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Inflation's got legs

"In my opinion," says Murray Stahl, co-founder, chairman and CEO of Horizon Kinetics, LLC and progenitor of the Inflation Beneficiaries ETF (INFL on the New York Stock Exchange Arca), "they've started a process that may go on for decades—that is now outside the ability of anyone to control."

We write to explain and, with Stahl, to speculate. By "they," our informant approximately means The Man: central bankers, legislative bodies, governments in general, the International Monetary Fund and, for want of a better term, the angels and archangels who direct the rise and fall of nations. The "process" to which he refers is inflation.

No sooner did Jerome Powell, chairman of the Federal Reserve Board, retire the unhelpful inflation modifier "transitory" than Wall Street lobbied to un-retire it. Now the CNBC-compliant institutional message is that the rate of inflation has peaked and the Fed will presently stop tightening. The yield curve will invert. There will be, or is now, a statistical recession, but it will give way to a new expansion. The stock market bottom is in. The bond yield top, ditto.

As usual, Stahl is a dissenter from the consensus line, though, as he is first to say, that doesn't necessarily make him right. And one could observe that, with respect to inflation, he is no disinterested party; INFL needs inflation as Elon Musk needs attention. But nobody twisted Stahl's arm to make him predict, in so many words, that today's toddlers will quaff their first legal beer ("That will be \$1,000, young man") while suffering from the same inflation that plagued their parents.

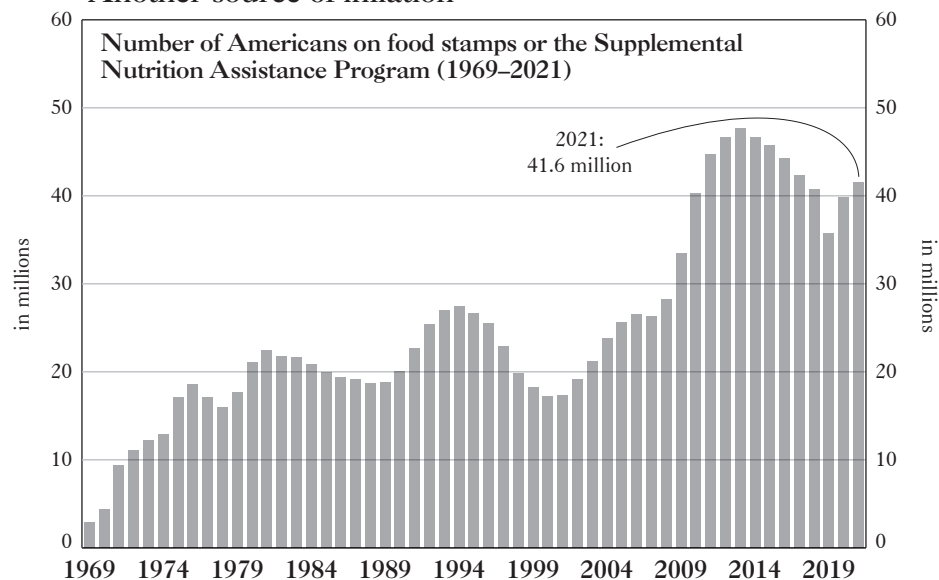
Today's plunging growth in M-2, collapsing lumber price, sleepy gold price, falling bond yields, still-elevated dollar exchange rate, etc. do not lend superficial credence to Stahl's contentions. Where does he get them? Not by direct reference to the canons of Keynesian, monetarist or Austrian thought (although he is well aware of those ideas). He rather seems to think them up.

Stahl collects facts and builds investment hypotheses. Not exactly a theorist, he creates a worldview from micro- and macroeconomic observations. At 68, he is old enough to have seen such investment singularities as a bear bond market, and he draws on that lived cyclical experience, too.

Stahl expresses himself in prose, not bullet points, and makes no attempt at elevator-pitch conciseness. Our (unauthorized) attempt at that miniaturization goes like this: Welfare-state entitlement inflates the demand side of the economy. Welfare-state regulation shrinks the supply side of the economy. Easy money lifts nominal purchasing power. Geopolitical strife impinges on the international division of labor.

