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INFLATION WORRIES: REAL OR IMAGINED?

Investors are currently engaged in an interesting conversation, one that addresses what could be a major shift in the economic profile of our country and the world. The conversation centers around the question of whether or not the massive amounts of stimulus, both fiscal and monetary, which are presently being administered in historic amounts, will lead to high levels of inflation. Since inflation has been in a secular downtrend for some 40 years to the benefit of the economy and financial markets, a major change of trend would indeed be damaging. Inflation, as one of the major economic elements, can be very destructive to asset values, challenges policy makers, and makes future planning by businesses and consumers more difficult. Therefore, it behooves us all to be wary of the possibility of rising inflation pressures.

We have a vision of the future, one that does not include either of the extremes of deflation or virulent inflation.

This paper will address the issue by focusing on the short and long term. With regard to the short term, we find it unusual for fears of inflation to be surfacing while we are in such a deep hole economically. Note that the Federal Reserve's favorite inflation measure, the Personal Consumption Expenditures index (PCE), was most recently 0.8% on a 12-month basis and 0.9% excluding food and energy. It is a fact that inflation is not currently a problem, so any view of potential inflation must reach into the future. That does not mean it cannot happen, but its onset, if it happens, is not likely for a few years. Having dismissed inflation as a short-term possibility, let's turn to the longer term.

Looking forward to possibilities and potential outcomes, it is always appropriate to look back as well. It might be helpful to briefly review the history of inflation since its last peak in 1980, in the process highlighting some of the major factors that caused its decline since then. While there were shorter-term or cyclical economic influences that contributed to inflation's decline, they would not have been sufficient to enable such a long and consistent decline. Rather, its extended downward trend could only be caused by secular forces that tend to be immutable. We take a special interest in this time period, for it matches perfectly the history of our firm, with its founding date being September 30, 1980. We have witnessed firsthand this important piece of economic history.

1. VOLKER AND THE FED DO THEIR JOB. It is difficult for many to fully appreciate the severity of the inflation problem of the 1970s. The Consumer Price Index (CPI) rose consistently in the second half of the decade, reaching double-digit levels in 1979 and peaking at 13.5% in 1980. At this point, Federal Reserve (Fed) Chairman Paul Volker, with great courage, led the Fed to a policy of taking the lid off interest rates and letting the federal funds rate rise to whatever level it took to begin to break the back of inflation. Shorter-term interest rates reached 20%, and the benchmark 10-year Treasury note traded at a yield of 15%, levels that are unimaginable in the context of our economic world of today. The policy succeeded at the expense of causing two recessions in the 1980-1982 period. It was at this point that inflation began its historic and secular decline. Many events followed over the next 40 years that helped sustain the downward trend, a few of which we will review. Our choices will be the larger and what we believe to be the more important contributors to the trend, some of which are still in place and likely to be more or less permanent fixtures of the economic scene.

2. THE BERLIN WALL CAME DOWN AND THE SOVIET UNION COLLAPSED. The deflationary impact of recessions is always about the demand side of the supply/demand equation. Stated simply, excess demand creates pricing power for the supply side, while excess supply empowers purchasers to demand lower prices. It was the imbalance of demand over supply that led to rising inflation of the late 70s, and the recessions of the early 1980s began to reverse the balance in favor of more supply and less demand. The

trend toward increasing supply was made even more dominant later in the decade of the 80s when the Berlin Wall came down in 1989 followed by the collapse of the Soviet Union in 1991. These events signaled an end to communist hegemony in many parts of the world and unleashed the power of capitalism around the globe. The major implication for inflation was the huge number of new workers who came into the global economy, creating a surplus of labor worldwide. Labor surpluses created deflationary pressures since employers had pricing power with regard to wages. Following soon was the establishment of businesses that were able to produce goods and services cheaper due to abundant and inexpensive labor sources, in essence pushing the supply side to dominance. This chapter of history was very important in furthering the downward trend of inflation that had begun in the early 1980s.

