

Analysis and Action

Why is Inflation so Low?

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Since 1980, the rate of inflation has declined every decade. In the 1980s, inflation averaged 5.5%; in the 1990s, inflation fell to 3%; and during the first 12 years of the new millennium, inflation dropped, yet again, to 2.32%. Over the past 12 months, inflation, as measured by personal consumption expenditures (PCE), has fallen to 1.15%, a 50-year low.

As a result of this entrenched long-term disinflationary environment, short- and long-term interest rates have fallen in sync. This decline has occurred as investors require less of a yield premium to offset the negative impact of inflation. To wit, long-term interest rates have declined from 16% in 1981 to 2.6% today.

In the current low inflation and low interest rate scenario, the pressure is on for portfolio managers as they struggle to identify attractive yield-generating strategies for their excess funds. And under these circumstances, making wise investment choices naturally involves scaling expectations to economic realities. That said, reasonable options do exist.

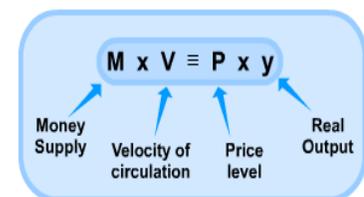
On the following pages, we compare the relationship between inflation and monetary supply and behavior: both in economic theory and practice. By examining the roots of low inflation and its prospects for the future, an effective credit union portfolio strategy can be shaped.

Monetarism: Fact or Fiction?

Monetarism is a school of economic thought that maintains that **money supply** has a direct, proportional relationship with the price level. For example, if money supply increases, there would be a proportional increase in the price of goods.

American economist **Milton Friedman**, generally regarded as monetarism’s leading exponent, famously said, *“Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.”*

The link between money and inflation has been made by the quantity theory of money, which proposes a positive relationship between changes in the money supply and the long-term price of goods. It states that increasing the amount of money in the economy will eventually lead to an equal percentage rise in the prices of products and services.



Here’s the conundrum then: How could the Fed have tripled the monetary base since 2008 without the money stock (M2) ballooning, triggering big jumps in spending and inflation? What’s wrong with our

tried-and-true theory?

Let's explore why inflation is close to all-time record low levels while the Fed is "printing money" 24/7. First, let's start with some terminology and a review of what the Fed controls and what it does not.

The Fed Controls:

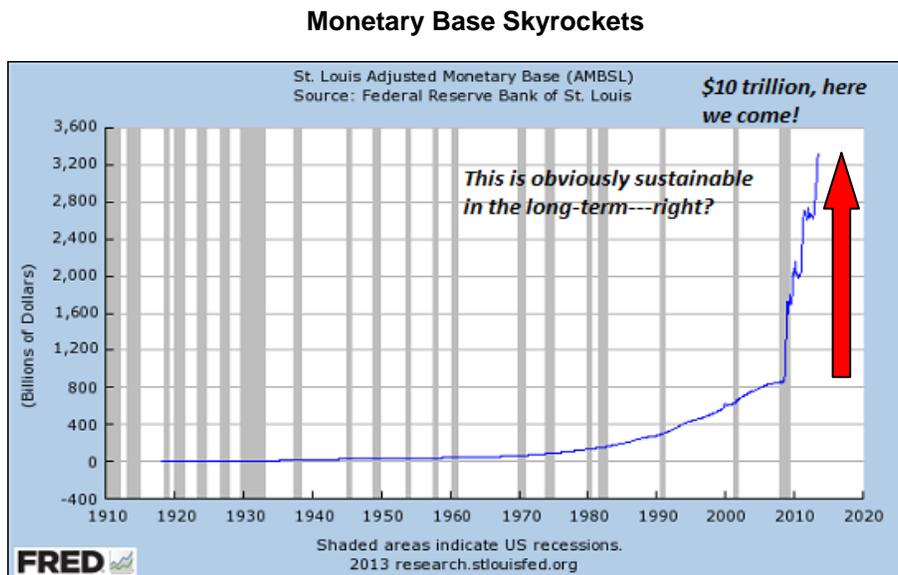
- **Monetary base** – the sum of U.S. currency in circulation and bank reserves held at the Federal Reserve. Up until late 2008, it consisted mostly of currency with a small amount of bank reserves held mostly to meet regulatory requirements.

