# Long Forgotten Economic & Market Threat - Inflation

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**Overview – Inflation is Not Nearly Dead**

The US inflation rate has hovered around 1.5% over the last decade, well below the Fed's target rate of 2% most of the time. Such low inflation for such an extended stretch is quite unusual given historical economic relationships, especially with the economy strong and the unemployment rate near historic lows late last year and earlier this year before the pandemic hit.

Normally, inflation rises when unemployment is very low and, conversely, inflation tends to fall when unemployment is high. Over the last several years, it has done neither and this poses a challenge for economists, financial market participants, policymakers and the general public who must make decisions based on what they expect inflation to be in the future.

Unfortunately, the general public has now been lulled into a potentially dangerous mindset which assumes high inflation is a thing of the past. In fact, the best market estimate of expected future inflation – which is the spread between Treasury bonds which are indexed to inflation and non-indexed securities – indicates that investors expect inflation over the next 10 years to average less than 2% per year. That's a scary assumption, in my opinion.

There are important reasons why inflation has been subdued for so long and there are many who expect this trend to continue indefinitely. However, there are also equally important reasons to believe inflation will come roaring back before too long, especially if the Fed continues to print money at a historic rate, and if the government continues to run multi-trillion-dollar annual budget deficits. We'll talk about both possibilities today.

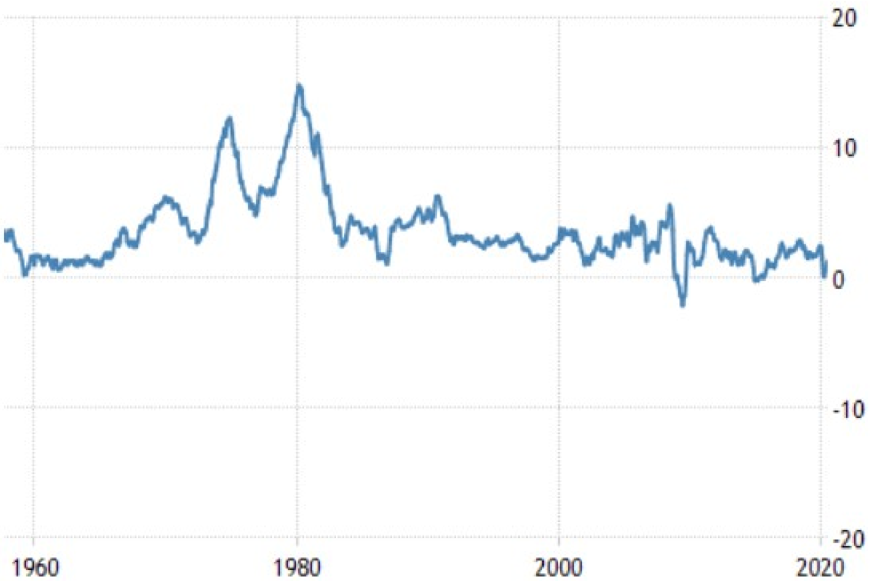
**Inflation Usually Rises, But Not Always**

The traditional short-run trade-off between inflation and economic activity suggests that, over horizons of a few years, low unemployment will boost inflation and high unemployment will lower inflation, with other factors – such as changes in food and energy prices – also mattering in certain time periods. This relationship is known as the *"Phillips Curve,"* (named after A.W. Phillips, who discovered the relationship in the 1950s).

The notion behind the relationship is basic supply and demand. When economic activity and demand are high relative to the economy's capacity to produce goods and services (supply), the attendant pressure on resources will tend to drive up prices and wages.

While this relationship has been generally borne out historically, it has not proven true over the last decade. The inflation rate has consistently fallen short of expectations in recent years. I'll given you several reasons why this has occurred as we go along below.

**U.S. Inflation Rate – 1960 to Present**




**Source: US Bureau of Economic Analysis**

As you can see above, US inflation spiked significantly higher in the 1970s and peaked in 1980 when the Consumer Price Index approached 15%, the highest in the Modern Era. Most Americans were outraged at this out-of-control rise in prices. It occurred while President Jimmy Carter was in office, and many believe inflation was a big factor in his landslide loss to Ronald Reagan in 1980.

Since the massive drop in inflation in the early 1980s, the growth in the inflation rate has trended gradually lower and is expected to approach zero for all of 2020.

1980 was also the year when the Fed Funds rate hit a record 18%. With inflation clearly out of control, then Federal Reserve Chairman Paul Volcker made it his mission to stamp out inflation by way of ratcheting up short-term interest rates, despite the risk of starting a recession.

**Fed Funds Rate**


**Source: Federal Reserve Bank of St. Louis**

The Fed Funds rate fell dramatically from the 1980 peak to effectively zero (0.00%-0.25%) by the end of 2008 and remained there until the end of 2015. It then climbed to 2.4% by mid-2019 and has since retreated once again to near zero earlier this year.

Federal Reserve Chairman Jerome Powell has said consistently this year that the Fed is committed to leaving its benchmark interest rate at or near zero for several more years if needed to restart the economy. Then in late August, Powell made a surprise announcement that the policy committee is prepared to leave the Fed Funds rate at or near zero *even if* inflation rises above its 2% target.

