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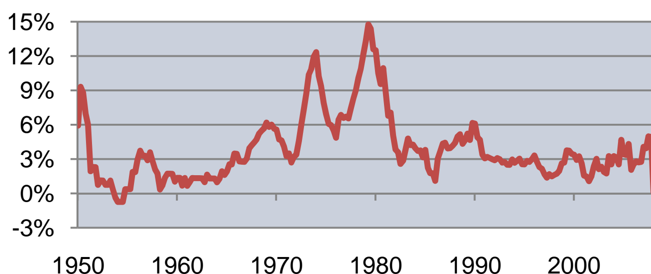
INFLATION: SHOULD WE BE WORRIED?

Today the U.S. economy remains in recession and inflation is running at a very low level. It is generally assumed that as long as the economy remains in recession, deflation is a greater threat than inflation. Even so, one of the hottest topics of discussion and speculation is the potential for a significant rise in inflation in years to come due to unprecedented amounts of fiscal and monetary stimulus that authorities have put into the system. Our purpose here is to explore the basic economic fundamentals that can have a direct effect on inflation, and provide some perspective on the possibility of future inflation.

First, what is inflation? Inflation is defined as a general increase in the level of prices of goods and services. When a general inflation exists most economic constituencies have the ability to raise prices, or demand higher wages. Commodities may be in short supply and therefore producers can command higher prices. Labor has the ability to demand higher wages, and businesses pass along these costs to consumers. There is a psychological element to inflation also. "Buy today for tomorrow it will cost more" becomes the watchword. Typically, these conditions are associated with a supply and demand mix where there is more demand than supply in most goods and services.



The most common measure of inflation is the Consumer Price Index (CPI) which is produced monthly by the Bureau of Labor Statistics. On a year over year basis, the CPI has averaged 4.1% over the last fifty years, reaching a high of 14.8% in 1980 and a low of -1.3% last month. It is widely held that the Federal Reserve (FED) prefers that inflation, excluding food and energy prices, not exceed 2%.

Technically speaking, inflation occurs when the nominal supply of dollars grows faster than the real demand to hold dollars. The supply of dollars in the U.S. economy is managed by the FED. The FED increases its balance sheet and the supply of dollars in the system by purchasing bonds from financial institutions which will typically use those dollars to originate loans. Those loans are made to consumers and businesses to purchase goods and services which can have the effect of increasing (bidding up) the prices of those goods and services. The dollars that were originally borrowed are spent multiple times as more loans are made from the deposits of goods and service providers. This concept is referred to as the velocity of money and it is the essential component for turning a large supply of dollars into inflation.

Even though the FED has injected an excess of liquidity to the system, if the liquidity does not have movement, or velocity, inflation does not occur.

Over the past twenty years the velocity (multiplier) of the money supply (M2) has averaged 1.93 with a high of 2.11 in June 1997. It is currently at a 20 year low of 1.70. With respect to the amount of dollars in the economy's monetary base, the FED's balance sheet totaled approximately $850 billion prior to the Bear Stearns bailout in March 2008. As of mid-May 2009, assets have grown to $2.20 trillion. As a result, total depository institution reserves have increased over 2000% from April 2008 ($43.5B) through April 2009 ($881.5B). In summary, the supply of dollars is at a historic high with $824.3B (93.5% of total reserves) available as excess reserves for banks to loan.

The velocity of money, however, is at a 20 year low which means that those dollars are not being spent and re-spent. In essence, the enormous liquidity that the FED has driven into the system is stymied at financial institutions that are determined to maintain a high degree of liquidity in order to increase and maintain their capital ratios. Further, consumers and businesses are not demanding that liquidity in the form of credit due to general de-leveraging (debt reduction) and a high rate of unemployment. If the economy continues to de-leverage and unemployment rates increase, it is unlikely that the demand for dollars will support an increase in the velocity of money.

Aggregate demand (consumption) must absorb the slack capacity that has built-up for suppliers of goods and services for them to be able to begin passing through the costs of increases in workforce and production. Currently, the unemployment rate stands at a 20 year high of 8.9% and is expected to reach as high as 10.0% later this year. Until the labor market begins to recover and the economy trends back towards an unemployment rate closer to the 20 year average of 5.5%, it is highly unlikely the economy will experience the demand-pull influence of consumers bidding up prices. Similarly, capacity utilization as a % of total production capacity has reached a 20 year low of 68.3% versus an average of 80.4%. This suggests that there is a significant amount of unused production capacity which would have to be absorbed by demand before the economy would experience cost-push pricing pressure from suppliers.

With respect to the value of the dollar itself, several factors suggest that it will remain strong relative to other currencies regardless of any perceived threat of domestic inflation or political call for a new international reserve currency. Despite the recent ups and downs in the value of the dollar versus other currencies, it is still widely considered to be the most reliable store of value in the world. This is principally due to the consistent strength of the U.S. economy, the independence of our financial governing bodies and the prudence of their policies. The dollar is still considered the most widely accepted means of international payment. The total value of international trade billed in U.S. dollars is much larger than the value of transactions conducted by the U.S. and countries with currencies pegged to the dollar. Finally, U.S. financial markets provide international investors a very large, liquid place to invest.

Over time, the U.S dollar has become ingrained as the predominant currency in the international financial trading infrastructure.

We recognize the risk of inflation over coming years based on the enormous amount of liquidity currently being made available to the economy, however we do not believe that serious inflation is a given. Just as the FED has injected liquidity into the system, it can take equally dramatic steps to drain it. These steps could include increasing reserve requirements to reduce the amount of loans that can be made, raising policy rates such as the FED Funds target and Discount rates to make borrowing less attractive, exiting markets they have helped make liquid (including the mortgage and asset-backed bond markets), allowing currency swap contracts to expire and finally, borrowing money from banks they have bought assets from to finance them. Admittedly, this will be a difficult process that will require precise timing, and political will. The strength of recovery and utilization of slack in the system, the savings rate within the U.S. economy, the interplay of global economics, and most importantly, the actions of the Federal Reserve will play a role in determining whether or not we again enter a period of rapid inflation.

Our best judgment is that if inflation becomes an issue, it will not likely occur until late 2010, or 2011. Our firm will be monitoring all the above mentioned factors, and will attempt to derive the current investment policy as events unfold.

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