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ECONOMIC STIMULUS AND INFLATION: HOW MUCH IS TOO MUCH?

SUMMARY

Inflation can ravage incomes as well as certain asset returns as it cuts purchasing power. So is inflation about to rear its ugly head? The short answer is: Not yet. Although some are worried that U.S. and global monetary and fiscal policies—low interest rates, a massive increase in the money supply, increased deficit spending and a major fiscal stimulus—could lead to inflation in a recovering economy, the chances are low in the short- to medium-term. Over the next three years, slow economic growth, continuing unemployment and underutilized production capacity should keep inflation at bay. Beyond that, as economies improve, central banks, such as the Fed, and governments will need to carefully pull back the monetary and fiscal reins in order to avoid future incipient inflation. Assets that can help a portfolio anticipate or weather inflation include inflation-linked bonds, commercial real estate, commodities and, over the long term, stocks.

Over the last year, economies around the world fell into recession, which essentially means that individuals, businesses and governments "earned" less and spent less on producing and consuming goods and services. Across the globe, governments have responded with monetary and fiscal stimulus as well as other policies designed to prevent further damage, stabilize economic and financial systems and, hopefully, start the slow road to recovery.

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Specific actions vary by country, both in terms of their details and the speed with which they are being implemented, and all such policies should be considered experimental given there is no formal recipe book for combating and defeating a major global recession. In fact, one critical issue that has surfaced concerns the relationship between current stimulus and emerging global inflation. Some experts are worried that government policies are leading to—or soon will lead to—uncontrollable price increases that will erode savings.

Our forecast for inflation is: Not yet. In fact, recently deflation has been more of a concern than inflation. Still, while we don't see a reason to be concerned about inflation in the immediate future, down the road governments will be challenged to find the courage and the right time to pull back on stimulus to prevent future inflation.

- What is the connection between government stimulus and inflation?
- Are we laying the foundation for sustained inflation or deflation?
- What can investors do to protect their portfolios against inflation's ravages, if and when it does appear?

At its most basic, inflation is caused by too much money chasing too few goods and services. In the current environment, government monetary and fiscal stimulus are continuing to inject massive amounts of new money into the economic system, so the worry is that these policies are laying the groundwork for inflation.

MONETARY ACTIONS HELP STIMULATE ECONOMY

In the United States, the Fed is largely responsible for monetary policy—regulating short-term interest rates and the money supply to combat both unemployment and inflation. In 2008 the Fed, using its traditional authority, lowered short-term interest rates nearly to zero, purchased massive amounts of government securities and took other measures that effectively increased the money supply. The Fed also acted in a more extraordinary capacity to help stabilize the financial system by purchasing or making loans against a wide range of corporate securities, first from commercial banks and then from investment banks. These programs increased the Fed's balance sheet to more than $2 trillion while injecting even more money into the economy.

FISCAL POLICY ANOTHER SUPPORTING FACTOR

Government fiscal policy also kicked in, first through automatic mechanisms such as unemployment insurance payments and then through stimulus and deficit spending. In February, Congress passed a $790 billion stimulus package focused on tax cuts, direct aid to individuals and state and local governments, and on longer-term support for health care, infrastructure, and other pressing policy areas. Beyond specific stimulus spending, the federal government did not pare back its regular budget in light of diminishing, recession-influenced tax receipts. Deficit spending, which totaled about $455 billion in fiscal year 2008, is projected to quadruple in 2009.

Both monetary and fiscal policies are being used to stimulate the economy. Low interest rates and "easy money" are intended to make it more attractive to borrow, invest and spend. Spending programs put more money in the pockets of individuals, businesses, and state and local governments, which, in turn, are expected to spend a large proportion of it.

But before we declare that these policies are inflationary, consider two other issues that are currently limiting price increases throughout the economy. First, the global economy is contracting rather than expanding, which means that it is producing goods and services at a rate far below its potential. For example, U.S. GDP is about $14 trillion per year and at peak employment levels, could be expected to increase about 3% per annum. Falling short of that potential growth, as the economy is currently, means that there is underutilized capacity both in the means of production (factories, computers and other equipment) and in the labor supply. So even if demand (e.g., more cash in their pockets) from individuals, businesses and governments increases due to monetary and fiscal policies, the economy can respond to that increased demand by quickly increasing the utilization of the labor force and means of production without much trouble. Key indicators, such as rising job losses, falling factory and home production, are indicative of this excess capacity and future potential.

Second, the United States and other countries are apparently caught in a "liquidity trap," where extremely low interest rates are failing to stimulate borrowing and spending. For example, for the last several years consumers, in aggregate, have saved little, if any, of their income and have increased their debt load. In the last few months, however, the savings rate has risen to about 6% of income while spending has fallen. Moreover, banks and other lenders have tightened their lending standards even as their capital positions have improved due to government capital infusions. So, even though the money supply has increased, private-sector participants haven't increased their spending commensurately.

