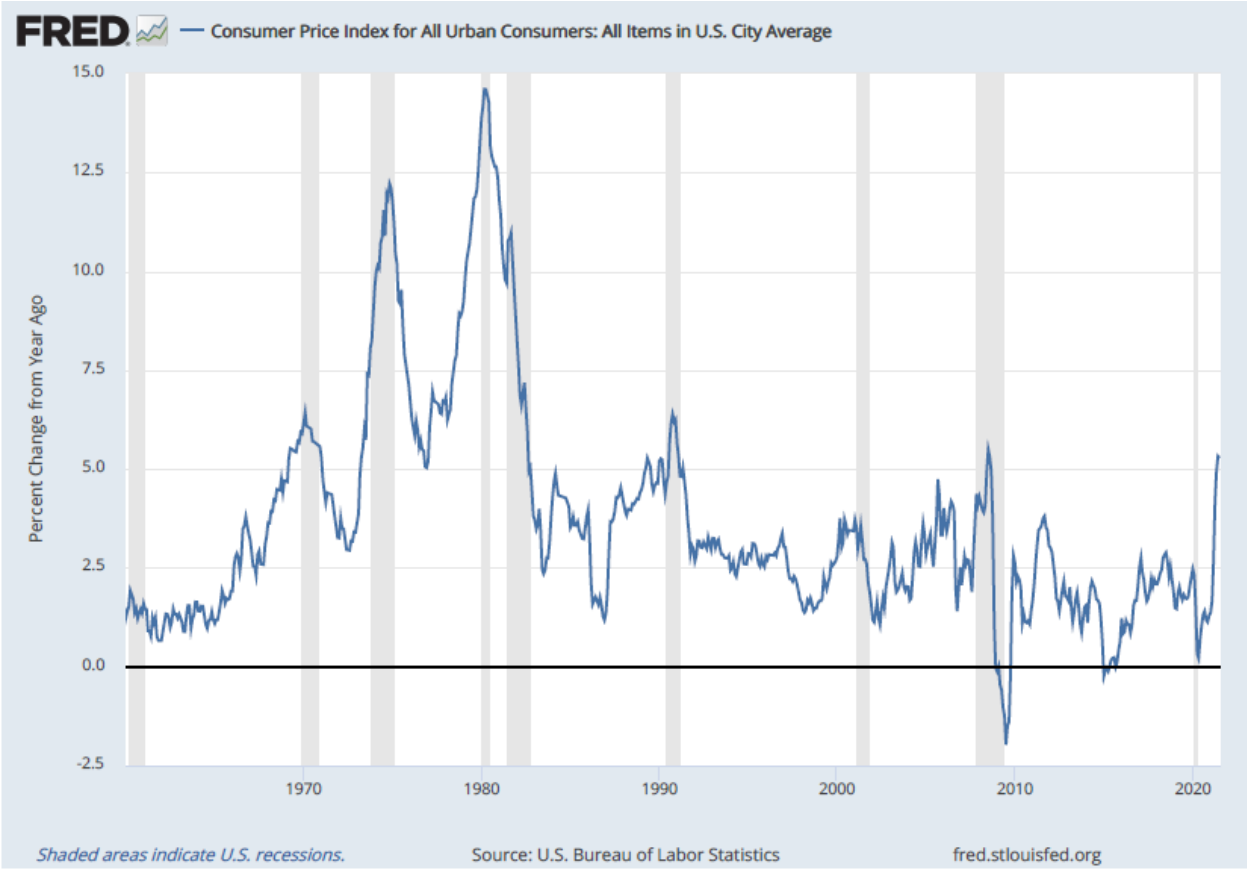
Honey Badger ADVISORS LLC

Inflation is Here

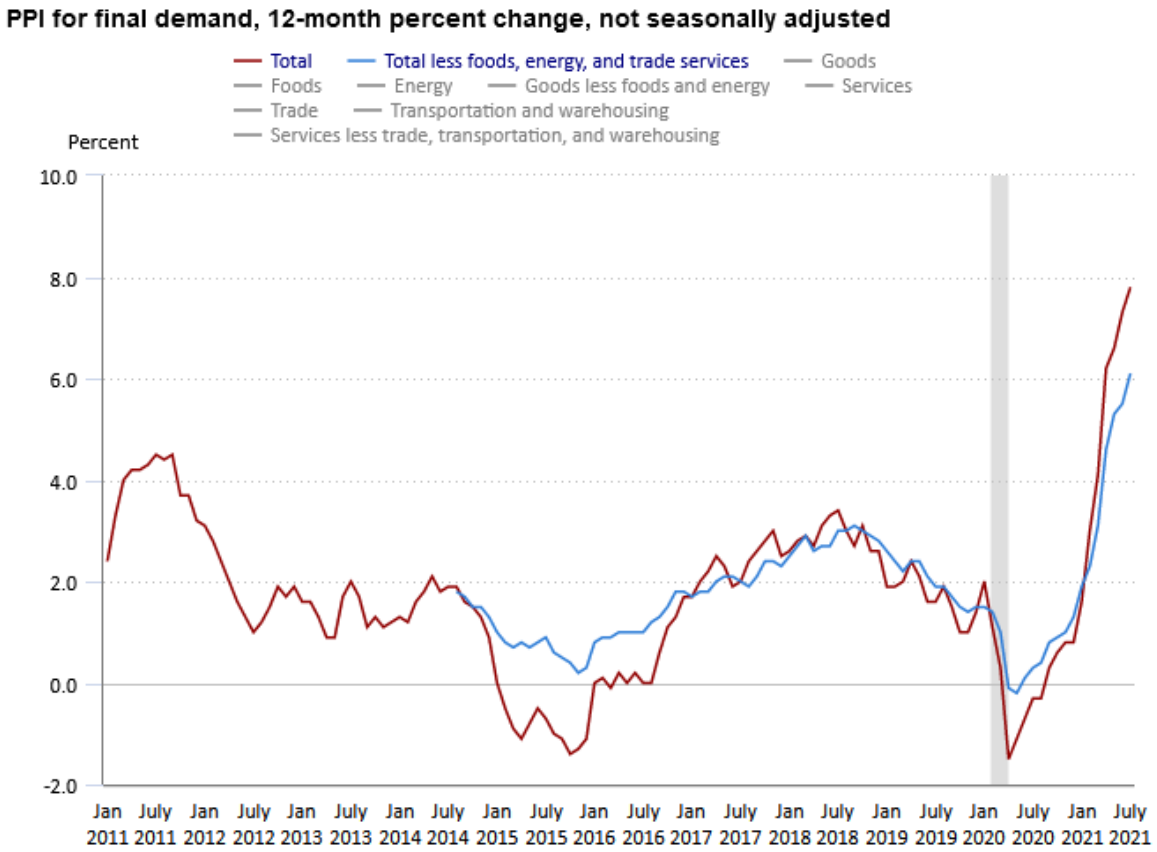
If you looked at your budget over the last several months, you must have noticed that you can afford less than before – prices of common goods and services have been going up and now we have a clear indication in economic data:



U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average [CPIAUCSL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPIAUCSL

The latest reading in July 2021 came at 5.28%.

For over 10 years inflation was very subdued hovering around 2%. The Fed expressed their belief that this is "transient". We disagree – stimulus packages provided the means and the pent-up demand from the pandemic ignited the demand. In the CPI graph above the sharpness of the increase and the amount are unlike any of the recent inflation increases. Moreover, the PPI index is running hot as well, coming at 7.8% increase from previous year:



