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The Fed, Inflation and Too Much Money?

Since the end of the Great Recession in 2009, inflation has remained stubbornly low. Even after ten years of economic growth and an unprecedented injection of money into the economy, inflation has consistently remained below the Federal Reserve's stated target of two percent per year. The causes of this weakness are a matter of intense debate, and even the Federal Reserve expresses puzzlement over its policy's lack of effectiveness in creating more inflation.

This low inflation has kept interest rates well below their historical levels, which has encouraged more borrowing and punished bond investors with low yields. When inflation does start to rise, investors should expect interest rates to follow, which will have a significant impact on their portfolios. It is important, then, for investors to understand these issues that are now being closely scrutinized by the markets.

The Federal Reserve and the Markets

A moderate amount of inflation is a crucial element of a healthy economy: too low and we risk entering a spiral of deflation, too high and we risk runaway inflation and a chance of a devalued currency. Deflation is particularly intractable and the Federal Reserve never wants to see inflation get close to being negative.

Milton Friedman, the late Nobel Prize-winning economist, famously defined inflation as "too much money chasing too few goods." The Fed attempts to manage inflation through its control of the money supply. It closely follows the economic data and pumps money into the economy when it decides inflation and economic activity are too low, and then pulls money out of the economy when it is trying to cool things down.

The fundamentals of stocks and bonds are affected by this economic cycle. Corporate revenue growth and earnings are boosted by an expanding economy, and face strong headwinds when the economy slows. The financial markets are always trying to forecast future earnings, so any move by the Fed to slow the economy can be expected to be an overhang on stock prices and to raise concerns about the credit quality of bonds.

The most direct and visible impact of inflation and Federal Reserve policy is seen in the bond market and the level of interest rates. The Fed, through its manipulation of the money supply, sets the overnight Fed funds rate. Short-term rates directly correlate to the Fed funds rate. Investors in bonds demand a premium over short-term rates to compensate them for the risk of lending out their money over time and the loss of buying power from future inflation. If the bond market's expectations of future inflation rise, it will push up longer-term interest rates.

At the onset of the Great Recession in 2008, the Fed undertook the most aggressive monetary loosening in its history and subsequently drove the Fed funds rate down to less than a quarter of a percent, where it stayed for six years. In order to gain some yield, investors were forced to take on more risk by buying either longer term bonds or dividend paying stocks. Even with the Fed gradually undoing this policy since 2016, the Fed funds rate has risen to only about 2.4%, which is substantially lower than the 60-year average of 4.8% and only slightly above measured inflation.

Currently, the differences between shorter-term and longer-term interest rates show that the bond market does not see much inflation in the future. The Treasury note due in ten years yields only 0.3% more than the one due in five years--not much compensation for an additional five years of potential inflation. With longer-term rates currently at such low levels, it is far more likely for rates to rise from here than decline.

Price Inflation versus Asset Inflation

One can be forgiven for questioning the consensus that inflation is low. High valuations abound in real estate, for instance. According to Green Street's broad commercial property price index, commercial real estate has risen over 7% a year since the bottom of the market in 2009 and has average valuations not seen since 2005. Residential real estate values have risen similarly in many markets.

The flood of money into the banking system and resultant low interest rates have encouraged investment in all sorts of assets. Publicly traded companies have borrowed money at low rates to buy back their own stock and private equity firms with record amounts of cash are taking companies private. But these are assets, not goods being consumed, and increases in their valuations are called asset inflation.

The Fed looks at price inflation, not asset inflation. It keeps a close watch on the two main inflation indexes that track the price changes of a basket of goods consumed by the average American: the Consumer Price Index ("CPI") and the Personal Consumption Expenditures Price Index (PCE). The Fed puts more weight on the PCE, which lately tends to run about one half percent lower than the CPI, primarily due to its greater emphasis on government and business healthcare spending relative to direct consumer healthcare spending.

The Debate about Low Inflation

As we complete the 10th year of our current economic expansion, Gross Domestic Product (GDP) growth continues to run below 3%, while PCE inflation has averaged only about 1.5% over the past five years. Whether these sluggish rates of growth are due to the unusual nature of this economic cycle or a more fundamental change in the economy is one of the issues being debated. There are several explanations for the current low inflation numbers.

The Federal Reserve responded to the financial crisis by flooding the banking system with money and expanded its balance sheet from $800BN to $4.5TRN. This more than quadrupling of asset purchases injected far more money into the economy than was historically needed to accommodate the cumulative 35% GDP growth since then. One explanation is that, while the Fed has put an enormous amount of money into the financial system, the banks have not fully lent that money so it remains trapped in the banking system. Rather, they have used some of that money to rebuild damaged balance sheets.

