

Sea Changes, Inflation and Bubble Bias

Brett Hammond

The Shape of Recovery?

Hi, I'm Brett Hammond, Chief Investment Strategist of TIAA-CREF, and I'd like to speak to you today about "Sea Changes, Inflation and Bubble Bias." That title sums up our latest thinking about the way forward as the economy and the markets begin to recover from what we refer to as "the Great Recession."

Right now there's a lot of speculation -- in the investment community and the popular press -- about the shape that economic recovery might take. The alphabet soup of U, V, W, and L shaped curves you hear so much about... they're really just ways to help visualize the path of recovery. So, a "V" means the recovery has a sharp downturn followed by a sharp, somewhat symmetrical upturn; while the "L" shaped recovery means that after the initial downturn, the economy is flat or slow to recover.

Today, we want to push back a little on some preconceived notions about the recovery and challenge the conventional wisdom out there. And, based on the economic and market scenarios we see over the next 1-5 years, talk about what it may mean for individual investors.

You'd have to be living a pretty sheltered life to miss the stock market's incredible run up lately. And as people start to feel like we're turning the corner, they begin to wonder, "What will the broader economy and the stock markets look like over the next few years?"

To answer this, many experts have zeroed in on the role that the government might play. Will the government's efforts lead to a steady, sustained recovery... or no recovery at all? Or, has the

government already gone too far... leading to an overheated economy and inflation?

The inflation scenario has received a lot of attention of late. Those who are worried say things like, "Look how much the Fed's balance sheet has grown." "Look at these skyrocketing deficits." Or, "The Fed and Treasury have never used this combination of tools before... how do we know there won't be some unintended consequences?"

Now, we're not saying that inflation isn't an important factor for businesses and investors to consider at some point. But, the global economy has undergone some critical changes that make inflation much less of a threat. Instead, we see other potential risks -- like asset bubbles -- that deserve more attention.

Although there's no definite consensus out there, most visions for the way forward fall into three very general categories.

A modest recovery with low inflation... a relapse into deeper recession, or... a bout of recovery-strangling inflation.

Now these scenarios and their outcomes are very different, but they each assume that inflation and recession are the two biggest threats to the global economy.

But, at TIAA-CREF, we've asked ourselves some tough questions about these scenarios. "Has the world changed?" Have there been some huge shifts that have made price inflation much less likely and other challenges, like asset bubbles more likely? By asset bubbles, we mean things like the commercial real estate overbuilding of the late 1980s, the dot-com bubble of the late 1990s and the housing bubble that in large part led to the current situation.

The Formation of Asset Bubbles

Inflation occurs when there's too much money chasing too few goods and services -- and asset bubbles behave in a very similar way, except in the case of bubbles it is savings chasing investments. From the Dutch tulip craze of the 1600s up to today, bubbles have emerged when large pools of savings fuel increased risk-taking. Inevitably, intense hype begins to circulate around a certain investment fad which is supposed to offer the best potential for outsized returns relative to risk. As money floods in, the price of the asset -- whether it's a technology stock or a vacation property -- gets bid up beyond its intrinsic value.

Asset bubbles are not the same thing as conventional inflation, which is a general rise in prices. In the past, a tight labor market, falling inventories and deficit spending have all led to inflation... just to name a few.

It's important to keep in mind that more than one of these conditions can happen at once. Take the 1970s. Deficit spending combined with easy money, an end to wage and price controls and falling inventories in the energy sector all pushed inflation into double-digit territory.

Today, rising deficits, an increase in the money supply and last summer's energy shock remind us of the 1970s. But, unlike the 70s, our economy now is far from overcapacity. Unemployment is high. And wages and prices certainly aren't going up. Not in any meaningful sense.

And there have been some major shifts in the global economy that make the status quo more likely than a sudden spike in inflation. Just-in-time manufacturing and a more flexible labor market have led to leaner production and declining real incomes -- two factors likely to keep inflation in check for the foreseeable future.

But, on the other hand, the free-flow of capital and a global savings glut have helped fuel asset bubbles -- which played a major role in triggering the two most recent recessions. We think asset bubbles are here to stay... so much so, that in addition to recovery, relapse and inflation let's add what I'll call "Bubble Bias" as our fourth potential scenario.

It's probably safe to assume that it will be quite a long time before policymakers can reliably prevent asset bubbles from forming. So what does this mean?

Well, in the broadest sense, all asset return expectations contain an inflation component. In fact, you can think of asset returns as composed of building blocks. The first building block is the real interest rate and the second one is expected inflation. These two add up to the expected nominal return on a U.S. government bond, for example. For equities, a third building block might be the equity risk premium, or the extra return investors demand for buying relatively riskier stocks instead of less risky bonds. In this building block approach, the lower inflation or inflation expectations, the lower overall asset returns, even if the other building blocks remain the same.

So don't wish for inflation to disappear entirely. A little, but not too much inflation is sometimes a good thing. For example, if consumers expect prices to always stay the same, there's no penalty in delaying purchases or investments.

The bottom line. Don't get too fixated on inflation. If asset bubbles are the more relevant risk, then investors need to consider investments and products that better protect against a somewhat different future. One where overall price inflation is relatively sleepy, but bubbles and the volatility associated with them are regular occurrences.

For example, you can broaden your horizon beyond a narrow focus on the most volatile, bubble-prone asset classes by creating and maintaining a truly diversified portfolio that also incorporates products that guarantee a minimum return. A well diversified portfolio that judiciously combines guaranteed income with stocks and bonds can help to smooth out the effects of unpredictable asset-specific bubbles.

Investors should also try to avoid a critical psychological trap during times of extreme bubbles, namely the tendency to focus on what is rising or falling rapidly in the market this week, today or even this minute. Taking the long view will enable you to look beyond the immediate to a set of long-term investment goals and the best way to reach them.

To do all this, a financial advisor can help you develop a thoughtful asset allocation -- one that keeps the focus on your long-term goals, not the latest investment fad.

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