3. DEMOGRAPHIC CHANGES can have a material effect on economies, working quietly and slowly under the surface but with significant influence on patterns of supply and demand. The most obvious demographic trend has been the aging of the world's population over the last 40 years. The importance of this trend is that as people move through their life cycle, they tend to make changes to their saving and consumption practices, thereby inflicting pressure on either supply or demand. While medical spending does increase with age, in general, older people consume less as they age, which has major bearing on overall economic growth. Lower economic growth is associated with lower inflation. Demographic trends are pointing toward zero growth in the population of the U.S. by 2050. Little can be done about this trend, hence a more permanent disinflationary impulse.

4. INCOME AND WEALTH INEQUALITY is a global phenomenon, but it is more severe in the U.S. than in most parts of the world. The trend toward inequality has been going on for most of the 40-year period we are discussing, but it has become a major topic of concern only in recent years. The condition continues to worsen as income and wealth become more and more concentrated in fewer and fewer hands. There are many dimensions to the income and wealth inequality problem, but we will focus on the one that has a major effect on inflation: demand. Income and wealth are the stuff of consumption, which represents some 70% of Gross Domestic Product (GDP), the most basic measure of our economic progress. When such large amounts of wealth are held by a few, the truth is that they can only spend so much, and this has a real effect on overall consumption. The wealthy, as a result, become high savers as illustrated by the fact that the top 10% of earners save about 40% of their income. A high savings rate does have some positive elements to it, but in terms of overall demand, the wealthy just cannot spend it all. In this way, income and wealth inequality subdues the demand side of the equation and is a contributor to slower economic growth. Again, slower growth tends to be less inflationary.

5. TECHNOLOGY is almost always disinflationary, for it provides the ability to do more with less. As it develops and improves, it tends to drive prices down. One has only to purchase a large-screen television today to realize how technology has driven prices down persistently over the last 20 years. The same trend can be found across the economy in many sectors or industries. Perhaps the greatest disinflationary impact has been in the area of capital goods. Think about brick-and-mortar construction as one part of capital spending and about software and computing power as another. While brick-and-mortar businesses have heavy labor inputs and are subject to cyclical influences like fluctuations in commodity prices, software and computing is softer, and prices have been declining in this sector for years. Technology has become a larger and larger part of our economy, and its drive for more and more capability at a lower cost has been a significant contributor to lower inflation. Technology as a disinflationary source is here to stay.

SUMMARY. We have briefly discussed several secular trends that appear to be as strong today as they were in prior years. The excess of labor in this country, and especially globally, does not appear to be in retreat. Demographics move forward at their own pace and are indisputably moving us toward aging populations. Income and wealth inequality has been accelerated due to the pandemic as the gap between rich and poor widens. This issue could possibly be improved by more progressive tax rates, but that has consequences

too and may or may not be likely. For now, income and wealth inequality remains a strong disinflationary force. Technology has been on a path of ascendency in the economy, and while antitrust sentiment may be rising, breakups of major companies might actually accelerate technological progress as competition increases. We believe that the totality of these factors supports the view that the supply/demand equation in the world today leans toward more supply than demand. The basic problem with the U.S. and global economies is a shortage of demand. The common thread running through several of these secular themes is a dampening of demand relative to supply, which implies lower growth and, in turn, low inflation. It is very difficult to get an inflation cycle going when supply exceeds demand, an inherently disinflationary condition. In the absence of changes in some of the secular forces, we feel significant inflation is not likely for a few years, if then.

There is an interesting argument by some economists that relates to the massive fiscal spending that has been implemented to fight the pandemic recession. It assumes that because monetary policy is now at, or close to, the zero-bound, fiscal policy must become the main weapon for stimulation. The argument postulates that in the absence of aggressive fiscal policy, the secular forces we have noted would have been strong enough to drive the economy into deflation, and by inference, negative interest rates. Because of the strong disinflationary tendencies in the economy, aggressive fiscal policy will be necessary in the years ahead, even after it has bridged the immediate gap in demand due to the pandemic.

