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The following contains a brief discussion from the Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane.

SIMG Thoughts on Inflation
Part 1

Beginning in the fourth quarter of 2020, we started to focus on inflationary risks, and in the last three months, the world has become laser-focused on the issue. So far, our thesis has played out as expected, and the data seem to support the case that we will have some inflation. The real question is whether it will be transitory or structural.

If you were to ask me to make a case for unanchored inflation, and a sharp rise in interest rates, I am certain I could present a very compelling argument. If you asked me to take the other side and present a case for a temporary uptick in inflation and then a reversion back to continued low inflation and low rates, I have just as much confidence we could deliver that line of reasoning as well.

The NY Times ran an article on March 14, 2021 in which they asked ten economists to comment on inflation. I thought Larry Summers, the Harvard economist and former Treasury Secretary had an insightful answer. He said that he thought there was a 1/3rd chance for each of these scenarios: 1. higher inflation, 2. financial instability and recession, and 3. policy makers getting it right.
As much sense as Secretary Summers' analysis made, I think I preferred Olivier Blanchard's answer best. He is the former chief economist for the IMF. Here is his response:

> I shall plead Knightian uncertainty. I have no clue as to what happens to inflation and rates, because it is in a part of the space we have not been in for a very long time. Uncertainty about multipliers, uncertainty about the Phillips curve, uncertainty about the dovishness of the Fed, uncertainty about how much of the $1.9 trillion package will turn out to be permanent, uncertainty about the size and the financing of the infrastructure plan. All I know is that any of these pieces could go wrong.

Knightian uncertainty is a notion developed by economist Frank Knight. His distinction is that "risk" applies to situations where we can define the potential outcomes, and assign some probability to those outcomes. There is risk in rolling a pair of dice, but we know what the odds are of any given number. "Uncertainty" on the other hand, applies to matters where we can't identify all the possible outcomes, and can't even begin to know what the likelihood of any particular outcome. Think: Donald Rumsfeld's famous line on unknown unknowns.

We could run down the list of macro-related issues, and encounter the same dilemma. And these are the risks we can identify. We are well aware of the inflation risks, the COVID risks, geopolitical risks and so on. Discounting the probabilities of the various outcomes is challenging, but something we can make educated guesses about. But what about *uncertainty*? What about the events that we are entirely unable to anticipate or measure?

We are used to dealing with risk and uncertainty; it's ever-present, and it's at the very core of what we do. What's different is that *so many of these risks and uncertainties are in the hands of policy makers*, and therefore they aren't company-specific, but instead are sweeping factors impacting the entire economy. In some sense it's been this way since 2008 and the GFC, but the scale has only grown since then. What keeps me up at night is Mr. Blanchard's comment, "All I know is that any of these pieces could go wrong."

And it's not just about what can go wrong, but it's also about the side effects and unintended consequences. If you've taken enough economics classes, you probably learned that price controls are problematic at best. They rarely produce the intended results, and they create some odd incentives. The classic example is rent control, which is intended to keep the cost of housing low. However, with artificially low rent, there is a reduced incentive to build new properties or to invest in existing ones, which in turn limits the available supply. By definition, this leads to a market out of equilibrium, and a shortage of the very thing they're trying to supply.

If you think of interest rates as the price of money, then the Fed's actions are significant price controls, and have created a market that is out of equilibrium and surely filled with strange incentives. What will be the lasting impact of those incentives? If the Fed stopped all intervention, and promised to let natural market forces dictate the entire yield curve, where would rates be today? What would the impact be to the stock market? Would we be worried about inflation still?

There are a lot of risks on the horizon. Investors are aware of most. In terms of Knightian uncertainty, we *aren't* aware of the curve balls coming at us. All of this reinforces a thesis I proposed some time ago, that the rate of change in the world and in the economy is only accelerating. While this is scary news, it's not necessarily bad news. I don't mean to imply that these uncertainties are reasons to be bearish. As a long-term investor, these events can create compelling opportunities for alpha. I would contend that what we at Stephens Investment Management Group do best is identify change, and exploit the market's chronic underestimation of the magnitude and duration of change. The more change, the more opportunity.

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