MARKET COMMENTARY

Inflation is not a Concern…Yet

March 2, 2010

By: Andrew Douglas, SVP and Chief Investment Officer, Wealth Management Group

On March 18, 2009, the Federal Reserve announced that it was going to purchase Treasury and other securities in its continuing efforts to boost the economy. The Fed dubbed this strategy Quantitative Easing, but the financial markets called a spade a spade and knew the Fed was simply printing money. Printing money – the phrase conjurers up images of Weimar Germany and people carrying money around in wheelbarrows. Before the ink dried on the Fed statement, cries went out that the U.S. would soon become like Zimbabwe or some other 3rd world country with hyperinflation and an economy decimated by its debilitating effects. It is now 12 months later, and the Fed is scheduled to wind down its purchase program at the end of March. The Fed's balance sheet has exploded over the last few years and has reached $2.2 trillion, from an $800 billion level that was the norm during the 2000's. During this period of rapid money growth, the Consumer Price Index (CPI) recently emerged from a period of deflation (negative inflation rates), the first such occurrence in the U.S. since the 1950s. Last Friday the core CPI (CPI excluding food and energy) declined by over 0.1% in the U.S. for the first time since 1982. As these seemingly contradictory events play out, arguments are advanced for everything from hyperinflation to Japan-style deflation and everything in between.

Theories on the causes on inflation have been hotly debated since the rise of Keynesianism in the 1930s and the counterpunch of Monetarism in the 1970s. The two basic theories regarding inflation today center around output gaps and money growth. The proponents of the output gap theory state that inflation is dependent on the output gap, or the difference between current growth rates and potential growth rates. If the economy grows faster than potential, demand for resources such as labor increase and prices also increase. When output is slower, excess capacity builds and blunts any price pressures within the economy. While some, such as Barclays Capital, argue that the output gap is much smaller than widely believed, the consensus is that the gap is large and excess capacity abounds. It would take several years of above trend growth to absorb all the excesses in the U.S. before inflation would become a concern. Those that point to growth in monetary statistics have the most compelling argument. The explosion of money created by the Fed and other central banks, as the theory goes, would lead to rapid credit creation and "too much money chasing too few goods" and hence inflation. However, the monetary transmission mechanism is broken and the monetary multiplier has plunged. In other words, all the money the Fed has created is not reaching the economy, but is stuck in the reserve accounts of banks. Unless the credit spigot opens up suddenly or the Fed leaves the reserve balances in the system for too long once lending begins again in earnest, the growth in the monetary base is not inflationary.

If we are not worried about inflation in the short-run, then why are we looking for long-term rates to move up in 2010? Wouldn't a disinflationary environment be positive for long-term rates (i.e., they move lower)? Yes, that would be positive, but our worry for 2010 is twofold – inflation expectations and supply. Inflation expectations have a profound impact on monetary policy and interest rates, as what people expect inflation to be in the future, will shape many financial decisions. With our call that the Fed will not be raising rates in 2010, this should lead to more anxiety about future inflation rates as the Fed keeps rates near zero. This slow build in inflation expectations will gradually push longer rates higher over the course of the year. In addition, the Treasury is attempting to term out its debt and increase the average maturity of Treasury securities. The pushing of bond supply farther out the curve, coupled with the cessation of asset purchases by the Fed, will lead to further pressure on long rates. So while we are (nervously) comfortable with the short-term outlook for inflation, the intermediate-term view is not as pretty. But that's a story for a future commentary.