Cadence Bank Podcast: In Good Companies

Season 2 Episode 3: The Fundamentals of Inflation: Supply and Demand

Most people *sort of* understand inflation: prices are rising, cost of living is more expensive, your dollar doesn't go as far. And that's true! But what's behind that phenomenon? That's when explanations start to peter out. Fortunately, we know someone who is super knowledgeable about inflation Cadence Bank's Corporate Treasurer Tell Alessio. On this episode, Tell explains the forces that govern inflation and the theory behind it all: supply and demand.

Supply and demand are foundational concepts across economics, but when you apply them to inflation, you get a much clearer picture of our current situation: its causes, its consequences and, potentially, its conclusion. We'll dive into how supply-driven inflation differs from its demand-induced counterpart, and why one is more stubborn than the other. Plus, the surprise beneficiaries of the past six months, the limits of wage inflation and the credit shift that can protect your business.

Tell Alessio makes history as our first-ever repeat guest, back by popular (supply and) demand! In this episode, Tell tells all! Don't miss it!

Episode Transcript:

[00:00:00] **Patrick Pacheco:** You know how many economists it takes to change a light bulb?

[00:00:02] **Tell Alessio:** How many?

[00:00:03] **Patrick Pacheco:** Seven, plus or minus 10.

[00:00:04] **SFX:** Theme music in

[00:00:08] **Tell Alessio:** The problem is that the Fed doesn't have a scalpel, they've kind of got a hammer and they can keep beating the heck out of that nail, but they can't really do what Congress should be doing, which is being very specific about policy, how to improve employment in certain sectors of the socioeconomic classes.

[00:00:23] **Patrick Pacheco:** I'm Patrick Pacheco, and you're listening to Season Two of *In Good Companies* from Cadence Bank, the podcast where we guide you through the forces shaping your business—inside and out.

> [00:00:32] **Patrick VO:** Over the first several episodes of Season Two, we've been unpacking the realities of inflation--supply chain shocks, interest rates, Mom & Pop's, and monetary policy. On this episode we wanted to zoom out and explain the theory behind it all--the forces that govern *every* period of inflation, not just the one we're in right now. Armed with that knowledge, we'll look at our present moment with fresh eyes--the surprise benefits, the industries at risk and the switch you should make before it's too late. To sort through all this, we called on our old friend and first-ever repeat guest--Tell Alessio.

[00:01:11] **Patrick Pacheco:** I know you're Tell Alessio, but why don't you introduce yourself and tell us what you do at the bank?

[00:01:15] **Tell Alessio:** I'm the corporate treasurer for Cadence Bank, and in that role I manage the investment portfolio of the institution as well as our liquidity and how we fund the bank. And I really enjoy what I do here.

> [00:01:25] **Patrick VO:** Tell was one of the very first people we had on the show, back in November 2021--go check out his episode if you haven't heard it already. But a lot has changed since then.

[00:01:39] **Tell Alessio:** The marketplace has really changed. Our customers are dealing with a lot of different challenges that they didn't have to deal with last year, and expectations on a whole have really diversified. We've gone from an environment where we were trying to exit COVID and things felt pretty good to now we're in an environment where inflation seems to be running hot and it's a challenge for all of our customers and especially the consumer who's trying to make ends meet.

[00:02:03] **Patrick VO:** Most people *sort of* get inflation. Prices going up, paying $50 for something that used to cost $40. That's when the explanations start to peter out. To *really* understand inflation, you've got to start with how it's measured.

[00:02:18] **Tell Alessio:** So inflation's really the rate at which prices are changing and inflation really has a couple different components to it. Specifically there's this benchmark number that the marketplace uses to define what inflation is, and that's the CPI, the consumer price index. That's an index that the Bureau of Labor Statistics comes out with each month, indicate a basket of different types of goods and services and how they're changing in price. Then what they'll usually do is take that top headline CPI number and they'll break out from that what they call core CPI, which basically strips out food and energy, which helps get a sense of not just what are you paying at the pump or in the grocery store, but what does everything else that you're consuming costs you and how much faster is that increasing. There's also asset price inflation, which if anybody who has owned a home or has equities, they can understand that those assets also increase in price and that is another component of inflation, not in those personal consumption numbers.

[00:03:22] **Patrick Pacheco:** So maybe from you, everybody has their own personal experience with inflation, where does it strike you that you're feeling inflation?

