The Habits of Great Investors: Inflation and Conflation

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"Warren, I just want to absolve you from any worries. You're going to fail. And the reason you're going to fail -- my daughter may starve to death and you're going to fail, but I'm not going to blame you because it's because the Democrats are in and they're all Communists."

- William Hertzog Thompson, Warren Buffett's Father-in-Law, Circa 1951

Hello, great investors. There's been a recent news item that caught my eye, presenting a great opportunity for investors to learn something instructive. I want to discuss it and highlight some important lessons.

Market Reaction to Political Commentary

You may have seen in the news that the president criticized Federal Reserve Chairman Jerome Powell on social media, specifically on the social media platform X. Trump stated that the Fed needed to cut interest rates and added that Powell's termination "couldn't come fast enough". He was very critical, implying he might fire the chairman. The stock market reacted strongly, dropping approximately 3% in a single day in response to this tweet. It would be highly unusual for a president to fire a Federal Reserve chairman, so the stock market reacted very negatively.

The next day, Trump clarified in an interview that he had no intention of firing Powell, describing his earlier statement as hyperbolic but reiterating that it's a perfect time to lower interest rates. The stock market then rose by 3% that day, recovering the previous loss.

Two Core Lessons: Inflation and Conflation

I see two important lessons from this event, which I call "Inflation and Conflation". The first lesson concerns the outlook for Inflation and Trump's call for lower interest rates, evaluating whether that's appropriate. The second lesson addresses the risk of conflating our politics with our investment policy.

Lesson 1: Inflation and Interest Rates

Let's start with inflation and interest rates. Interest rates play a critical role of our economy's vibrancy, determining mortgage rates, credit card rates, business loans, and other credit facilities. They affect the cost of borrowing money, impacting our incomes, house prices, and the stock market — key aspects of our economic lives. The Federal Reserve sets the Fed Funds rate, a benchmark from which consumer lending rates flow. The Fed uses the money supply and interest rates to promote price stability, raising rates when inflation is a concern to make borrowing more expensive and slow economic activity, or lowering rates to stimulate the economy when activity is sluggish, and recession fears arise.

Is a rate cut justified?

Was Trump right to say the Fed needs to cut interest rates? Presidents and politicians often advocate for lower interest rates to boost prosperity, sometimes overlooking the risks associated with inflation. My experience suggests that they prioritize growth over concerns about inflation. Trump, despite being a Republican, isn't particularly monetarily conservative in my view. During his first term, he consistently called for lower interest rates when the economy was doing well, which I didn’t think was necessary. His current stance isn’t surprising, but this time, I believe he’s right

During and after COVID, the Federal Reserve boosted the money supply and cut interest rates to stimulate the economy to prevent a recession. This led to a significant inflation spike, with the Consumer Price Index rising 12% over 18 months, the highest since the 1970s. Once this inflation concern was recognized, Jerome Powell and the Fed took decisive action, raising rates and contracting the money supply, bringing inflation down to the Fed’s 2% target. However, monetary policy still remains tight now, despite the fact that this target has generally been met. If it remains too restrictive, inflation may no longer be the issue, but a recession could emerge due to an overly constrained money supply and high interest rates.

Do tariffs cause inflation?

Some argue that Trump’s proposed tariffs will lead to inflation, necessitating the Fed to maintain high interest rates. I disagree because I align with the view that inflation stems solely from the money supply, rather than tax policies like tariffs. To explain, consider a simplistic economy with you and your local market. Your income is $10 a week, which is the money supply in this two-person economy. The market sells apples and oranges at $1 each. With $10, you buy five apples and five oranges weekly, setting the “Fruit Consumer

Price Index" at $10. If the government imposes a 25-cent tax on both apples and oranges, and your local market passes on that added cost to you, apples and oranges now cost $1.25 each.

However, if your income remains $10 per week, you can no longer afford five of each. Preferring apples, you wish to continue to buy five apples per week, which will now cost you $6.25, leaving only $3.75 for oranges, enough for just three oranges at $1.25. The shopkeeper, left with two unsold oranges, will eventually be forced to lower the price of oranges to 75 cents to clear inventory, allowing you to buy five oranges with your $3.75. While apple prices rose to $1.25, orange prices fell, keeping the "Fruit Consumer Price Index" at $10 since the money supply (your weekly income) didn't change.

Tariffs cause price dislocations — some goods rise in price, others fall — but overall inflation won't increase because it depends on the money supply. Therefore, I believe it's appropriate for the Fed to cut interest rates, though I'm obviously unsure if they will.

Lesson 2: Avoid Conflating Politics and Investing

Now, let's discuss investor behavior and the actions you take in response to constant news, specifically, I'd like to point out how this news item highlights the danger of conflating your investment policy with personal politics.

The Warren Buffett story

My favorite example is Warren Buffett's story from 1951, when he proposed to his wife. His father-in-law, skeptical of Buffett's prospects, invited Warren to sit down and discuss his future. Buffett's father-in-law predicted that he would be a failure, claiming Buffett's daughter might starve to death because Democrats, whom he called communists, were in charge under President Harry Truman and would ruin the country. At that time, the S&P 500 was at 23; today, it stands at about 5,600, and Buffett is one of the world's richest individuals. Buffett has often spoken about the mistake of conflating politics with investments, and I agree.

Political emotions and market reality

This danger feels as though it is at its highest in my career due to intense emotions around the political scene, particularly the president's personality. Many believe he'll ruin the economy, that growth is impossible, and the U.S. is finished. Numerous recent articles in mainstream and financial media claim the old investing rules are broken, we're in a new era, and the economy and stock market can't grow as they have for centuries. Some suggest selling all investments due to the current political regime, implying that "this time is different" for the dark future of America. I won't opine on the president or government, but stress that conflating investment policy with politics is a gigantic mistake. This time is never different, no matter who is president. We've endured 45 presidents, some great, some terrible, and we'll survive this one, whether you love or hate him. I recommend keeping your emotions about political figures safely away from your investments.

Final thoughts and investor takeaway

Investors who reacted to Trump's tweet about firing Powell experienced a rollercoaster: a 3% market drop one day, followed by a 3% rise the next. Those who sold during the decline missed the rebound and subsequent gains, with the S&P 500 now near its all-time high of 5,600. Similarly, investors who sold at 4,900 during tariff fears in April missed the recovery to 5,600. Why base investment decisions on hyperbolic social media posts? Those who sold are now whipsawed, facing losses with the market higher. Don't conflate politics with investments, regardless of your feelings about the president. That's my best advice.

I hope you found this valuable. I have two favors to ask: I love your comments and questions, so please share this on social media and send me feedback. And if you know someone who would benefit from this understanding, please share it with them as well.