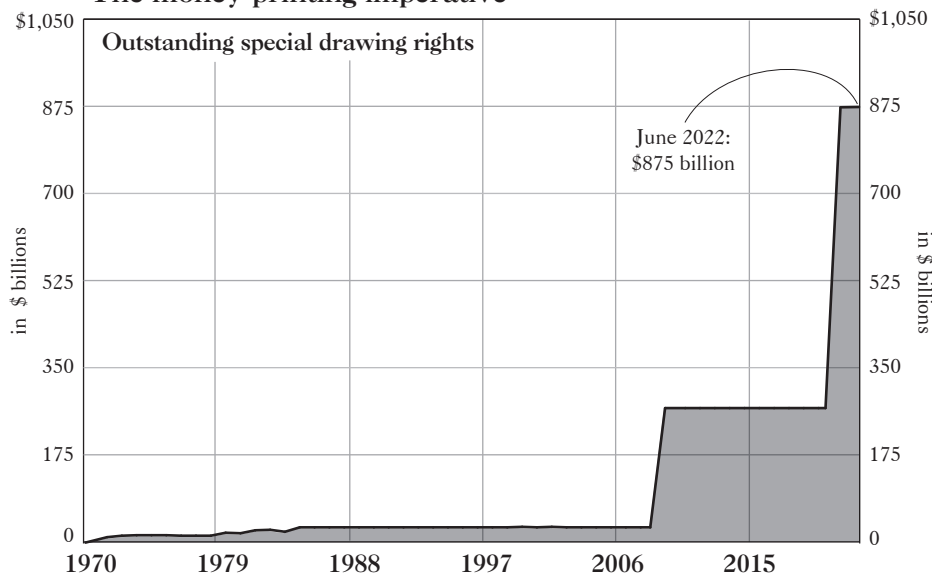
Missing in this condensation is microeconomic nuance. Take, for instance, Stahl's theory about 21st-century wages: "Because so many people's work is so specialized, it's not easy to replace a specialized employee. They have a unique form of bargaining power. For employees of

Another source of inflation



source: U.S. Department of Agriculture

The money-printing imperative



source: International Monetary Fund

the past—let's say, the classical assembly line worker or agricultural laborer—labor was highly unspecialized. Labor was a commodity.”

Specialization is rather today's fact, Stahl goes on: “There are not merely plumbers, there are people who specialize, let's say, in the kind of plumbing you do in industrial waste treatment or very complicated municipal water systems. Aircraft mechanics are another example.”

To become an airline mechanic requires 18 months of classes or 18 months of on-the-job training and a passing grade on the Federal Aviation Administration's written, oral and practical exams. The timeframe expands to 30 months to qualify for both airframe and power-plant ratings.

To which might be appended a few recent lines from the CEO of Stanley Black & Decker, Inc., Jim Loree: “The skilled labor shortage is one of the biggest challenges facing the U.S. economy, with 650,000 open jobs in the construction industry alone. This problem existed long before the pandemic but has certainly been exacerbated by it.”

A reported decline in the annual number of petroleum-engineering graduates from American colleges and universities—to about 400 this year from more than 2,300 in 2017—inspired a tweet observing that the Major League Baseball draft class of 2022 was bigger than the new crop of budding oil-company executives.

Which, in turn, calls to mind the June comments on petroleum refineries by Chevron Corp. CEO Mike Wirth: “We haven't had a refinery built in the United States since the 1970s. My personal view is there will never be another new refinery built in the United States.... You're looking at committing capital 10 years out. That will need decades to offer a return for shareholders, in a policy environment where governments around the world are saying, ‘We don't want these products.’”

Nor is refining uniquely neglected. Divide capital spending by the component companies of the S&P Global Natural Resources Index by U.S. GDP, as Stahl has done, and you see a trend that peaked in 2012. Whether such facts bode ill or well for planet Earth is outside our ken. However, on the narrow question of the supply of, and demand for, critical raw materials in the here and now, we judge that demand will trend higher and faster than capacity-constrained supply.

Type “FRED CPI index” into your favorite search engine, and behold the decades-long, virtually uninterrupted rise in consumer prices. We, with Stahl, conclude that the depreciation of the currency is the social-democratic norm. New and different is the rate of decline.

Listen to Stahl talk about inflation (or read the July edition of his Horizon Kinetics market commentary that's posted on the HK website), and you'll

learn something about the following subjects: diamonds, food stamps, the nature of 21st-century work, the end of the Cold War, interest rates, impediments to seaborne commerce, the government's social contract with the electorate and the common stocks of businesses that work with the bare minimum of human hands. The list commingles inflation-themed investment opportunities with thoughts about the causes of the inflation that gives rise to opportunity.

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A 1976 alumnus of Brooklyn College, Stahl founded Horizon Asset Management in company with Peter Doyle and Steven Bregman, among other colleagues of his from the old Bankers Trust Co., in 1994. (A 2011 merger added “Kinetics” to the corporate name plate.) The firm, which is employee-owned, manages a total of \$6.8 billion, including \$1.3 billion in the INFL exchange-traded fund, \$1.4 billion in mutual funds, \$900 million in alternatives and \$3.2 billion in separately managed accounts. Bitcoin mining was a 2017 Horizon Kinetics initiative and INFL a January 2021 launch. And newly arrived as of May is a closed-end fund holding standardized, tradable diamonds. Unlike the Fed, Stahl's firm didn't just discover inflation.