THE INFLATION FORECAST

On the one hand, government policies are increasing the amount of money and demand for goods and services. On the other hand, private sector borrowing and spending are down, and the economy could absorb increased growth without straining its production capacity. What does this mean for inflation?

According to the Bureau of Labor Statistics, consumer prices, which dropped by about 1% in 2008, stopped falling and rose modestly in the second quarter of 2009. In addition, financial markets, as well as some experts and Wall Street pundits, began to anticipate economic growth in the latter half of 2009 and a return of inflation due to an improving economy. For example, some economic indicators showed signs of sending out "green shoots" in the second quarter of 2009. In turn, the stock market, after falling over 50% from peak to trough, staged a major rally beginning in early March. Oil prices, which had fallen dramatically due to decreased demand in a poor global economy, rose from about $46 to over $72 per barrel in the quarter. Perhaps most important, inflation-linked U.S. Treasury bond (TIPS) began to attract investors. TIPS returns, which fell in 2008, rose in the first half of 2009 while other Treasury bond returns fell.

These signals, while dramatic, are premature. They could prove disappointing for near-term economic growth but pleasing for investors worried about inflation. For example, corporate earnings growth is still declining in the United States, the United Kingdom, Eurozone and some other countries. Unemployment is still on the rise. And economic growth, which could begin to rise in the latter half of 2009, will certainly not come anywhere near its full-employment potential for some time to come. In addition, the bulk of fiscal stimulus in the United States will not be spent until 2010 and 2011. In other words, we have a long way to go before the labor force, production capacity and lending are in short supply. These and other indicators suggest a major economic recovery that pushes the United States and global economies into an inflationary spiral. This may result in delaying the recovery even further than the current stock market and TIPS returns have anticipated.

Nevertheless, in about three years' time, inflation should be a major concern. Global economic growth will return closer to, or even above, its long-term potential, unemployment will decrease, excess production capacity will decline, and lending will resume. At that point, the danger will be that low interest rates, a large money supply and fiscal stimulus could indeed lead consumers and businesses to overspend when compared with the economy's ability to produce. If so, then we will have sown the seeds of inflation.

To combat this possibility, the Fed needs to remain vigilant for a time, then it should begin to raise short-term interest rates, sell some of the securities on its books, and, in general, rein in the money supply and borrowing. The federal government should, likewise, begin to limit deficit spending. Two factors will make it difficult to do so. One is knowing when to cut back. Just as there is no specific recipe for dealing with a major recession, there is no formula for making the transition to an expanding economy with little inflation. It will involve careful monitoring, analysis, and judgment. The other factor is political. Both the Fed and the federal government will face considerable pressure from consumers and businesses not to limit short-term growth by reining in monetary and fiscal policies. For the sake of longer-term growth, however, they need to resist the temptation, or the economy will overheat and prices will rise. Future inflation will be dependent on their success in dealing with both of these factors.

INFLATION AND INVESTING: SOME OPTIONS MORE AFFECTED THAN OTHERS

If potential inflationary conditions emerge, investors may consider assets that can help to limit the effects of inflation on their savings and investments. Although inflation is an important factor, it is one of many that should be reflected in any asset allocation. Individual asset classes that are sensitive to inflation in different ways include the following:

Inflation-Linked Bonds are the purest form of inflation hedge. For example, TIPS returns are explicitly tied to the U.S. Consumer Price Index, so any money invested in such a bond will receive a real return plus inflation over the life of the bond. Investors should be aware that returns from an investment in an inflation-linked bond *fund* could underperform and even trail inflation when inflation expectations are low or falling (and the opposite when inflation expectations are high or rising). This is because returns for an inflation-linked bond *fund* are dependent on changing market prices. Nevertheless, inflation-linked bonds come closest to providing explicit inflation protection.

Nominal Bonds are sensitive to inflation, but in the wrong direction. Prices of nominal bonds, and their returns, tend to drop when inflation expectations increase.

Equities tend to outperform inflation over long periods of time. However, there have been periods, such as 1974 to 1982, when inflation considerably outpaced stock returns. Investors who need short- and medium-term inflation protection should limit, but not necessarily eliminate, equity exposure.

Commodities, such as oil, basic metals and certain other goods, tend to benefit from increased demand during economic good times, as we saw during the first part of the current decade when global economic growth was robust. So inflation that is associated with a heated economy can be good for commodities. Commodity returns can be particularly volatile and may underperform other assets during less robust periods.

Commercial Real Estate has been, over the long run, an excellent inflation hedge. Still, there are periods, such as the present, when real estate underperforms both inflation and other assets. And commercial real estate prices can lag changes in inflation.

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