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Inflation: The Good, the Bad, and the Ugly

By Ismail Ghodbane, Portfolio Manager
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The notion of inflation can incite a wide range of sentiments, depending on an individual's vantage point. For consumers, inflation represents the looming threat of increased prices and decreased purchasing power. For investors, inflation poses an imminent risk to the real rate of return on investments. For economists and policy makers, inflation represents an essential economic force with a moderate inflation rate as a facilitator of sustainable economic growth. Inflation may become problematic when directional movements result in adverse economic conditions if left unchecked by monetary policy.

The Good

A stable to moderate pace of inflation can correlate with healthy economic progress and expansion. In addition to signaling growth, moderate inflation can encourage consumer behavior as a catalyst for increased spending activity. Consumer spending is incentivized by the idea that the purchasing power of today's dollar is greater than that of tomorrow's dollar. Increased spending theoretically leads to increased business revenues, leading to increased salaries and wages, causing greater disposable income potential and an increased marginal propensity to consume. While overly simplified, this description portrays the "economic good" caused by the consumer's anticipation of inflationary growth. This concept is especially important in the context of an economic recovery as it hypothetically prevents the Keynesian notion of a "paradox of thrift."

Without inflationary pressures, consumers are encouraged to save as opposed to spend. Income saved does not get injected back into the economy, leading to stifled production and growth. As a result, aggregate savings actually decrease and the recessionary environment is exacerbated. It is important to consider the economic impairment that could be caused by a significant decrease in consumer spending, particularly in a period of recovery. For our U.S. consumption-driven economy, the expectation of a moderate level of inflation is necessary for sustainable growth.

Inflation plays a significant role in the Federal Reserve's ("the Fed's") dual mandate, which defines the central bank's objectives and underlying monetary strategy principles. The mandate calls for the realization of "stable prices" as one of two fundamental long-term goals. Price stability (perceived to be an inflation rate of 0% to 2%) provides desired levels of economic activity and employment by improving pricing mechanism transparency. This translates to individuals making well-informed economic and investment decisions. Currently, the Fed has set an inflation target of 2% before it plans to move forward with further normalization. While debatable, most economists agree on the range of approximately 2% to 3% as an optimal level for a modern economy. The hope is that inflation can reach a stable range without any significant deviations.

The Bad

There are several inflationary perils that are relevant in today's global economic landscape, the most pertinent being the risk of deflation and the persistence of stagnant low-level inflation. Years after the financial crisis, a number of economies continue to grapple with effects of deflationary pressures. Last month, the European Central Bank announced the implementation of quantitative easing to combat the downward forces that could lead to deflation. Earlier this month, the effects of deflationary pressure were reflected in the sovereign bond market as we witnessed more than 25% of European sovereign bonds at negative yields. The American economy appears comparatively stable in the post-recession recovery. However, what was supposed to be a short, transitory period of low inflation continues to seem disturbingly perpetual. As the Fed strives to normalize monetary policy, the persistent low level of inflation reveals a potential for instability and uncertainty.

Inflation has been drifting under 2% for nearly two years. The year-over-year change in Personal Consumption

DETALUS INSTITUTIONAL
T: 314.997.3191
F: 314.997.3358
383 MARSHALL AVE., ST. LOUIS, MO 63119
DETALUS.COM

Expenditures (PCE) for December was 0.7% as falling oil prices had a role in the suppression. December Core PCE was down to 1.3% on a year-over-year basis. Expectations are that inflation will remain suppressed through the first several months of the year due to movements in energy prices and a strong US dollar. However, if inflation continues to persist at low levels through the remainder of 2015, there will be major concerns regarding the fragile nature of the economy.

Deflation (or negative inflation) poses a large risk for economies. Deflation is a sustained fall in general price levels that exerts long-term negative effects on an economy. Consumers will limit their spending with the expectation of continuously falling prices. Individuals also feel less inclined to borrow, even if for a productive investment, as holding cash provides a positive real yield. Deflationary expectations ultimately have the potential to depress an economy and lead to a downward spiral known as a deflationary trap. In such situations, wages continue to fall in tandem with prices while production slows, ensuring continued negative pressures on the labor market. Rampant deflation causes severe economic problems.

The Ugly

The dilemma the Fed could soon face is an unattractive one. As the current objective is to normalize monetary policy by raising rates later this year (potentially as early as June), the Fed still has several major concerns. The most conspicuous offender is the low level of core inflation. If inflation data continues to lag, falling short of the 2% target, the Fed will be forced to remain "patient" and further postpone a rate hike. With the combination of a data-dependent stance and an exceptionally low rate environment, the Fed is unable to use policy tools to guide inflation towards its desired level. Furthermore, a decrease in the federal funds rate is no longer a viable option to boost wage and price inflation. If lethargic data levels persist, economists and investors alike may begin to lose faith in the central bank's influence.

With regards to its data-dependent philosophy, the Fed is hopeful for inflation rates to increase by mid-year. The Fed's outlook is upheld by a recent trend of strong labor market data. Job gains continue to impress with roughly one million jobs been added in the past three months.

Unemployment continues its long-term descent and is closing in on the maximum employment objective of the aforementioned dual mandate. However, the millions of full-time job seekers who have begrudgingly settled for part-time positions and are therefore left out of the official unemployment figures must also be considered. More importantly, the increase in employment has not yet prompted a desired movement in wage growth. While hourly earnings were inspiring in January, the overall trend has been noticeably underwhelming for the past several years. Until there are regular, substantial improvements from the current stagnation in wage growth, concern will continue regarding consumption and the underlying stability of the economy. The lack of inflationary pressures coupled with idle wage growth should make the Fed apprehensive of the deflationary consequences a premature rate hike might cause. The worst-case scenario for the Fed would be to dampen or even reverse the fragile progress of the recovery.

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