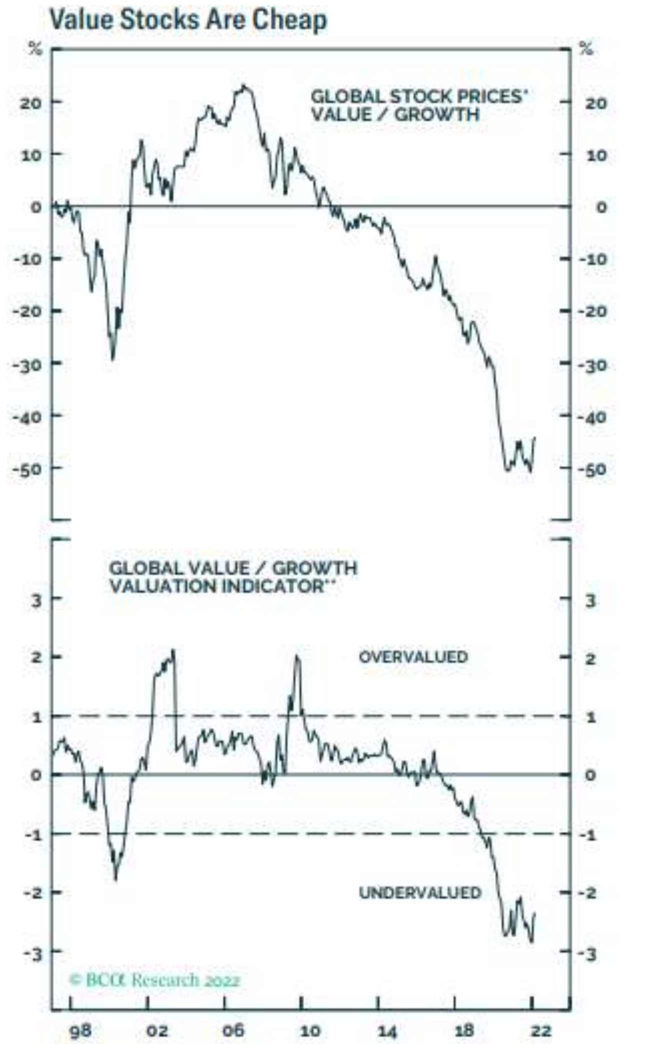
These are key reasons we have slowly been using declines in the market to put some of our 'dry powder' to work over the past couple of months while preserving enough 'ammo' should lower entry points become available. With coming Fed interest rate hikes likely to cause at least a 'hiccup' in the markets when they occur, this seems the prudent strategy at the moment. Insider buying has picked up since the big declines in January, which I view as an encouraging sign there are still some pockets of value within equities even if I still believe the market is at least fairly valued on the whole, with many areas seemingly overvalued.

Investors tend to migrate to value and GARP stocks when interest rates are rising, especially if the economy is cooling, which it clearly is. Big recent declines in **Meta Platforms** (Facebook) and **Netflix** are good examples of what happens to pure growth stocks in this type of environment on any kind of disappointment. ...

Our thoughts

As we have repeatedly stressed, we don't believe in attempting to time the market. One of our favorite quotes, and one that we have previously shared, comes from Jack Bogle, founder of the Vanguard Group, on the ability of investors to successfully time the market: **"I don't know anyone who's got it right. In fact, I don't know anyone who knows anyone who's ever got it right."**

However, geopolitical crises have often provided buying opportunities, as Mr. Market overreacts. That hasn't been the case so far with the current selloff. For example, our last IVA System Pick was BCOR, as detailed in December's Newsletter. Unlike panic lows, single day reversals like we saw on January 24th, which set the intraday low for this selloff, are not statistically predictive. We have allowed cash to build in client accounts, including two relatively large cash infusions, and for now are waiting for more clarity on **Whammy #2**.



* REBASED TO JAN. 1997 = 0%.
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Value Stocks are inexpensive, as noted in last Friday's Global Investment Strategy Report, and shown to the right: "Despite having outperformed tech-heavy growth stocks by 14% since last November, value stocks remain exceptionally cheap by historic standards." The Report also reiterated their predictions on the course of interest rates:

"US rate expectations continued to move up this week, egged on by St. Louis Fed President James Bullard’s statement earlier today declaring that he favors raising interest rates by a full percentage point by the start of July. The market is now pricing in six rate hikes by the end of the year.

Historically, bond yields have increased starting about four months before the first rate hike and over the period in which the Fed is raising rates.

