

CHESS MATCHES, KNOBS, and RATCHETS — UNDERSTANDING BEHAVIORAL *INFLATIONOMICS*

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Physical phenomena adhere to immutable laws. While Finance and Economics are far from random, their lawfulness is not rigid but unfolds on a complex behavioral chessboard. There, the moves of consumers, savers, investors, planners, and controllers (fiscal/governments and monetary/central banks) are sequentially counterposed.



Welcome to *Inflationomics*, your guide to understanding the critical championship chess match shaping today's markets.

In the opening, playing 'White,' the global economy shut down following the CoViD outbreak.

This caused a collapse in supply chains, demand, inflation (CPI 2.5% > 0.1%), interest rates (10-yr. US Tr. 1.6% > 0.8%), output (US GDP \$22T > \$19T) and the broader market (S&P 500 3300s > 2400s).

Playing 'Black,' the Fed responded by lowering its target rate to 0.25%.

Entering mid-game, there was a vigorous rebound in the market (4700s), the economy (\$25T), interest rates (1.5%), and inflation (7%). It was met with the Fed's non-move (rates left at 0.25%) under the expectation that inflation was "transitory."

This did not happen, and the game got utterly messy.

After peaking (9.1%), inflation declined significantly (3%+), while the Fed was frantically hiking rates (1.8% > 5.5%), a move mirrored in the bond market (3.0% > 4.9%).

This is the current state of the chessboard:

Fearing that White (Economy/Markets) could reignite inflation, the Black (Fed) has mounted an outsized (2% above CPI) demandflation defense to a diminishing supplyflation challenge—for too long (over a year). This misplaced defense has backfired.

Since 2022, persistently higher rates have skyrocketed borrowing costs, depressed business earnings, and endangered less well-capitalized households and businesses (even triggering bank failures). Mortgage affordability has plummeted, top-tier employers have turned to cost-cutting and layoffs, and consumers have retrenched.

One might hope that this dynamic operates like a *knob* that is initially dialed up but eventually will get turned down, but not everything works that way. Instead, many shifts work like *ratchets*.

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Businesses have begun raising prices, and employees are pushing to secure increases in earnings, benefits, and entitlements—all of which act like inflationary ratchets, not knobs. When interest rates eventually decline, these increases won't recede, cementing a secondary wave of demandflation. That can spell checkmate against the Fed, and the odds for that increase the longer the central bank awaits.

Supplyflation requires speedy remobilization and fiscal discipline but doesn't respond well to monetary interventions. The side effects of the Fed's prolonged and misguided defense are now generating a secondary wave of demandflation.

Wall Street pundits cheer the Fed but remain immobilized, awaiting its next move. Meanwhile, our strategies take a different approach, which we invite you to explore!

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