Inflation: What the Doctor Ordered?

The jumbled word cloud above was created in the wake of Chairman Bernanke’s testimony before the House on July 17th. Word clouds are essentially graphic representations of words based on their prevalence in speech or writings where the more common a word is, the bigger and bolder it appears. Many would expect words like *Treasury*, *unemployment*, *economy*, or even phrases such as *QE3* to be the biggest and the boldest in Bernanke’s speech, but they would be wrong. As can be seen, a single word stands out from all the others… *inflation*. Inflation?!

This may seem like something of a contradiction. After all, just within the past few weeks, Bernanke was quoted as saying inflation was too low. This statement was made after his favorite gauge for inflation, the Personal Consumption Expenditures Index (PCE), was up a mere 1.05% year-over-year, matching the slowest pace in the index’s 54 year history and well below the Fed’s established goal of 2% inflation. How is it possible that inflation is too low? To most people who drive a car, pay tuition, or put food on the table inflation certainly does not feel too low.

Nonetheless, taking Bernanke’s statement at face-value, how can something so seemingly benign at 1.05% be so significant? It’s not like we are experiencing massive deflation or hyperinflation. Referring back to the word cloud above, one would almost need a magnifying glass to find the words: *stability*, *prices*, *housing*, and *rates*. Yet, coming in at 1.05%, the word inflation is big enough to be on the first line of a vision test. Besides, why is low inflation (or even a little deflation for that matter) such a bad thing in the first place?

Dissecting Inflation

Before getting too far ahead, it helps to have a little background on inflation and how it is measured. Despite Chairman Bernanke’s particular affinity for the business-derived PCE, the broadest and most simplified measure of inflation for goods and services is the Consumer Price Index (CPI). Measured by the Bureau of Labor Statistics (BLS), the CPI is essentially a basket of goods and services at the individual level where costs are averaged over time and the output is a single number or rate. On the surface, it’s a simple concept; however, skeptics argue that these government-generated numbers are intentionally skewed to show unrealistically low rates due to the index’s impact on cost-of-living adjustments to Social Security, pensions, and Medicare. Charles Hugh-Smith of *OfTwoMinds* blog suggests this is just one of the reasons why inflation may be significantly understated. He argues that CPI does not correspond with the goods and services people spend money on as seen in GDP numbers, and is quoted saying “If healthcare is 18% of the U.S. GDP, i.e. 18 cents of every dollar goes to healthcare, then how can a mere 6.5% wedge of CPI devoted to healthcare be remotely accurate?”
Excerpt from Governor Ben S. Bernanke’s Remarks Before the National Economists Club, Washington D.C., November 21, 2002

“The second bulwark against deflation in the United States, and the one that will be the focus of my remarks today, is the Federal Reserve System itself. The Congress has given the Fed the responsibility of preserving price stability (among other objectives), which most definitely implies avoiding deflation as well as inflation. I am confident that the Fed would take whatever means necessary to prevent significant deflation in the United States…”

Whether there is gamesmanship going on here or not, the fact of the matter is that, since 1978, the components comprising the CPI have changed over 20 times. What began as an index measuring a constant standard of living has become a measure of true cost of living, with the current theory suggesting that consumers will substitute less expensive products for more expensive products over time when available. The BLS has accordingly substituted hamburger for steak and Wal-Mart for a blend of different department stores in an attempt to make the index better reflect the times. While this may seem like a trivial distinction, the impact is huge. If CPI were measured the same way it was back in 1980, inflation would currently be running at about 9%.

Diagnosis: Deflationophobia

Despite what the 1980-based version of the CPI might suggest, there are a number of deflationary factors currently at work in the economy - some good and some bad, some cyclical and some structural. Deflation and inflation are much like cholesterol in that there is good and bad of both. But what is certain is that the majority of the Fed currently believes that deflation is a greater risk to the economy than inflation at this point. Central Bank alarm bells go off at the mere thought of deflation. The reality is that deflation can be just as corrosive to an economy as severe inflation, if not more. As aggregate demand slows, prices decline, buyers delay purchases because they expect prices to go even lower, inventories rise, and a further downward price spiral ensues. While inflation helps borrowers pay back debt less expensively, deflation increases both the real value of debt and the costs of existing debt in nominal terms, making the servicing of debt more expensive. Further, deflation hits the bottom line directly as government revenue is reduced as corporate and individual tax receipts decline due to falling incomes, creating a double whammy for debt-laden governments like the U.S.

There are plenty of signs that deflationary fears are well founded. For one, the Chinese economy enjoyed an economic and housing boom for years leaving their government scrambling to build infrastructure, even in the form of Potemkin-like cities. Now, however, China’s rate of growth has slowed and commodities, as a group, have softened. Further, globalization and technology have helped lower manufacturing costs and, in turn, have aided in the elimination of many blue-collar, middle-class jobs in America in the process, widening the chasm between rich and poor in the process. Significant economic softening and Depression-like unemployment in some parts of the Eurozone give credence to the belief that good inflation of any kind will be difficult to create and bad deflation will be hard to prevent in the near future.