[00:03:30] **Tell Alessio:** So Patrick, my oldest son just went to college. He started his freshman year at Spring Hill and he's thriving down there. But in preparation for that, we decided that we would provide him with a car. And so I thought, I have an 11-year-old car, that's the perfect car for him. It's an Acura TL, it's still nice. I've kept it in good condition. So I went to go look for a car for myself and the car that I wanted to buy four years ago probably cost $30,000, $35,000, but today it costs almost $60,000. And so we were driving, we actually stopped by a Honda dealership and I was just walking through the floor and there's a brand new Honda Civic, it was $21,000 and I thought, "I'm going to save myself $40,000 today. I'm going to get him a brand new Honda Civic and I'm going to keep my Acura TL."

[00:04:12] **Patrick Pacheco:** So is inflation always bad? Or sometimes you hear people say there's a healthy level of inflation.

[00:04:25] **Tell Alessio:** To your point about is there any good inflation? I think we've heard the Federal Reserve over the past few years, really over the past 20 years, say that their target inflation number is 2%. That 2% number, they want positive inflation because it's really difficult for the Fed to fight deflation, which is negative inflation. The Fed doesn't have much in their toolbox to be able to do that. So they like to see a number that's positive so that they can respond with their main policy tool, which is their interest rate tool to be able to curb higher inflation.

[00:05:00] **Patrick Pacheco:** So it's easier for the Fed to slow things down than it is to speed things up, as a general rule?

[00:05:06] **Tell Alessio:** That's correct. Absolutely.

> [00:05:07] **Patrick VO:** Inflation is big news right now. You may have heard on this very podcast that over the summer, inflation hit a 40-year high. I asked Tell to put those numbers in context.

[00:05:20] **Tell Alessio:** The number that I like to look at is that PCE core inflation, which as of July was 4.6%. That strips out some of the energy and food noise, the less durable inflation. And it's also the metric that the Fed likes to point to. Your headline CPI number year over year is at 8.3% for the month of August. That number is kind of a shocker. You're going to see that in the headlines, but what you're really seeing more durable inflation is really more that core, or even if you look at the food and energy on CPI. So if you strip out the food and energy from the CPI number, it's more like 6.3%.

So we're somewhere in that 4 ½% to 7% inflation environment according to those metrics, and the Fed really wants it right around 2%. And so that's why you're seeing some action from them to try and curb that higher level.

> [00:06:16] **Patrick VO:** To find out how we reached this point, you've got to go back. Way back. To Econ 101.

[00:06:23] **Tell Alessio:** So inflation is really made up of two things. It's the supply side, what does it cost to make a good? And then what is someone willing to pay for it? So you basically have to start out with what does it cost to create a good or service? And once you have that base cost, then you have a margin or a return that you need on that cost, and then where does that cost meet the customer demand? So where can the customer willingly pay for that good or service? And that willingness and ability can change over time, but it also has a lot to do with the competitive environment on the supply side. So if you have an environment where you have lots of suppliers, the cost of a good or service will generally gravitate to a lower price because there's more competitive supply of it. On the flip side, if you have a good that's in strong demand and the consumer has an ability to pay for it, prices will gravitate up. And so that's how the price discovery is identified within in the marketplace.

[00:07:22] **Patrick Pacheco:** So if we then restrict supply all of a sudden and there's a demand for it, it's going to push prices up.

[00:07:30] **Tell Alessio:** That's exactly right.

> [00:07:32] **Patrick VO:** So what's our current inflation caused by? Supply or demand?

[00:07:30] **Tell Alessio:** It's both, but all of it brought on by COVID, at least the initial, I think.

[00:07:41] **SFX:** Play outro theme music; false ending

> [00:07:43] **Patrick VO:** So there you have it, folks. It's both–supply and demand. Thanks for listening, we'll be back next week with another--

[00:07:51] **SFX:** Cut music; perhaps a record scratch

> [00:07:55] **Patrick VO:** I'm just kidding. Of course, there's more to it.

[00:07:58] **Tell Alessio:** If you look at the headline CPI number, the number we talked about, that was like 8.3%. That is really driven heavily by the supply side of the Russian Ukraine oil issue, the supply chain disruptions that are occurring because of that on food. And then also if you think about China and how this globalization effect which really has held down the cost of global labor, it's somewhat reversing. You can kind of see it in some of the legislation that's coming out of Congress where we're trying to bring jobs back on board and do more manufacturing in the U.S. That is, by its very nature, inflationary because the cost to produce something in the U.S. is higher because labor's more expensive, especially recently if you think about what's happened with energy costs, whether it's oil and gas or how that flows through to utility bills. But then also on the food side, we've seen a really significant increase in the rate of inflation in both those two numbers. And those tend to be somewhat temporary. They also tend to be supply shock driven. So if you look at the inflation equation, there's a demand side and there's a supply side, with what we've seen with the crisis from Ukraine, the Russian crisis on oil and as well as what we saw with COVID and the supply shock, we saw supplies have trouble, it costs more money to get goods, it took longer. So, therefore, the supply side really did force up prices in those two buckets.