FISCAL POLICY, DEFICITS, AND DEBT. Aggressive fiscal policy implies budget deficits, and a logical question arises around the debt that is required to finance the deficits. The use of deficits to stimulate economic activity is the essence of fiscal stimulus. Many observers fear that exploding government debt will lead to inflation. This may be the case if fiscal stimulus were to be great enough and sustained enough over time to produce a surge in aggregate demand. Only time will tell if extreme fiscal measures will remain in place after the pandemic and how successful this policy will be at overcoming the shortages in demand.

It should be noted that fiscal policy has already been somewhat stimulative even before the pandemic, with deficits as a percentage of GDP running in the 2-4% range over the last seven or eight years, and most recently, near 5% as a result of the 2017 tax cuts.

Additional fears center on debt-to-GDP ratios that exceed 100%. Will this inevitably produce inflation? Economists are divided on this question. We note that while Japan is supporting debt in the range of 250% of its GDP, there is no sign of inflation. In contrast, the U.S. debt to GDP ratio is now approaching 100%. There are other dimensions to the debt/GDP ratio that go beyond the question of inflation and the scope of this paper.

The different types of fiscal policy are important to consider. Current fiscal spending is more on the order of disaster relief as one-time checks, extended unemployment benefits, and payroll protection plans are not expected to be in place once the recovery is further along and the economy is able to support itself. These more or less one-time fiscal measures will cease, and it will be necessary to develop policy measures that promote investment. Such policies might take the form of spending for infrastructure improvements or research and development, initiatives that would encourage longer-term and sustainable job creation and thus demand.

THE ROLE OF THE FED. The Fed operates under a mandate to effectively promote the goals of full employment, stable prices, and moderate, long-term interest rates. Presently, because of the pandemic-induced recession, its focus is almost exclusively on the first goal: full employment. With unemployment still near 9%, the Fed is doing everything in its power to stimulate economic activity. Meanwhile, stable prices and moderate, long-term interest rates are taking care of themselves.

The fact that the Fed has dramatically expanded its balance sheet and, in the process, produced a surge in money supply leads to the fear that all the money sloshing around in the system will lead to inflation. One of the main ways of measuring the impact of money supply is velocity, which basically measures how money that is available is being applied to economic

functions. Since the Great Recession, money velocity has been in steady decline and in the current environment has taken another sharp step down.

Until money velocity increases substantially, the link between money supply and inflation is tenuous. What would make velocity expand is a surge in overall economic demand. Here we come back to the basic condition of the U.S. economy: a shortage of demand. We expect the immediate shortage of demand to improve in the months and years ahead, but to what level? Will it improve enough to create a condition of virulent inflation? Only time will tell, but we remain of the opinion that the secular trends that are subduing economic growth are formidable opponents.

CONCLUSION. We do not dismiss the possibility that the U.S. economy could again be subject to inflationary pressures. In fact, we believe inflation is likely to be higher in years to come, but in our opinion, not likely to be extreme. After all, the Fed desires more inflation and is doing everything in its power to get inflation up to the 2% level. To date, it has been unsuccessful. Predicting the future is, of course, very difficult, and we claim no special expertise. But we do feel that the discussion surrounding the possibility of severe inflation is premature because of the deep hole we find ourselves in and the deflationary pressures now evident. Again, we look forward with respect for the presence and persistence of major, secular forces that are inherently disinflationary. It will take a lot to overcome them. All of this will be reviewed by our firm in the months and years ahead.

We have a vision of the future, one that does not include either of the extremes of deflation or virulent inflation. We are looking forward to an economy that returns to "normal," a condition that we have labeled "the 2% world." This view acknowledges the limits to economic growth imposed by low labor force expansion and productivity. The right figure for potential real GDP growth seems to be about 2%, and considering the secular forces we have discussed, that rate of economic growth should be accompanied by low inflation and interest rates. We consider this to be a positive outlook, encompassing a set of conditions that will allow businesses to prosper and standards of living to increase. We look forward to a return to this "normal" state after a few years of recovery from the economic damage of the pandemic.

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