the advisor

Spring 2018

Inflation Watch

Monetary policy has remained in crisis mode since onset of the Global Financial Crisis (GFC) a decade ago. The world economy seems to have recovered, and yet we still have not emerged from the greatest monetary experiment ever attempted.

In an effort to generate economic growth and stave off deflation, interest rates plumbed levels never seen before in history and central banks implemented quantitative easing (printing money to buy bonds). The US Federal Reserve alone bought over $3.5 trillion of U.S. treasury and mortgage-backed securities, most of which was purchased well after the American economy emerged from recession. The Bank of England, European Central Bank and Bank of Japan all followed suit.

Do the central bankers understand the effects of their experiment?

Their interventions gave the illusion of prosperity and encouraged financial leverage of such epic proportions that the world is even more debt burdened than before the GFC. The amount of debt matters. As such, it now takes a much smaller increase in interest rates to slow economic growth, heighten credit concerns, and increase market volatility.

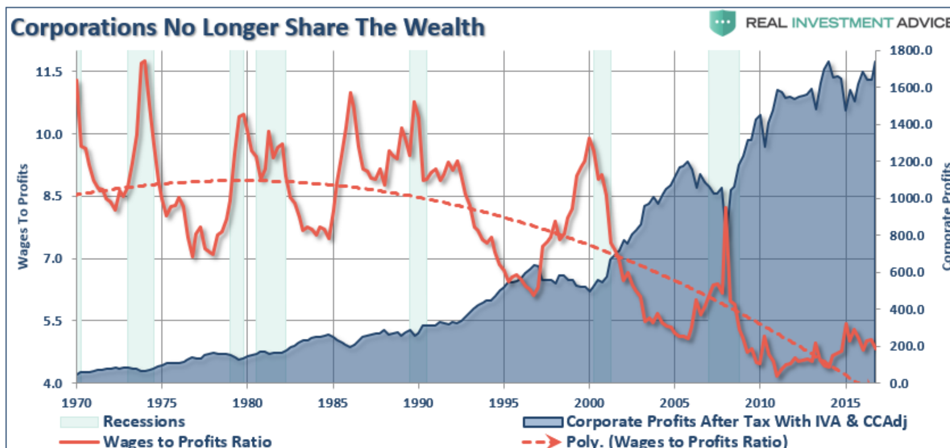
Having taken the global lead in starting this monetary experiment, the Fed, under its new chair, Jerome Powell, is now leading the way out. It is hiking interest rates and shrinking its balance sheet (i.e. quantitative tightening). The Fed cites an improving economic outlook from US$1.5 trillion in tax cuts and from Congress lifting spending limits, both of which should be a propellant for the American economy this year.

Also cited by the Fed are tightening labour market conditions and accelerating consumer prices (i.e. inflation). A small, constant rate of inflation is generally considered healthy for an economy but large and volatile jumps can be harmful. To maintain its dual mandate of stable prices and full employment, the Fed is supposed to raise interest rates once inflation appears to be accelerating.

But published estimates of inflation suggest it is below target. Changes to the measurement methodology in 1983 has led to the persistent understating of real rising price levels for the median household, thereby clouding the Fed's policy decision.[1]

The most widely used proxy for inflation is the consumer price index (CPI). The US Bureau of Labor Statistics (BLS) publishes a monthly estimate of the annualised increase in prices on a basket of goods and services consumed by a representative household, which are then tracked over time. However, the BLS has redefined the basket's contents over the years, biasing inflation downwards.[2]

Nonetheless, the market jitters of February suggest there is a growing concern that the Fed could be behind the inflation curve. Investors might smell resurgent inflation on the spring air but there is a limit as to how much of a rise in interest rates to temper it that they are prepared to tolerate.



There are two parts to inflation: core goods and core services. The Fed is more sensitive to service (e.g. wage) inflation. With dramatically reduced corporate tax rates for American businesses, a number of US companies announced that they will share the upside with their employees in meaningful pay rises. If American corporations honour their promises, a material increase in wage inflation could occur towards the end of this calendar year, making the Fed look like it actu-

(Inflation Watch cont'd)

ally is behind the curve. However, the economy appears to be weakening at the margins and the Fed, fearing inflation, is hiking right into it.