While we do not think the Fed will need to deliver more tightening this year than what is already discounted, we do think that investors will eventually be forced to revise up their expectations of the neutral rate to between 3%-and-4%. However, the market expects the Fed to stop raising rates when they reach 2%, which we regard as unrealistic."

Finally, this on inflation from Morningstar:

The Inflation Hedges Haven't Hedged

When inflation arrived, they slept.

John Rekenthaler
Feb 14, 2022

The Imperfect Storm

On May 12, 2021, inflation struck the United States. That morning, the Bureau of Labor Statistics announced that the nation's core inflation rate--derived by stripping out food and energy costs from the Consumer Price Index--had risen by 0.9% in April, the largest such increase in 39 years. Although core inflation has since declined, the rate remains well above its previous level.

The surge was unanticipated. When 37 economists were surveyed in November 2020, their prediction for the 2021 core inflation rate was 1.8%. In addition to providing the median estimate, the forecasters were also asked whether 2021 core inflation would exceed 4%. They estimated that possibility as zero. Not less than one chance in 100. Not less than one chance in 1,000. Not even one chance in 10,000. Zero. (The actual amount was 5.9%.)

The conditions were ideal for inflation hedges, not only because prices surged, but also because they did so suddenly. Investment hedges don't necessarily protect against widely predicted troubles, as those events may already be reflected in the securities' prices. But they should certainly defend against surprises. A hedge that doesn't shield against abrupt shocks is a failed hedge.

Four Candidates

And this, unfortunately, is largely what investors have owned: failed hedges.

1. *Gold*. The traditional inflation hedge, of course, is gold, a commodity with more than 5,000 years of price history. Since the Bureau of Labor Statistics released its announcement, gold bullion has dogpaddled. Nobody looking at a gold price chart would be able to tell when inflation resurfaced.

2. *Treasury-Inflation Protected Securities*. Along with gold, TIPS are the most logical inflation hedge. After all, they were created by the U.S. government for exactly that purpose. As with gold, TIPS have gone nowhere. From May 12 until now, they have gained barely more than 1%. So far this year, relates Morningstar's Tom Lauricella, their performance has been worse yet, with TIPS chalking up losses.

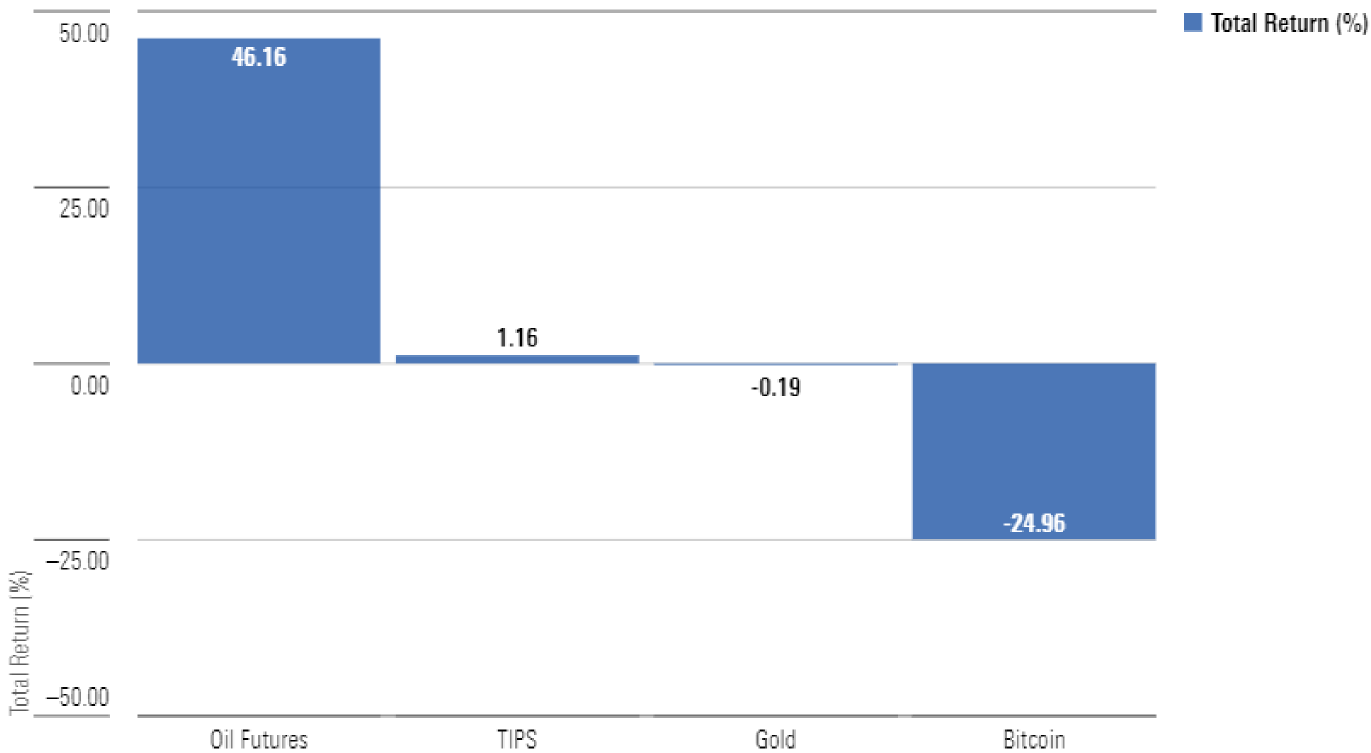
3. *Cryptocurrencies*. Cryptocurrencies are commonly regarded as electronic inflation hedges. That makes sense. Historically, gold has appreciated when fiat currencies have stumbled. So, why would the modern equivalents of gold behave differently? But behave differently they have. Unlike gold, cryptocurrencies haven't broken even since the Bureau's announcement. They have lost money, badly. (Bitcoin's main rivals of Ethereum and Binance Coin have performed somewhat better, but they have also been in the red since mid-May.)