> [00:08:59] **Patrick VO:** So food and energy costs are particularly sensitive to disruption, and supply breakdowns can cause those prices to spike. But while they're volatile, they're also the goods we rely on the most, and we feel those changes acutely.

[00:09:14] **Tell Alessio:** In general, what moves goods and services is oil and gas, and if energy prices are up, it just costs more for everything. And so that's the piece of energy that flows through to all other prices. And that's been the hardest, I'd say, hit for many Americans. There was a Bloomberg article out that said one in six Americans is having a tough time making the utility payments. And I wouldn't be surprised given what we've seen, and really the warmer weather we've had across the whole country as it relates to probably some global warming impacts that are driving prices of that higher and usage higher.

> [00:09:50] **Patrick VO:** Behind all these disruptions, there's another cost that's rising--labor.

[00:10:14] **Tell Alessio:** And then also if you think about China and how this globalization effect which really has held down the cost of global labor, it's somewhat reversing. You can kind of see it in some of the legislation that's coming out of Congress where we're trying to bring jobs back on board and do more manufacturing in the US. That is, by its very nature, inflationary because the cost to produce something in the US is higher because labor's more expensive. Now some of that was Fed driven. One of the things that the Fed has really done through COVID has been to have their foot on the gas trying to have full employment, and they really worked hard at getting full employment across all socioeconomic and racial classes. And the problem is that the Fed doesn't have a scalpel, they've kind of got a hammer and they can keep beating the heck out of that nail, but they can't really do what Congress should be doing, which is being very specific about policy, how to improve employment in certain sectors of the socioeconomic classes.

> [00:10:59] **Patrick VO:** This is where supply and demand forces overlap. Although higher labor costs can drive up the price of goods on the supply side, those increased wages become purchasing power on the demand side.

[00:11:12] **Patrick Pacheco:** How does the pay people are able to generate out of job wages, wage inflation, how does that fit into those or where does that fit into those?

[00:11:21] **Tell Alessio:** So wage inflation is, it's primarily the factor that drives demand inflation. And what's critical about that is what I refer to as your purchasing power. It's how much faster is your income increasing over the cost of what you're buying? Because as long as your wages are increasing, your income is increasing at a faster pace than the things you're buying, you're actually able to have a better lifestyle. You can afford more. And so when you think about wage inflation, it really drives the demand side where someone's purchasing power is strong enough that they can afford to pay up for a good that maybe they didn't have to or couldn't or didn't need to a month ago or a year ago. Then you had from Congress Aa enormous amount of fiscal support through the crisis between the economic stimulus payments, the unemployment benefits that got extended, the PPP program. And I can go on and on.

> [00:12:15] **Patrick VO:** That influx of stimulus cash kept the economy afloat, but it also tipped the scales toward demand.

[00:12:22] **Tell Alessio:** Then you had from Congress an enormous amount of fiscal support through the crisis between the economic stimulus payments, the unemployment benefits that got extended, the PPP program, and I can go on and on. They created about seven and a half trillion dollars worth of support during COVID that really helped the demand side. So it gave people money when they needed it, when otherwise would've probably been forcibly austere, which would've supported a lower price environment. And instead they fueled that price increase by giving people the ability to consume when they otherwise would not have been.

[00:12:45] **Patrick Pacheco:** I wondered, do you think COVID, when people didn't have anything to spend money on, did that act as almost like getting a raise? All of a sudden you had extra money and it had to go somewhere eventually?

[00:12:56] **Tell Alessio:** That's exactly right. I mean, they had obviously a lot of extra money from stimulus, but that extra money that they weren't spending on travel or experiential things like going out to eat, instead they were sitting at home ordering goods off of Amazon and buying new furniture and making home improvements and all of those goods. And that clearly, the availability of more money created a significant pressure on the demand side of the inflation equation.

> [00:13:23] **Patrick VO:** While supply-driven inflation can be more immediate and dramatic, inflation caused by demand generally sticks around longer, which is another reason the Federal Reserve is addressing that side of the equation.