While tax cuts can be pro-growth, they have to focus on the 80% of American's that make up the majority of the consumption in the economy. The American consumer is tapped out and savings rates are declining; pent up demand is probably a thing of the past. In fact the majority of consumers will receive an "average" of $1,182 in the form of a tax cut, ($98.50 per month), but the increase in take-home pay has already been offset by surging health-care costs, rent, energy and debt service payments. Until the consumptive capability of the bottom 80% is increased, there will be no "economic boom."[3]

If consumers don't have more money to spend, they can't buy the goods and services which drive corporate revenues. If top line revenues do not substantially increase then corporate tax cuts will be used for other purposes. It follows that companies are unlikely to increase wages because higher pay increases tax liabilities and benefit costs, eroding bottom line profitability. In an environment of weak top-line revenue growth, company executives are very protective of the bottom line. Profits support share prices, which also directly impacts executive compensation. Ergo, "accelerating" wage inflation may be a non-starter.

The problem underlying the current situation is that we haven't really exited the Global Financial Crisis. We are still burdened by many of the problems that nearly took down the financial system in 2007-09, and that have been hidden by years of the great monetary experiment.

What would it take to wipe the slate clean and finally put the GFC behind us? Leaving aside issues such as demography, economic growth and other structural factors, the main headwind is debt. To move forward, we need debt destruction.[4]

Debt destruction can happen in one of two ways, either through default or through inflation. The former we experienced, devastatingly, in the 1930s Depression and the GFC; the latter we experienced, relatively less painfully, after WWII in order to destroy accumulated war debt and during the 1966-81 period, where the Vietnam war and two oil crises played havoc with inflation. The latter periods demonstrated that negative real interest rates, called 'financial repression', could effectively destroy debt.

Thus central bankers (and their political masters) might actually like inflation to come in unexpectedly higher, for somewhat longer. There are three good reasons for that.[5]

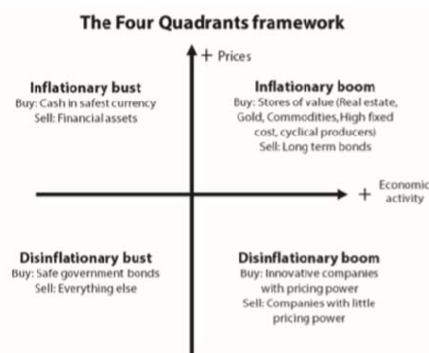
First, it could generate a perception of some sort of return to normality.

Second, the higher inflation is relative to interest rates (financial repression), the more debt will be destroyed, and debt destruction through inflation is certainly preferable to debt destruction through default.

Third, higher inflation would lead to higher interest rates which could reduce corporate Defined Benefits (DB) pension liabilities, removing a huge potential problem for the government. Many pensions are perilously underfunded, but a 10-year government bond yielding 4% or higher could allow many of those plans to move back into funded status.

Higher inflation would have to be imperceptible for a while to be truly effective. Could central bankers pull off this artifice?

If so, there are four near / medium term possible outcomes for investors:



If we move into an *inflationary boom*, a time of rising growth and rising inflation, then value stocks, commodities and emerging markets are the investments to hold.

If we experience an *inflationary bust*, a period of falling growth and rising inflation, then property, commodities and strong currencies (e.g. Swiss franc) will provide safe harbour.

If we have a *disinflationary boom*, an episode of rising growth and falling inflation, then growth stocks and long term bonds are the place to be.

With a *disinflationary bust*, a period of falling growth and falling inflation, then only cash and long term bonds should be held. A hawkish Fed would most likely lead to a stronger dollar, bringing on the deflationary bust that nobody wants.

Quite the inflationary predicament. Over to you Mr. Powell.

Sources:

1. Brodie Gay, "Why Isn't There Any Inflation?", CFA Institute, 19 March 2018
2. Ibid
3. Lance Roberts, "There Will Be No Economic Boom - Part II", RealInvestmentAdvice.com, 8 March 2018
4. Niels Jensen, "An Inflationary Bust Or . . .?", The Absolute Return Letter, February 2018
5. Ibid
6. Chart page one, Lance Roberts, "There Will Be No Economic Boom - Part II", RealInvestmentAdvice.com, 8 March 2018
7. Chart page two, Charles Gave & Louis-Vincent Gave, "A "Once in A Generation" Shift", Evergreen Gavekal, 2 March 2018

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