



Where is Inflation?

There has been much discussion and debate concerning the potential for inflation in the U.S. and world economies; yet, there has been really no hint of it emerging in any of these economies. Is the threat simply hype or should we be concerned? Our opinion is, given the unprecedented number and amount of liquidity injections from the U.S. and global central banks, inflation will certainly rear its ugly head at some point in the future...for us it's not as much a question of *If*, but *when*.

Inflation is defined as a rise in the general level of prices of goods and services in an economy over time. There are many forces that lead to changes in prices which need to be analyzed in order to fully understand inflationary forces. The domestic and global economies are far too complex and dynamic to simply analyze one force and draw conclusions. In addition, there are short term forces which may mask a longer term trend. Hence there are many moving parts making prediction of future inflation extremely difficult. A look at some of the forces follows.

Money Supply

In general, the consensus macro economic view is that a long sustained period of inflation is caused by money supply growing faster than the rate of economic growth. If this dynamic ultimately holds true over time, there seems to be little doubt that inflation is coming. Since the summer of 2008, the U.S. government has committed more than \$8 trillion to domestic bailouts and direct liquidity injections into the domestic economy. This has been followed in lock step by world central banks. Economic growth has been slow to respond to the liquidity injections but the environment is gradually improving. Many who argue that inflation isn't a problem point to the fact that we simply haven't seen it yet. That is the major problem with inflation – once you see it, it is too late. What we need to remember is that there is a time lag as the increased money supply floats around the system. Typically the time lag is considered to be from 12 to 18 months. Assuming how deep this recession is, perhaps the time lag is slightly longer, possibly 18 to 24 months. If the money supply began to increase in earnest in August of 2008, or 15 months ago, inflation might be just around the corner. There is no question that the money supply has seen unprecedented growth. So what other forces could be holding back inflation in the short term? There are a few.

The Velocity of Money

The velocity of money is an important concept to understand related to inflation and money supply. Money supply is the critical factor behind inflationary pressures. However, without the velocity (or demand), inflation may not emerge until demand for goods improves. The velocity of money is often used to describe the rate at which money changes hands from one transaction to another; stated another way, how fast money is used for purchasing goods and services. If all the money that has been printed is just sitting on the sidelines and is not used to purchase goods and services, upward pressure on prices may remain subdued (velocity is low). This is what appears to be occurring today due to banks not lending and consumer confidence remaining low. As money begins to be used for goods and services, upward pressure on prices should emerge and inflation readings will begin to rise. When will banks lend and the economy strengthen?

Bank Lending and the Consumer Holding Back Inflation in the Short Term

Much of the money supply growth has been injected into our financial system to save the failing banks and financial institutions. As has been widely reported and known, these banks are hoarding the cash to shore up their balance sheets and are not lending. The government is incenting and placing pressure on the banks to increase lending to small businesses and consumers in order to drive economic growth. This has not yet occurred in a meaningful way. As such, banks have been a major factor in restraining inflation. This too will change.

Bank profits are improving as evidenced by the third quarter earnings reports. As profits increase and balance sheets improve, more loans will be written. As lending activity improves, borrowed money will be utilized to purchase goods and services thereby increasing the velocity of money. As more money moves through the system and changes hands, more dollars will be chasing the existing goods and services thus placing upward pressure on prices. We are at the early stage of this but given how weak the financial system still is (remember that this recession is a bank driven recession), this lag of activity should not be a surprise. We expect lending to improve and thus inflationary pressures to increase.

Business and Consumer Demand Needs to Improve

Businesses and consumers must be confident in order to increase spending. Up until a few months ago, most businesses and consumers still believed we were heading for another Great Depression. Spending also has been held back longer than normal. However, indications are that consumer and business spending have been turning up. In fact, many retailers are now reporting dramatically improved trends and news; it appears that corporate America is resuming spending and that outlooks are brighter. As confidence improves so too will spending. This again increases transactions and places greater demand on goods and services driving prices higher. Most economists predict a domestic growth rate of 2-3% in 2010. Although this is still a relatively low rate of growth, it is a major improvement from the -6% growth rate posted by the U.S. economy in the first quarter of 2009. Business and consumer spending is picking up and so too might inflation.

The real danger is that after the economy hits bottom, as it apparently did in the middle of 2009, all the money sitting on the sidelines and in the banks will come rushing out. We must remember that there remains a record amount of money in money market mutual fund accounts and interest bearing bank accounts. I have seen estimates showing that over \$3.5 trillion reside in money market mutual funds and nearly \$7 trillion in bank accounts. In addition, these idle funds are earning a near zero rate of return so the propensity to move them is fairly high. If this money begins to be utilized for goods and services, the upward pressures could be very high.

Labor and Productivity

Labor costs are another major inflationary force. As we know, the unemployment rate just passed 10%. Although leveling off, this remains very high which stems the pressures on inflation in the short term. Productivity has increasing as fewer workers are forced to perform the same amount of work thereby driving up the amount of work per employee. These are likely short term forces. As the economy improves and the employment picture improves, productivity is likely to decrease and wage pressures may increase. Workers might start demanding higher pay to keep pace with rising prices. In the short term, the level of unemployment has been deflationary. However, this is likely to begin reversing course in the near future and contribute to inflation.

The Bottom Line – Do Not Blink – Inflation May Appear

The major factor for inflation is comfortably in place – A rapid increase in Money Supply. The above short term forces are restraining inflationary pressures. As these short term issues begin to change, inflation is likely to emerge. The stage is set and a rapid emergence is not out of the question. At the same time, the

Federal Reserve Bank has to hold interest rates down for as long as possible in order to improve the housing market. As such, the Fed is going to have a difficult time getting out in front of the inflation curve. Needless to say, we are worried about inflation and believe it is just a matter of time before we see a re-emergence of pressure.

How to Invest

The investment landscape can be challenging in an inflationary environment and hedging this risk is important. Real (hard) assets hedge better than paper assets because real assets have a value and inflation does not erode this value, in fact it might increase the value. Stocks can gain value in an inflationary environment as earnings rise with higher costs and greater demand but investors will likely have to deal with continued high levels of volatility. Treasury bills and most other fixed income instruments are yielding very little and face principal price erosion as interest rates rise making them not preferred vehicles. Treasury inflation protected securities, or TIPS, provide protection against inflation because the principal value increases with inflation as measured by the Consumer Price Index. When TIPS mature, the investor is paid the adjusted principal or original principal, whichever is greater.

Real Estate is often viewed as a good hedge against inflation because it is a real asset. However, given the Federal Reserve's stimulus to the housing market in the way of credits and artificially low interest rates, many investors worry that real estate may be heading for another asset bubble which might deflate. In addition, many real estate pundits argue that housing isn't yet through its initial correction phase which began two years ago. As such, real estate may not be the best inflation hedge in the current environment with consumers still stretched and unemployment high.

That leaves the other real asset class which might be the best inflation hedge: commodities (gold, silver, copper, wheat etc.). Commodity prices usually rise when inflation is accelerating so they act as a natural protector. Few asset classes benefit from rising inflation but commodities usually do. As prices of goods and services increase, it stands to reason that the commodities used to produce the goods and services will increase as well. We prefer to utilize a broad basket of commodities as the safest and most diversified means of investing. Often times, individual commodities (gold for example) can go through periods of asset bubbles aside from inflation (i.e. investors flocking to gold due to panic). To avoid the difficulties of trying to determine which commodity is best at any given time, we eliminate the guess work by owning the broad asset class.

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