Since inception, INFL has delivered a cumulative return of 24.5% versus 11.2% for the S&P 500 and 0.3% for the Bloomberg TIPS Index. Energy royalty companies such as Viper Energy Partners, L.P. (VNOM on the Nasdaq) and Prairie Sky Royalty, Ltd. (PSK on the Toronto Stock Exchange) have significantly contributed to those gains. So, too, has Texas Pacific Land Corp., on whose board Stahl sits and whose praises Horizon Kinetics sang in the first research report it published 20 years ago. Detractors to performance include Japan Exchange Group, Inc. (8697: Tokyo), owner of the Tokyo Stock Exchange, and Intercontinental Exchange, Inc. (ICE), owner of, among other worldwide bourses, the New York Stock Exchange.

The presence of securities exchanges in the INFL portfolio opens a window on Stahl's investment thinking. One might suppose that the exchanges on which financial assets change hands

would be especially susceptible to the ravages of inflation. Certainly, the stock market seems to believe it.

Not Stahl. The exchanges, like royalty trusts, are toll-takers, he observes. They do not produce a product but earn a contractually fixed share of the revenue of the counterparty that does. He asks, knowing the answer: Would you rather own a gold mine, with the attendant gold-price risks, or a royalty company like Franco-Nevada Corp. that earns a share of mining revenue whatever happens to the gold price?

Inflation victimizes most businesses, especially the fully staffed and capital-intensive ones. Better, then, to invest in the lightly staffed, asset-lite inflation beneficiaries. "It's still a thesis," Stahl concedes of the intellectual underpinning of the INFL portfolio. "It has to be proven that the companies with the lowest labor-cost components can be [inflation] beneficiaries. I don't think the world, in general, is looking at stocks through that lens.... So I have this construct, this mental construct, of the world. And like many times in my life, I think I'm in the minority."

Cast your eye back to the transformation of the world's product and labor markets some 40 years ago, Stahl beckons. From 1990 to 2021, according to the World Bank, the global labor force expanded to 3.46 billion people from 2.32 billion. The central banks had nothing much to do with this disinflationary jolt, nor with the related opening of worldwide commodity markets

to former totalitarian pariah states. The decline and fall of inflation-inducing political systems (e.g., Soviet Communism and unreformed Chinese Communism) was rather the catalyst for the disinflation that the tides of geopolitics are now reversing.

Far from being the norm, then, Stahl contends, the past several decades were the anomaly: "Anomalous as to the conditions that created the historically extreme corporate profit margins. Anomalous as to the 40 years of declining interest rates that supported extreme stock and bond valuations and that enabled governments to finance spending levels in excess of tax revenues and otherwise unsupportable levels of debt."

So it's back to the future, though not, as an inflation hawk may reflexively assume, to the 1970s. The ratio of gross public debt to GDP, which closed the 1970s at 32%, today stands at 123%, slightly higher than the post-World War II peak. The government would surely meet the next recession with a gust of spending, just as it did the pandemic. How would it pay the bills? Not without more monetary magic, as Stahl and we—and Federal Reserve Governor Christopher J. Waller—independently agree. In reaction to the Great Recession, the Fed monetized bonds and mortgages and pinned interest rates to the floor. The pandemic crystallized an even more aggressive style of QE (which assets *didn't* the Fed buy in March 2020?), along with another episode of zero-percent rates.

"I hope we never have another two years like 2020 and 2021," Waller told the Dallas Society for Computational Economics on June 18, "but because of the low interest rate environment we now face, I believe that even in a typical recession there is a decent chance that we will be considering policy decisions in the future similar to those we made over the past two years." We requote those remarks (*Grant's*, June 24), because they speak to Stahl's contention that the money-printing impulse is ever present. Only its institutional form changes.

"They haven't expanded the Federal Reserve balance sheet very much," Stahl continues, "but they've managed to add \$650 billion of money creation [through] special drawing rights at the International Monetary Fund. So they're still at it, just at it with a different organization."

Then inflation, with apologies to Milton Friedman, is always and everywhere a complex phenomenon and above all a human one. Especially susceptible to inflation, we judge, is a society in which 41.5 million citizens draw food stamps (from the Supplemental Nutrition Assistance Program) in the context of a 3.6% jobless rate and 48 million households are instantly qualified for the government's brand new Affordable Connectivity Program, which subsidizes broadband service.

Inflation may ebb and flow, but it comes with the social-democratic territory.

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