The Fed Does Not Control:

- **M2** – the total quantity of account balances at banks and other financial institutions that can easily be accessed to make payments. M2 includes currency and certain deposit and money market accounts.
- **Velocity** – the frequency that money is spent in an economy: how quickly or slowly people spend their money. A host of factors influence velocity, but arguably the most important one is the type of borrowing and lending that occurs.

The Monetary Base and Excess Reserves

As shown in the following graph, since the Fed initiated quantitative easing (QE), the monetary base (U.S. currency in circulation and bank reserves) has gone parabolic, rising from \$800 billion to more than \$3.2 trillion! Much of the increase is due to the explosive growth in excess reserves at the Fed.



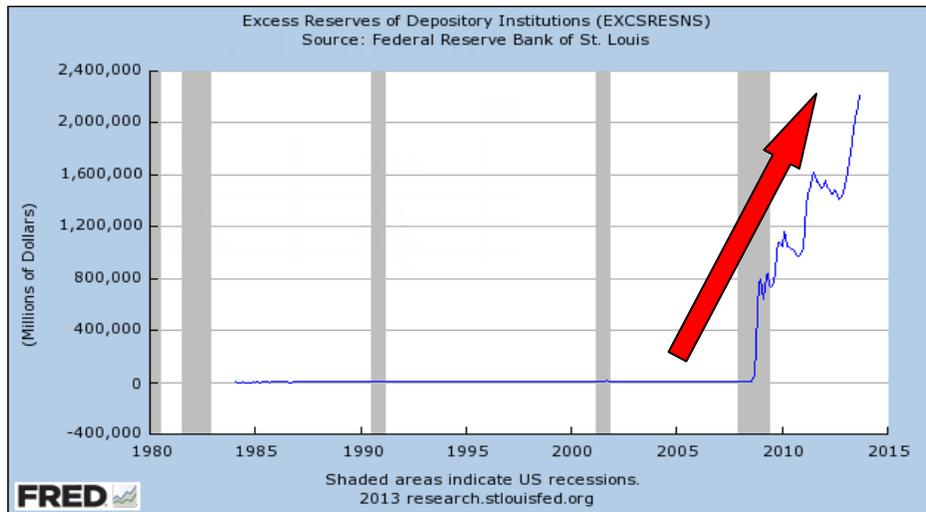
It is important to understand that when conducting monetary policy, the Federal Reserve *only* controls the quantity of bank reserves. Normally, banks have a strong economic incentive to put reserves to work by lending them out. If the banking system, as a whole, found itself with excess reserves, then the system would increase the availability of credit in the economy and spur economic activity. Precisely

this reasoning lies behind the classical monetary theories of Friedman. These theories hold that an increase in the monetary base should lead to a proportional rise in the M2.

Moreover, if the economy were operating at its potential, then if the banking system held excess reserves, too much “money” would chase too few goods, leading to higher inflation. Friedman’s maxim would be confirmed.

The big change is that, beginning in late 2008, the Fed now pays interest on reserves. Therefore for banks, reserves at the Fed are close substitutes for Treasury bills in terms of return and safety. As you can see in the graph below, banks would seemingly rather hold excess reserves safely at the Fed, instead of lending them out in a struggling economy.

\$2.3 Trillion Dollars are Parked at the Fed as Excess Reserves

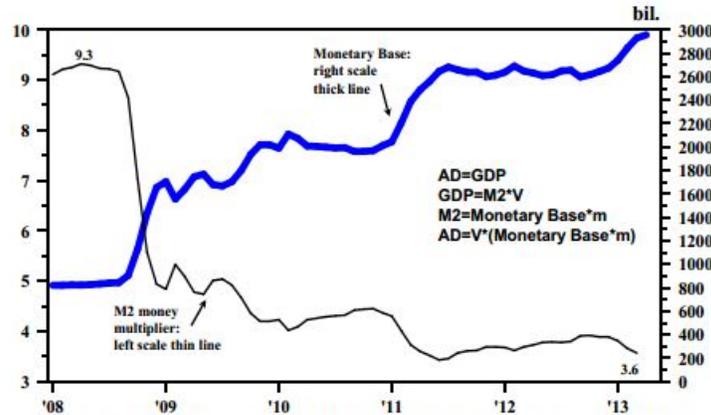


This is where Friedman’s theory has broken down. Despite a 300% increase in the monetary base, the year-over-year expansion of M2 is only 7%. This is nearly identical to its year-over-year growth rate in March 2008 before the Fed decided to *help out the economy*. In other words, the massive security purchases by the Fed have not resulted in a sustained acceleration in monetary growth – **the simple reason being that the Fed cannot force banks to lend, nor can the Fed force borrowers to borrow or consumers to spend. Without these dynamics, money growth does not exist.** This is why it has been often said that the Fed is “pushing on a string.”