Another puzzling aspect of the inflation question is the lack of wage pressure in the economy. The reported unemployment rate has declined to a 50-year low and the tight labor market should be driving up labor costs. With wages accounting for an ever-increasing percentage of business expenses, this should be causing inflation and forcing companies to raise prices.

Many people left the workforce during the Great Recession and there is a debate as to whether they were discouraged by the difficulty in finding work or were part of the large baby boomer cohort that is retiring due to age. The percentage of the population that is in the workforce dropped from 66% in 2007 to around 62% in 2015 and is just now beginning to recover. If many of the dropouts were just discouraged, the rising availability of jobs is now enticing them back and easing the pressure on businesses to raise wages to attract new job applicants.

Improving technology has also eased the pressure on wages. Lower-level jobs are increasingly being automated, which is pushing low-skilled workers back into the labor pool.

Another influence on U.S. inflation is the low level of interest rates and inflation in many overseas economies. When growth in foreign markets picks up, it could put some upward pressure on prices here. To date, that has not happened.

To believe that inflation is now permanently lower is to believe that "it is different this time." While fundamental changes in the economy do occur, we think that many of the above factors will work themselves out over time. Investors have learned that betting against history is unwise and usually fails.

Investment Implications

Investors have lately reached a consensus that recent soft economic data and trade war effects will force the Fed to cut interest rates at least once this year. However, if it turns out that the economic recovery is *not* different this time and inflation does begin to rise at some point, the Fed will then begin to pull more money out of the economy and raise the Fed funds rate. The bond market will start to factor in future inflation and push up longer-term interest rates.

Rising interest rates are particularly damaging to the prices of longer-term bonds so it will be important to keep bond portfolio maturities relatively short. Higher rates also put pressure on stock market valuations, and the growth stocks that have done so well in a low rate environment can be expected to underperform.

The current environment of moderate growth and weak inflation has favored stocks of companies that can grow revenue through innovation rather than just participating in a growing economy. Their popularity is reflected in the high valuations of growth stocks in the technology, communications, and consumer discretionary sectors and in some segments of healthcare. Utility stocks and REITS that provide attractive yields relative to bonds have also had their prices bid up and are relatively expensive. Highly valued stocks are typically the most affected by rising interest rates and are expected to underperform if the Fed starts tightening.

Energy stocks will look particularly attractive if inflation starts to rise. Their valuations do not even incorporate current oil prices, which will likely rise in a higher inflation environment. Basic materials stocks would likely also do well.

Many financial services stocks will also see higher earnings if interest rates start to rise, although this may be discounted by the stock market if there is a consensus that loan growth is slowing late in an economic cycle. However, as long as these stocks can be purchased at their current low valuations while the consumer is strong and unemployment is low, their relative performance may improve.

Large multi-national companies with the ability to raise prices were some of the better performers in the last inflationary period. Many of these are consumer staples stocks, which are normally considered a safe harbor in a volatile market. However, they have also provided good yields and their valuations have been stretched by the long period of low interest rates, so investors need to be selective about where to invest in this sector.

Finally, when interest rates start to rise it will be important for investors to emphasize stocks of high-quality companies with solid balance sheets and high-quality bonds. Long periods of easy money typically encourage excesses in the economy, and these risks remain hidden by low long-term interest rates. When rates start to rise, these excesses will be revealed and some segment of the financial markets will be in distress. When that happens, quality securities will outperform.

Market Outlook

After a strong start to the year, the U.S. stock market has entered a more volatile period. Investors have tried to assess the effects of continuing trade conflicts on economic and corporate earnings growth, and debated whether the Federal Reserve may have to backtrack further on its policy of preparing for a late-cycle increase in inflation. Bond market investors have pushed yields even lower as they anticipate a possible reduction in short-term rates, causing further off-and-on inversions to parts of the yield curve.

We still expect the economy to move forward for the time being, even if the rate of growth slows somewhat due to the impacts from the trade wars. Should growth appear to be slowing too much, the Federal Reserve can lower the Fed funds rate that it controls in response. Fed officials have recently indicated that they are prepared to do just that, if necessary. Thus, we think the odds of recession in the next year or so are still low. Stock market valuations, while not at an extreme, remain somewhat elevated relative to the possibility that earnings growth could be slower than expected amid further trade conflict news. Therefore, near-term caution with stock investments continues to be warranted.