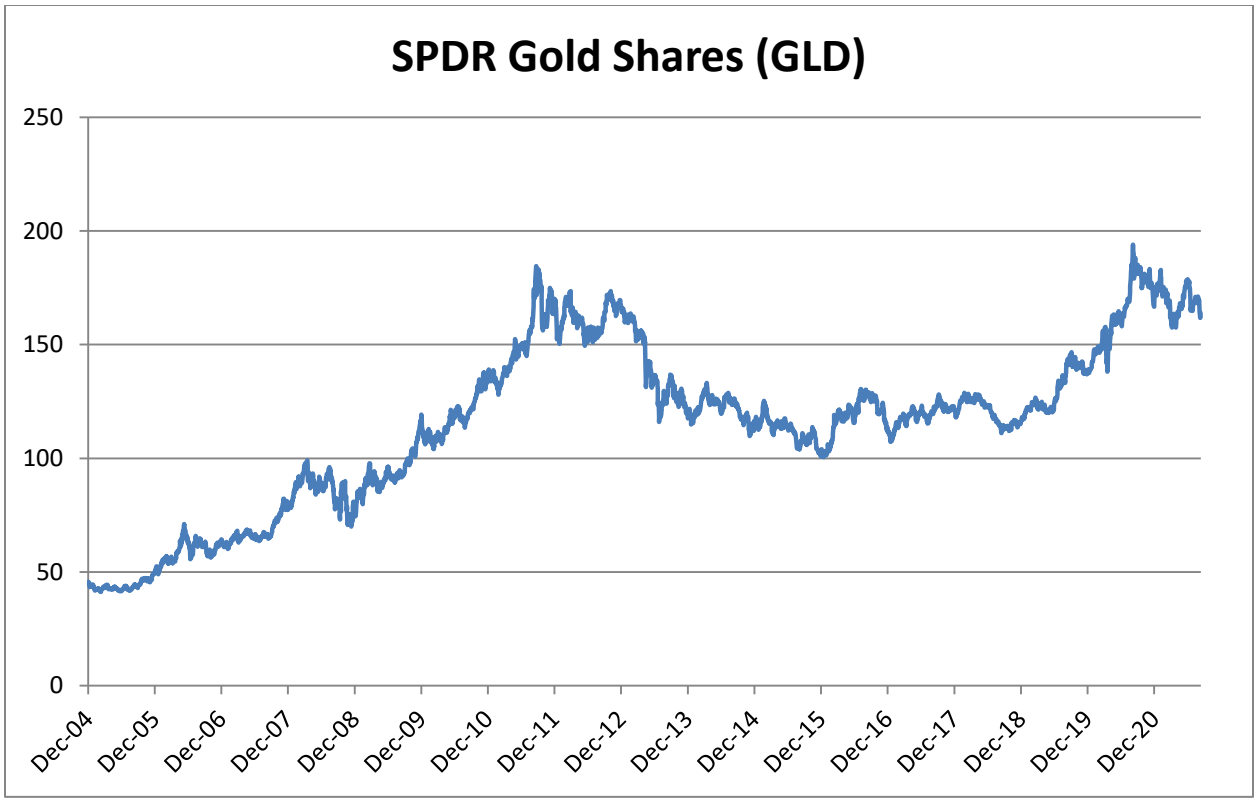
Source: US Bureau of Labor Statistics

This point to price pressures in the pipeline that will eventually be passed on to consumers. This leads us to conclude that we are going to see higher levels of inflation and for longer period of time. There is clear risk that the Fed is behind the curve and will have to react hard to runaway inflation, by raising interest rates and likely inducing a recession – which can be clearly seen in historical record.

What does higher inflation mean for investors and what can you do to mitigate the effect?

For bond investors, especially long-term bond investors this is very bad news. While the coupon is fixed the value of money received is diminishing at rates higher than that coupon.
On the other hand, companies have recovered their pricing power and that will bode well for the equities. Until the interest rates start rising again. None of this means that the market risk has suddenly disappeared; in fact, it is very much elevated.

In times of inflation, investors usually turn to commodities – the idea here is that commodities represent real tangible inputs to production and can thus keep the pace with inflation. For a big part of the investment public, the precious metals take that place. What is mostly forgotten is that commodities are not buy and hold assets. Production commodities and food have natural cycles and precious metals are volatile, which is exemplified by the Gold Shares ETF:



Retail investors are not in a position to follow the volatility of these assets effectively. The solution is offered in the form of CTA – commodities trading advisors also known as managed futures, which can take advantage of both rising and falling prices. Up until recently these were only available in the LP form to qualified investors, however multiple firms have setup liquid alternatives that replicate these strategies in accessible ETF and mutual fund form. Historical correlation to S&P500 is very close to zero or weakly negative. Combining a CTA allocation with a long exposure to stocks is an effective way to mitigate the effects of inflation as well as to reduce the equity market downside risk.

The effect of inflation is that investors are pushed into more aggressive equity allocations. While the equity market still has some room to grow, the correction is inevitable as the CPI graph above shows. Timing the pullback is a nearly impossible task; thus, one needs to think about ways to mitigate the risk now while the volatility is still manageable. One way to address this is to combine the long equity position with long dated put options. This is effectively buying insurance on the equity allocation. As with any insurance, it is not free, it reduces the participation in the upside, but it does reduce the effects of the downside. We believe that reducing losses in the downturn is the key to successful investing. A program like this can be implemented individually, or by using mutual funds and ETFs that have this feature built in.