[00:13:35] **Tell Alessio:** If you have high inflation numbers with just food and energy, it can cure itself pretty quickly as soon as those supply situations fix it. But on the more durable goods, it tends to be more demand driven. And if wages continue to increase then you still have a durable higher inflation level than we've seen really for a long time out of history. Economic theory tells you that raising rates will quell demand and less demand results in lower prices or price stability. So when the Fed raises rates, what they're really doing is they're making borrowings, or lending, more expensive for people. As you try to think through the overall economic spectrum, that's what they're doing. They're making goods more expensive, so that people will buy less. So it'll slow down growth—and slower growth means that people won't be demanding as much and it'll create stability in the prices. I don't expect prices to fall, but I do expect that they're trying to prevent them from rising further. And so that's really the end goal of the Fed is to re-establish that rate of inflation is lower, not that prices would actually fall below where they were a year ago.

> [00:14:47] **Patrick VO:** So those are the factors that add up to our current, complex inflation. But what are the effects? For some, they've been surprisingly positive.

[00:14:57] **Tell Alessio:** It definitely does depend on who you are mainly because if you think about that asset inflation number, people who own assets, we've had a lot of asset inflation through the COVID crisis and people who had assets and wealth, that has gone up considerably, especially people who own their own house.

Real estate has gone up about 20% a year according to Schiller's Index. And so you're seeing significant asset appreciation, but if you didn't own your own home and instead you were reliant on COVID stimulus, unemployment benefits and your rents have all of a sudden shot up as well as the extra money you're trying to spend on food and your utilities, it can be pretty challenging.

And I think that when it comes to those that have benefited the most, you have to think that it has to be the higher wealth brackets because equities are so much higher than they were, real estate is so much higher than it was, so people with assets really did benefit from the past couple years of inflation pretty significantly.

[00:16:04] **Patrick VO:** But even those with assets are feeling the pinch.

[00:16:07] **Tell Alessio:** If you think about the cost of home ownership and how much it's changed over the past six months, and it's not just the fact that housing prices are up 20% a year according to Schiller, but it's also has to do with the fact that the taxes are up, the insurance is up because the price of the property is higher. And then the mortgage rate at the beginning of the year was really around 3.25%, and today it's 6.30%. So the cost of home ownership has gone up almost a little over 40% probably, if you add all that up together. It's amazing how much of an increase shelter has had over the past six months.

[00:16:47] **Patrick Pacheco:** My electric bill is probably twice as much as my parent’s house payment was at 9 ½% interest rate. It's crazy. When there's four numbers in an electric bill, when you start telling the kids, "That's it, no more AC for you. Refrigerator's off. Everything, lights off." We're in austerity here.

[00:17:04] **Patrick VO:** Businesses have also had to adjust. Remember the wage inflation we mentioned earlier? Employers have had to account for those increased costs.

[00:17:13] **Tell Alessio:** Well, inflation in and of itself obviously affects the cost of inputs for a business's goods and service production. But the other thing that's happened is that the tight labor market the Fed has encouraged has resulted in a labor issue. Unfortunately, it's not just a pricing issue, it's starting to materialize into price. But originally it started as a scarcity because

we had people who either were home with COVID or just stopped participating in the labor force. And so our businesses really found it difficult to hire and retain talent.
And the retention side of it really started to pick up speed last year as the competition for each worker became more and more and more intense. And that intensity has now resulted in what we're seeing with wage inflation and how much more people need to pay.

[00:17:57] **Patrick Pacheco:** What sector is probably the most at risk right now if inflation continues to stay high and borrowing costs continue to go up?

[00:18:04] **Tell Alessio:** Businesses where it takes longer to adjust prices like commercial real estate where they have longer leases I think will see the shock more readily than businesses like we've seen in food services that are raising their prices every week in some cases. Or I've even seen some restaurants that'll put market price on a hamburger these days. They're able to respond a lot quicker than some of those more longer term contract businesses, whether that's contracts around real estate like I mentioned, or utilities, those kind of longer lease contracts will be the hardest hit.

[00:18:36] **Patrick Pacheco:** So how about borrowing costs for businesses? Have they really felt that and how's that been for the banks having a little bit of interest margin?

[00:18:45] **Tell Alessio:** So borrowers are just starting to see it, honestly. They probably started it this summer a little bit, but banks have actually been very slow to increase their loan rates. Part of that is that banks really wanted loan growth through COVID. There were lots of deposits, very little loans.

> [00:19:16] **Patrick VO:** With interest rates rising, Tell suggests converting any floating lines of credit into fixed ones—while you still can.

