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Inflation Is Not A Problem

There are only three ways to meet the unpaid bills of a nation. The first is taxation. The second is repudiation. The third is inflation. - Herbert Hoover

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What is inflation? What causes inflation? Many people pretend to know and will usually cite some variation of the following. *"Inflation is the general increase in prices and a fall in the purchasing value of money." "Inflation is caused by an increase in the money supply and/or the availability of credit."* But the definitions above are unsatisfying and incomplete for many of us as they leave out important elements such as demographic trends (the aging of societies), technological advances, government regulatory effects, supply shocks, the overall level of debt, as well as trade and global competitive forces realized through capitalism. Also, there is what many people consider to be good inflation – think investment asset price increases and then also bad inflation – think an increase in food prices. It is all very confusing and frankly I don't believe professional economists in general fully understand inflation and why it may or may not be bad – but that is a discussion for another day.

I have been a disinflationist for all my career in the markets. It hasn't been a difficult position to hold as the rate of inflation has been steadily decreasing since around 1980-81 and along with it bond yields. This isn't a US phenomenon but a developed economy phenomenon (see Japan, UK and continental Europe).

Ed Yardeni is a well-known and respected economist on Wall Street. He has worked for the major firms as well as for the Fed, and now currently runs Yardeni Research. I have been following his work since I began my career in the financial markets in late 1997 and find his commonsense approach refreshing. Please see his recent blog post below on why inflation isn't an issue and how it has been tripping up central bankers.
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Inflation Remains in a Coma in Major Economies, Frustrating Central Bankers

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By Edward Yardeni, President of Yardeni Research

I've been a disinflationist since the early 1980s. I first used that word, which means falling inflation, in my June 1981 commentary, "Well on the Road to Disinflation." The Consumer Price Index (CPI) inflation rate was 9.6% y/y that month. I predicted that Fed Chair Paul Volcker would succeed in breaking the inflationary uptrend of the 1960s and 1970s when he adopted a monetarist approach during October 1979. I certainly wasn't a monetarist, given my Keynesian training at Yale. I knew that my former boss at the Federal Reserve Bank of New York wasn't a monetarist either. But I expected that Volcker would use this radical approach to push interest rates up as high as necessary to break the back of inflation. Which is what he did.

Ever since then, reflationists have been predicting, without any success, that inflation is bound to make a comeback. They've been wrong for so long because inflation is so yesterday. The Great Inflation was basically a 1970s phenomenon attributable to the two oil price shocks of 1973 and 1979. Thanks to cost-of-living clauses in private-sector union contracts back then, those price shocks were passed directly to wages, causing a wage-price spiral.

The CPI isn't the best measure of price inflation because it has a significant upward bias. The Fed prefers the core personal consumption expenditures deflator (PCED), which better reflects the prices of the goods and services that consumers are actually buying. According to this measure, inflation has ranged between a low of 0.9% and a high of 2.6% since 1995.

In recent years, I've often declared: "Inflation is dead." I've frequently discussed the four deflationary forces (which I call the "4Ds") that have killed it. They are détente, disruption, demography, and debt. (See my 8/1 LinkedIn article, "**The Great Inflation Delusion**.")

The data show that at best inflation is in a coma, especially in the major industrial economies. Here is an update on the latest inflation readings:

(1) *US CPI and PCED.* In the US, the headline and core CPI were up 1.8% and 2.3% y/y, respectively, in October. However, the comparable readings for the PCED were only 1.3% and 1.6%.

Now sit down for this one: The Fed is seriously considering a "make-up" strategy for targeting inflation. That's according to yesterday's FT **article** "US Federal Reserve considers letting inflation run above target." Here is the gist of the plan: "The Fed's year-long review of its monetary policy tools is due to conclude next year and, according to interviews with current and former policymakers, the central bank is considering a promise that when it misses its inflation target, it will then temporarily raise that target, to make up for lost inflation."

With all due respect, that's hilarious! Why do Fed officials want to embarrass themselves by targeting inflation over 2.0% when they haven't been able to move it up to 2.0% since officially targeting that level in January 2012? Fed Governor Lael Brainard, speaking to reporters last week, said that a strict make-up rule would be too hard to explain to the public. I think she is right.

Since January 2012, the headline PCED has been tracking a 1.3% annual trendline. In other words, October's PCED was 4.7% below where it should have been if it had been tracking 2.0%. To get back to the steeper trendline by the end of 2022, the PCED would have to increase by about 12.0%, or 4.0% per year! Try explaining that to the public.

By the way, the big divergence between the CPI and PCED inflation rates during October was mostly attributable to consumer durables (up 0.5% in the CPI and down 1.0% in the PCED). In addition, medical care services were up much more in the CPI (5.1%) than in the PCED (2.1%). These divergences aren't unusual but par for the course. Rent inflation tends to be almost identical in the CPI and the PCED, but it has a much higher weight in the former than the latter, and it has been running hotter (at 3.7%) than the overall inflation rate.