Yet as I pointed out immediately after Mr. Powell made those comments, the Fed doesn't have much influence on the inflation rate in normal times, much less in the Covid-19 environment.

**Why Has Inflation Remained So Low For So Long?**

Economists have identified several possible factors that could have made inflation lower and more stable in recent years, and less responsive to the near record low unemployment rate earlier this year. Here are some of the reasons why.

**Globalization.** In recent decades, ongoing globalization has significantly increased linkages between countries. Greater trade in goods and services, as well as tighter connections across financial markets around the world, imply that US inflation may no longer be determined largely by domestic factors.

**Technology Advances.** The worldwide spread of the Internet has changed patterns of commerce for millions of consumers and businesses, providing greater price transparency and more competition for local businesses, thereby limiting price increases to some extent.

**Changes in Labor Markets.** The spread of global supply chains, declining unionization, a fall in the real minimum wage and shifts in social norms around pay may have reduced the ability of employees to bargain effectively for higher wages – thereby limiting inflationary pressures coming from tight labor markets.

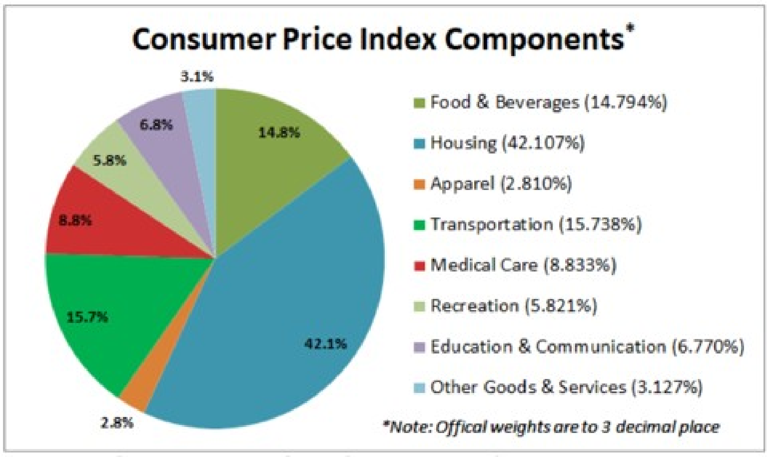
**Changes in How Inflation is Measured.** Changes in the methodology for measuring inflation also can hold down prices. For example, the introduction of a new price index category for cell phones in 2019 by the government reduced inflation in consumer goods retrospectively and likely in the future as well. Plus, changes in government policy which are unrelated to the state of the economy, such as changes mandated by the Affordable Care Act, could be keeping inflation in check.

**Changes in Consumer Spending Habits.** As I have suggested in recent issues of *F&TE*, the recent unprecedented government stimulus payments to families were helpful and some say saved us from a depression. However, as I have pointed out, many families did not spend the stimulus money but elected to save all or a significant portion of it. This, too, helped keep inflation in check.

These are just a few of the reasons why inflation has remained below levels that many forecasters predicted in recent years. There are others, but I think you get the point.

**Reasons Why Inflation Could Come Roaring Back**

I'll keep this closing section short because **my clients and readers are smart** , and I doubt any of you have bought into the growing myth that inflation has been banished indefinitely. Furthermore, I'll bet you are as aware as I am why inflation could return with a vengeance. But let's just click off the main threats.



Source: US Bureau of Labor Statistics

On the domestic front, the US budget deficit for fiscal year 2020, which ends on Wednesday, is estimated to hit a record $3.3 trillion, more than triple our previous record deficit near $1 trillion in fiscal year 2019. And it could be in that range again if more trillion-dollar stimulus packages are passed later this year or next, as is widely expected.

Our national debt is about to surpass $27 trillion, probably before the end of this year. It will exceed $30 trillion next year if this out-of-control stimulus spending continues in 2021. This is double what it was just 10 years ago… with no end in sight.

US Gross Domestic Product, the sum of all goods and services produced annually, is estimated to be apprx. $21.5 trillion. With the national debt expected to surpass $27 trillion this year, our debt-to-GDP ratio is approaching a record 120%. This should concern even the liberals.

The Fed's balance sheet, which consists mostly of US Treasury bonds and mortgage-backed securities (but recently corporate bonds as well), has exploded to over $7 trillion. And the Fed offers no assurances its historic bond buying is going to end… again, no end in sight.

This is just US debt levels. Ready for some even bigger numbers? Global debt surged to $258 trillion in the

1Q of this year (latest data available). That puts the global debt-to-GDP ratio at a staggering 331%. Maybe this trend can continue a while longer, but we all know it won't end pretty at some point.

To sum up, I think we all know the explosion in debt will have to end sooner or later. When it does, there will be only one of two options: default or inflate. Defaulting on their debt will not be the chosen option, at least not for developed nations. Inflating their debt away is the only other option.

That option will not be good for the value of our assets unless we take smart actions to protect ourselves, which is a discussion for another day.

My point today is, inflation is *NOT* dead as some would have you believe. Not by a longshot!

All the best,
Gary D. Halbert

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