[00:19:24] **Tell Alessio:** If you think about most commercial companies who enter into a project, they tend to gravitate towards fixed rate pricing because they know what their cost of capital's going to be over a time horizon. Commercial customers who have lines of credit are on a floating rate basis and that floating rate has gone up directly with the marketplace. So we've gone from a Fed fund rate of around 25 basis points up to where we are today at 325. So we're up 300 basis points. You consider that from a commercial lending perspective and you look at ... usually the prime rate is a good example of a prime borrower in the commercial space, that prime rate's gone from 325 to 625. So we've had a pretty significant increase in those short term floating rates. Fixed rates are adjusting a little slower and they'll pull through the full 300 to 400 basis points in the short order. And I think that you're seeing it in public markets where debt costs are rising pretty fast. The curve is obviously adjusting quicker than it ever has because the expectations for higher rates keep climbing, but banks tend to lag that.

[00:20:45] **Patrick Pacheco:** So predicting the future is always difficult. One thing we know, it's that God made economists so he could make weather forecasters look good. Where do you see things going? I mean, how long can this inflationary period possibly last?

[00:20:57] **Tell Alessio:** So first of all, I think that we're in for a longer period of time for higher inflation. I don't think it's going to be at the top of the range that we've seen this year, but something definitely well above what the Fed would like to see at 2%, probably something at the 4% to 5% range. My primary thought around that is really that shelter component of CRPI, that owner equivalent rents, that's a calculation. It's prevented from being very volatile. So there's still a lot of price increase that has to flow through into the top line numbers. So we're going to see inflation remain high for the next few quarters, at least.

> [00:21:34] **Patrick VO:** Ultimately, Tell says it will be demand factors that signal a light at the end of the tunnel.

[00:21:41] **Tell Alessio:** Yeah, consumption is slowing down. If we see consumption slowing down, that's the demand side of the inflation calculation. And if that slows, what the Fed would like to see is a soft landing. But I'm not really sure exactly what that looks like these days because it's difficult to avoid an abrupt bump when you're doing something so significant, so different than every other cycle we've ever seen. And so some of the unintended policy consequences will probably rear their heads. But I do think that we're going to see for the next 12 months pretty decent loan demand, which means that companies are still expanding and that people are leveraging the balance sheets that they have. Consumer's in a great place to start because it did pay down so much debt during COVID. But as we start to get through that 12 month period, I think that's where you start to see some leverage excesses - maybe that will cause some losses to start to materialize, but I think we're really 12 to 18 months away from that. I think that's a lot farther away than most people think. And that will help drive some additional growth on top of probably a little higher prices for a little longer period of time.

[00:22:44] **Patrick VO:** As inflation continues to dominate the news cycle, you'll have to zero in on what it means for you. What's driving price changes? Is it a temporary supply shock or more durable demand forces? What if you remove the more volatile goods? Once you know what to look for, you'll be able to cut through the noise. And if you own a business, don't get caught up in the headlines. Evaluate your lines of credit, keep an eye on your numbers and use that information to stay nimble.

[00:23:20] **Tell Alessio:** I think that most of our customers have a good sense of how inflation's affecting their micro business and that really is ... I think what's critical is keeping a pulse on what's happening. Honestly, what would be great for them to be able to do in the future is to build into contracts some price control as it relates to their suppliers. But in general, they're seeing that day in and day out. The top line numbers are fancy for news sources and they're eye-catching and they're great for political conversation, but they don't necessarily drive into what's happening within a certain geography or within a certain industry. And I would say that if you have your ear to the ground, you understand your business and the inputs, just making sure that you're adjusting your output at the same pace as the inputs.

[00:24:07] **SFX:** Theme music

[00:24:07] **Patrick VO:** I'd like to thank Tell Alessio, Cadence Bank Corporate Treasurer, for being our first repeat guest and for putting up with all our jokes.

[00:24:16] **Patrick Pacheco:** Well, Tell, it's great having you on. One last joke before we go. An economist walked into the pizza place, ordered a pizza and it comes out, the young lady says, "Do you want it cut in six pieces or eight?" He goes, "You better make it eight. I'm really hungry today."

In Good Companies is a podcast from Cadence Bank, member FDIC, equal opportunity lender. Sheena Cochran is our production coordinator. Our executive producer is Danielle Kernell, with writing and Production from Andrew Ganem and sound design and mixing by Ben Cranell at Lower Street Media. I'm your host, Patrick Pacheco. If you've made it this far, why don't you go rate and review us in your podcast app? It's the best way to grow the show so we can reach even more listeners. And while you're there, subscribe! We'd love to have you--because when you're with us, we're in good companies.

[00:25:07] **Outline: Disclaimer**