(2) *Eurozone CPI.* An 11/28 Bloomberg **article** reported that the European Central Bank (ECB) is expected to "tweak" its inflation target in an upcoming review of monetary policymaking: "The institution's first fundamental assessment in 16 years might conclude with a goal of 2%—instead of the current 'below, but close to, 2%' which some governors worry risks leaving inflation too weak." One word comes to mind: "Lame."

During November, the Eurozone's CPI inflation rate picked up to 1.0% from a three-year low of 0.7% in October. The core rate was 1.3%, the highest in seven months.

On 11/22/19, Christine Lagarde delivered her first **speech** as ECB president, "The future of the euro area economy." Remarkably, she spoke about monetary policy almost in passing, in just one paragraph in fact. Instead, she presented a case for fiscal policy to focus on more public investments in infrastructure, R&D, and education. She also said she wants to see more economic integration in the EMU. She is one of the few central bankers who seems inclined to acknowledge that monetary policy may have lost its effectiveness.

(3) *Japan CPI.* An 11/18 Bloomberg **article** reported that the Bank of Japan (BOJ) may be running out of ammo to boost inflation in Japan: "Speaking in parliament on Tuesday, [Bank of Japan Governor Haruhiko] Kuroda said there was still room to lower interest rates further, but added that he had never claimed the BOJ's easing ammunition was endless or that there was no limit on how low rates could go."

In fact, he is running out of support for additional monetary stimulus measures. The article observed: "Such low yields have gradually pushed institutional investors and regional banks out of the JGB market and into riskier assets. Many analysts see bankruptcies looming among beleaguered regional banks, where the old model of borrowing short and lending long has been upended both by a flat yield curve and a diminished demand for credit."

The BOJ has been reluctant to follow its peers around the world in easing policy this year, suggesting that the days of shock and awe from Kuroda's BOJ are over. There is more talk about doing more to stimulate the economy with fiscal policy, but it's all talk so far.

Meanwhile, Japan's CPI inflation rate is on life support. The headline rate was up just 0.2% during October. The core rate, which includes oil costs but excludes volatile fresh food prices, rose 0.4% y/y in October. Excluding the impact of the sales tax hike rolled out in October and the introduction of free childcare, annual core consumer inflation was 0.2% in October, slowing from 0.3% in September.

(4) *China CPI.* China's headline CPI inflation rate jumped to 3.8% during October. That was the highest since January 2012. However, it was boosted by soaring pork prices, which lifted overall food-price inflation to a more-than-11-year high, as consumer demand drove up prices for pork alternatives including eggs and other meat products. Hog prices have soared this year at the fastest pace on record as a result of the deadly African swine flu. Excluding food, the CPI was up just 0.9% during October!

(5) *Bottom line.* Inflation is in a coma. The major central banks continue to provide

ultra-easy monetary policy to revive it. All their efforts have been frustrated by the four powerful forces of deflation. Their ultra-easy monetary policies continue to drive stock prices higher, while keeping interest rates at record lows.

(6) *Contrarian alert.* Contrarians on inflation can take some comfort from the front cover of the April 22, 2019 *Bloomberg Businessweek* shown above.

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My view on markets has not changed. I believe the Fed is hellbent on keeping our current economic expansion going, which probably means asset price inflation will continue for the time being. I am under no illusions that financial markets are in balance, however if the post 2009 GFC (Global Financial Crises) has taught us anything, it is that policy makers have more power and effect on asset prices than we may have previously believed. At some point in the future we will have to pay the piper, I just don't know when that will be. For the time being, markets look in good shape to me, with stocks likely to go higher based on P/E multiple expansion due to low and steady interest rates. The one change I am making to portfolio's has been an increase in energy, oil and gas exposure. With the Fed less concerned about inflation, I wouldn't be surprised to see outperformance in the sector despite generally slower economic activity, as loose monetary policy could weaken the U.S. dollar marginally to the benefit of commodities broadly, energy and energy stocks. I think it's worth a shot given current conditions and due to the fact that the sector has been underperforming and/or losing money for a while now.

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Large Capitalization Technology	**Communication Services Sector**	**Financial Services Sector**
Emerging Markets Equities	**Healthcare Biotech & Pharmaceuticals**	**Consumer Discretionary Sector**
Healthcare Equipment	**Consumer Staples**	**High Yield Corporate Bonds**
Aerospace & Defense	**Investment Grade Corporate Bonds**	**Leverage Loans (Floating Rate Debt)**
U.S. Treasury Notes & Bonds	**Mortgage Backed Securities**	**Treasury Inflation Protection Securities**
Local Currency EMG Bonds	**Gold**	
Energy Related Equities		

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