4. *Energy*. Energy long ago lost its investment allure. Not only has oil badly trailed other assets since its 1980 peak, it also hasn't protected well against stock-market declines. Crude oil fell during the 2000-02 technology-stock downturn, lost two thirds of its value through the 2008 global financial crisis, and briefly turned negative amidst the pandemic. Recently, though, oil prices have surged, making energy the sole winner among the four potential inflation hedges.

Assessing the Results

The following chart depicts the returns since the week of the Bureau's announcement for the largest investable version of each of the inflation hedges: 1) SPDR Gold Shares (GLD), 2) Vanguard Inflation-Protected Securities (VIPSX), 3) Grayscale Bitcoin Trust (GBTC), and 4) United States Oil Fund LP (USO).

Exhibit 1 Inflation Hedges (Total Returns, May 12, 2021-Feb. 12, 2022)



Source: Morningstar Direct.

An unimpressive showing. Among the group, only energy has flourished, and it's doubtful given the lack of investor interest whether it even belongs on a list of inflation hedges. For example, United States Oil has attracted only $2.6 billion in shareholder monies, as opposed to $27 billion for Grayscale Bitcoin Trust, $41 billion for Vanguard's TIPS fund, and $60 billion for SPDR Gold Shares. Oil prices respond almost entirely to industrial demand rather than to investors' inflation expectations. ...

What's Going on Here?

The problem doesn't lie with the assets. (We disagree on Bitcoin, Et al. These have become speculative vehicles that are increasingly correlated with stocks.) Cryptocurrencies may prove to be illusory, and while oil prices advanced during this inflationary bout, they might well sink during the next one should industrial demand be slack. ... Gold's inflation-fighting powers have been amply demonstrated over many centuries. And TIPS were explicitly designed to combat rising inflation.

The reason for the uninspiring performance of the inflation hedges thus lies elsewhere, outside the investments themselves. One possible explanation is that current inflation is a mirage. Not to say, of course, that the Bureau of Labor Statistics cooked the numbers (government bodies are not in the habit of spoiling their own reports), but instead that the increase is only temporary. When the global supply chain becomes unstuck, inflation will diminish.

Another interpretation is that although inflation's arrival caught market forecasters unawares, it did not surprise investors. They did not know when inflation would surface, any more than did the forecasters, but they knew that sooner or later, the bad news would arrive. Consequently, they had already bid up the prices of inflation hedges. Thus, when inflation did appear, gold and TIPS failed to react, because their values already anticipated the event.

The evidence supports both answers. The bond market has treated, and continues to treat, today's inflation as a mirage. The yield on 30-year Treasuries has *declined* since May 12, 2021. (Yes, it has.) The public may regard inflation as a headache, but not bond investors. They see no need to hedge against inflation that will not persist. Also, it appears that inflation hedges have been aggressively valued. From 2018 through summer 2020, gold prices rose by more than 50%, while the real yield on TIPS shrunk to negative 1% from 1%.

The upshot: Inflation hedges disappointed because the financial markets aren't (yet) convinced that inflation is here to stay, and because the insurance they provide was costly. With hedges, as with other securities, the investment features alone don't determine returns. The cost of admission also matters. ...

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