This is quite apparent in the next graph. The money multiplier, as measured by the ratio of M2 to the monetary base, plummeted in late 2008, illustrating how profoundly the linkage between the monetary base and the economy has broken.

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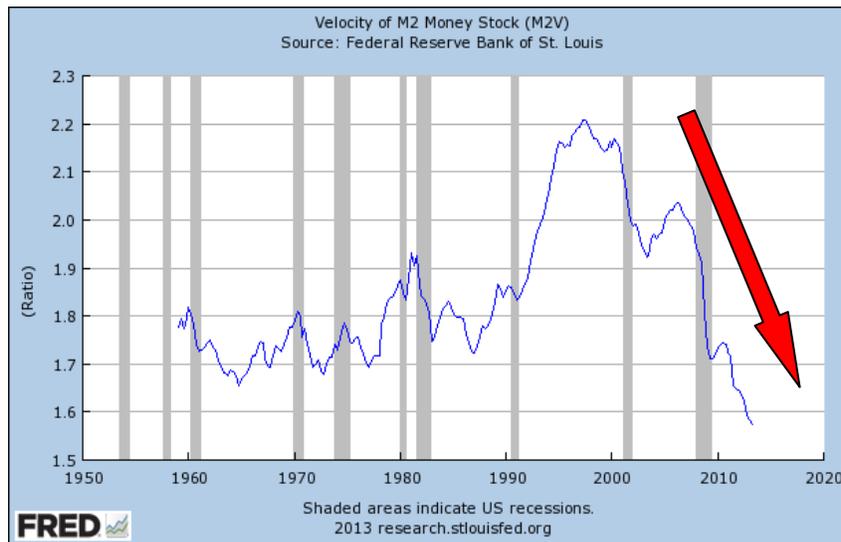
M2 Money Multiplier and the Monetary Base (monthly, source: Federal Reserve)



Velocity

Last but not least, not only is the Fed not in control money stock (M2), it cannot determine velocity (the speed that money turns over). For velocity to rise, any increase in debt needs to create an income stream. For the past several years, most lending activities have related to daily consumptive needs, including borrowing by the federal government. Borrowing to finance consumption does not generate a productive income stream, nor does it create resources to repay the borrowed funds. Consequently, velocity has collapsed, now standing at a six-decade low. Velocity is almost entirely outside the Fed's control.

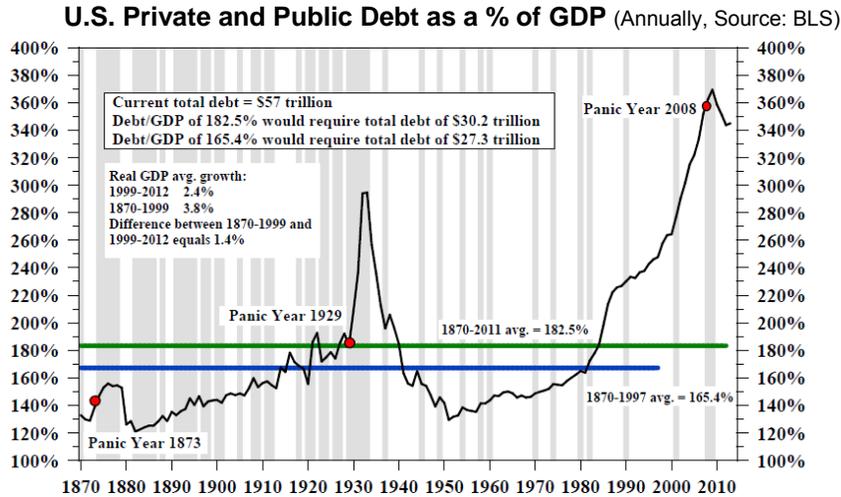
Velocity of Money at Six-Decade Low



The Bottom Line

The Fed clearly wants QE to spur lending and job creation. But the Fed can only make money available for lending. It cannot control where the money goes (or if it goes anywhere at all). The Fed cannot force people to borrow or banks to lend.