Is more Print-icillin the cure?

The last bout of real deflation known to the U.S. was the Great Depression. In a 2002 speech to the National Economist Club (prior to the Great Recession), Bernanke, who is widely known to be an expert on Depression-era economics, opened his playbook on how to avoid a repeat of a Great Depression-type deflation a full four years before he became Fed Chairman. In order to fulfill their mandate of “stabilizing prices and maximizing employment”, the Fed has been buying $85 billion worth of Treasury and mortgage-backed securities per month. The goal has been to create inflation and employment through asset inflation.

The theory is that the Central Bank will crowd-out the market by buying up theoretically ‘safer’ investments, such as Treasuries and Agencies, thus forcing investors to venture out further on the risk curve if they want to achieve higher returns. Investors, in many cases, have exited their traditional asset allocations and invested their assets in a higher concentration of riskier assets like stocks, corporate bonds, and real estate. This has the dual impact of creating a wealth effect for investors and ultimately lowering interest rates. The theory suggests that investors will do a cash-out refinancing on their home or sell some stock and redeploy the cash into demand for goods and services. Some would argue that at least part of the Fed’s strategy is working. The S&P is hitting more high notes than a Bee Gee’s song, bonds continue to show elevated prices from an historical standpoint, and even housing is making a comeback.
So Fed policy must be working. Right? Not so fast. Commodity prices are up 45% since the start of Quantitative Easing and the dollar is down 10% against a basket of currencies representing U.S. trading partners (even though many of these trading partners are doing their own version of money printing). Many believe the Fed has created asset bubbles, compelled investors to over-leverage their portfolios to realize a reasonable return, and pushed market participants to take on too much risk relative to their risk tolerances. Perhaps Chairman Bernanke agreed with the latter two points as he suggested in June that the Fed could begin ‘tapering’ their monthly purchases as soon as September. Markets, however, reacted violently to the mere talk of tapering. The 10-year Treasury was up over 100 basis points in yield and almost $88 billion was yanked from bond funds in the month of June, a one month record (previous record being $48 billion in October of 2008). Domestic stock markets similarly took it on the chin and the Dollar index hit a three-year high. And maybe most importantly, mortgage applications were down a whopping 39% due to the sudden rise in mortgage rates! Since June 19th, the Fed has been quietly trying to put the proverbial genie back in the bottle. They have gone from being hawkish by speaking of tapering and ultimately ending near-zero interest rates to taking a more dovish stance in hopes of bringing interest rates back down and getting mortgage applications back up. The Fed’s deflationaphobia also plays a significant role in their decision-making process, and as long as low inflation readings continue, the Fed will continue to prop the markets up with the printing presses.

**Prognosis**

It is difficult, as a shepherd of one’s capital, to have conviction in a market which is currently exhibiting historic lows in volatility and historic highs in complacency. The current market’s foundation for support is a policy where the Federal Government runs huge budget deficits and then funds them and past debt with bonds which are primarily bought by the Federal Reserve with printed money. What is happening with the economy and the market at this point simply defies logic. As QE3 continues, the Fed may be creating more harm to the economy than good. We are caught in a world where the likelihood of realizing bad inflation or bad deflation has increased exponentially. With the recent softening in housing as a result of the slight bump in interest rates, the large scale downward revisions of second half GDP numbers and the plethora of statistics which show tepid consumer demand, it is imperative to deploy a strategy to help portfolios perform well in a wide variety of possible scenarios.

The talk of the disappearance of inflation and the slow down in the world economy has helped cheapen prices of commodity-based stocks of all types to more reasonable levels where we are seeing value. Additionally, thanks in part to Detroit (now the largest municipal bankruptcy in history) and the ripple effect it has caused thus far, we are finding values in shorter duration municipal bonds even though they are still barely exceeding stated inflation in the short term. But what many investors forget is most financial instruments are priced off of the Treasury yield curve. It is difficult to justify going out long term on bonds or ‘buying the market’ when risks to investors are rising and value is declining. It is next to impossible to realize double digit growth in stocks and bonds with nominal GDP in the low single digits. Prudence dictates harvesting some gains in portfolios to create a war chest of liquidity for a time when spread-widening events begin to occur. In the interim, let’s hope that deflation does not become the largest word in Bernanke’s next word cloud.

Sincerely,

Chris L. Doucet  
Chief Executive Officer
Footnotes
3 Shadowstats.com, June 18, 2013
5 http://trimtabs.com/global/liquiditytheory4.htm
6 MarketWatch, “Mortgage Application Slump to Two-Year Low in Worrying Sign for Housing,” July 31, 2013

Admin Notes

• Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
• Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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