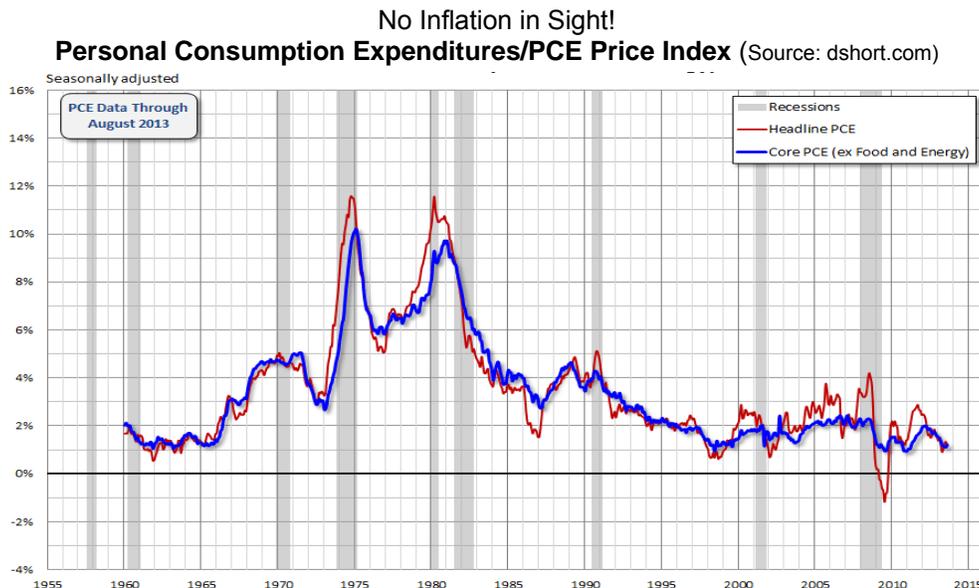
Additionally, the extreme level of indebtedness is a force entirely independent of the Fed. It is restraining aggregate demand and serving to neutralize what minimal influence the Fed has on the economy.



Thus, in a world of deleveraging – a glut of labor, a dearth of jobs and pressure on wages – inflation will have a very difficult time igniting. These are not conditions of hyperinflation. Heck, they are barely inflationary at all.

As of this writing (October 2013), the latest Headline PCE price index year-over-year (YoY) rate of 1.15% is a decline from last month's adjusted 1.33%. The Core PCE index of 1.23% is fractionally higher than last month's adjusted 1.13%.

The general disinflationary trend in core PCE (the blue line in the following chart) must be troubling to the Fed. After years of ZIRP and waves of QE, this closely watched indicator has consistently moved in the wrong direction since early 2012. It has been flat-lining in recent months. From a long-term perspective (spanning five decades), one can easily see that inflation is approaching all time record lows.



Portfolio Strategy

At the time of this writing (October 2013), we have a highly indebted economy with slow growth and low inflationary expectations. As long as these conditions remain, we continue to advocate putting excess cash to work. In terms of yield curve positioning, the intermediate sector of the curve appears to offer a favorable risk-return profile.

When this article was published, the 5-7 year part of the curve was offering an attractive yield, roll down effect and favorable total-rate-of-return profile. In terms of sectors, the following securities look to be constructive:

- Agency securities
- Investment-grade bank notes
- Corporate and municipal “bullet” securities

A final note. Of course, if the economy were to markedly improve, inflationary pressures could build. Under such circumstances, the Federal Reserve would need to remove monetary accommodation to keep the economy from overheating and excessive inflation from emerging. In such an environment, we would expect interest rates to rise – and possibly significantly – on the front end of the yield curve.

More Information

To obtain more information about credit union investment strategy, portfolio allocation and security selection, please contact the author.

Tom Slefinger, Senior Vice President, Director of Institutional Fixed Income Sales, and Registered Representative of ISI, has more than 30 years of fixed income portfolio management experience, and has developed and successfully managed various high profile domestic and global fixed income mutual funds. He has extensive expertise in trading and managing virtually all types of domestic and foreign fixed income securities, foreign exchange and derivatives in institutional environments.

At Balance Sheet Solutions, Tom is responsible for developing and managing operations associated with institutional fixed income sales. In addition to providing strategic direction, Tom is heavily involved in analyzing portfolios, developing investment portfolio strategies and identifying appropriate sectors and securities with the ultimate goal of optimizing investment portfolio performance at the credit union level. He can be reached at tom.slefinger@balancesheetsolutions.org or 800-782-2431, ext. 2753.

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