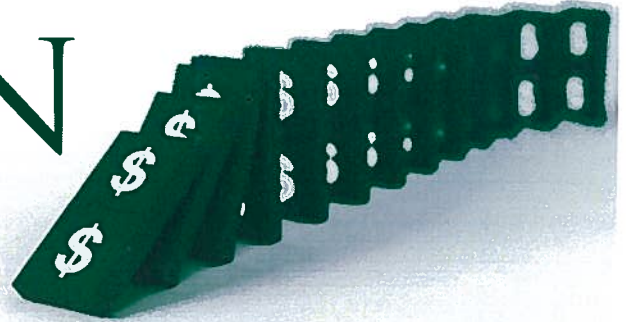


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INFLATION

Should We Be Concerned?

BY RAY RYAN, CFA



"Here we go again!" one might say, dreadfully, with regard to the prospect of runaway inflation in the near future. The Consumer Price Index (CPI) rose 12.2 percent in 1974; in August 1975, annualized inflation in Great Britain nearly reached a staggering 27 percent. During the miserable economic decade of the 1970s, unemployment was high, and economists crafted what came to be known as the "Misery Index." Given the policy responses to the economic crisis that began in October 2007, many experts have concluded that the multitude of fiscal programs will generate damaging inflation over the next few years. The money supply has exploded in size, and budget deficits are now projected to approach \$1.8 trillion as soon as 2010. As inflation is often described as the condition that exists when "far too much money chases after far too few goods," it is understandable why many people fear 1970s redux. Yet, as ESPN commentator Lee Corso likes to say, "Not so fast, my friend."



Ray Ryan is a Principal and Portfolio Manager of Patten and Patten, an investment management firm in Chattanooga. Ray is a CFA Charter Holder, a member of the Advisory Board for UTC's College of Business, and an Adjunct Professor of Finance at UTC. He is a graduate of Princeton University, where he had the privilege of taking a course taught by current Fed Chairman Ben Bernanke.

It is not a foregone conclusion that inflation will be the unavoidable by-product of monetary and fiscal policy measures designed to deal with the crisis. There are several possible outcomes, not the least of which is that our nation could suffer a similar fate as that of Japan – a "lost decade" characterized by deflation, not inflation. Another quite probable outcome is the restoration of confidence in global financial markets that establishes a foundation for many decades of prosperity. In order to develop both sides of the debate, it is instructive to examine the causes of inflation and, more specifically, the factors behind inflation in the 1970s.

Inflation is an economic phenomenon that reflects the immutable laws of supply and demand. Generally, when demand for a good or service exceeds supply, prices adjust upward to arrive at equilibrium between those two forces. Conversely, if supply of

a good or service is abundant, prices fall in order to stimulate demand. That is known as deflation.

Inflation tends to accelerate economic activity; deflation tends to defer economic activity. If one is convinced that the price of a good will be higher tomorrow than it is today, one will accelerate the purchase decision. As others fear further price increases, they, too, accelerate their purchases; that action, in turn, drives prices ever higher. Some might even resort to hoarding.

We have had recent, yet temporary or unsustainable, bouts of inflation: energy prices in 2005 following Hurricane Katrina and again in 2008; housing prices from 2003 through 2007; food prices in 2008. For the most part, however, constant, sustainable cost inflation has been relatively remote. Whether it is flat panel televisions, personal computers, iPhones or apparel, consumers

are aware that most prices tend to fall eventually. Americans are shrewd when it comes to bargain shopping. The notable exceptions have been health care and education costs.

Inflation also relates to the purchasing power of a nation's currency. The impact of currency movements is most directly felt in trade. In that regard, a period of protracted weakness in the dollar is quite concerning.

There are numerous causes of the inflationary 1970s. Decisions by policymakers to remove fixed exchange rates and abandon the gold standard unleashed a wave of global credit. The abundance of credit contributed to inflationary developments. Perhaps the best-known cause was the Arab Oil Embargo, a "supply shock" of our nation's most crucial imported natural resource. That period exposed our nation's key vulnerability – our dependence on energy resources developed in the Middle East.

There were other, less prominent factors that one should also consider, and these are unlikely to repeat. In the 1970s, the first wave of the Baby Boom Generation was reaching its prime earning years. Our nation's GDP remains quite dependent upon consumption, and the largest demographic force in modern history was boosting consumption as it established households and enjoyed rising standards of living. Today, as everyone is well aware, the Baby Boom Generation is approaching retirement. Capital preservation is more important than spending to enhance one's lifestyle.

In the 1970s, the labor force participation rate of women began an upward trend that lasted nearly three decades. The entrance of women into the workforce resulted in the proliferation of two-income families. Many families discovered the need for two vehicles. Two wage earners required clothes and other necessities for their profession or career. Suddenly, there was a need for industries that did not exist prior to this period, such as professional child care services. Today, it appears that the labor force participation rate of women has peaked.

In the 1970s, unionized workforces

were prevalent, representing approximately 40 percent of all those employed. Organized labor negotiated contracts with employers, known as collective bargaining agreements. Those agreements contained Cost of Living Adjustments (COLAs) that required annual wage adjustments pegged to some measure of inflation, such as the CPI. As prices rose, generally, producers were forced to raise wages. In order to maintain margins, companies would raise prices of their goods and services to consumers. Today, the percentage of labor that belongs to a union of some type is approximately half that of the 1970s. Whereas union participation among service workers is rising, the pressures faced by the domestic automakers – in addition to several other manufacturing sectors – suggest minimal impact from this factor over the next few years.

Various economic indicators support the notion that our economy is stabilizing and beginning to recover.

The U.S. and many other countries currently suffer from excess capacity. Supply, in other words, currently exceeds demand for many goods and services. Unemployment continues to rise, which is another indication that inflation should remain muted.

What, then, is the concern about? Monetarists are economists that adhere to the belief that inflation is a function of the money supply – i.e., if the money supply expands too far, inflation will be created. The monetary base of the U.S. has exploded in size since the economic crisis began. Additionally, burgeoning budget deficits will necessitate the issuance of mountains of public debt. Both factors contribute to a rather cautious outlook for financial assets

– principally stocks and bonds. Similar to the 1970s, in which "hard" assets such as real estate and commodities outperformed, many experts are predicting difficult years ahead for both the stock and bond markets. Yet, in terms of both public sector debt and budget deficits, the Japanese have maintained proportions much larger than the U.S., and Japan has been fighting a long-term battle with deflation ever since its property market bubble burst in 1989.

Indeed, the growth of the money supply is alarming. Inflation, however, requires both the growth of the money supply and a corresponding increase in the velocity of money. The velocity of money has collapsed. Therefore, current concerns over inflation could be misplaced. From 1933 through 1936, the U.S. economy was recovering from the worst stage of the Great Depression. Then, in late 1936, policymakers grew concerned about inflation and responded with both tax increases and interest rate hikes. The U.S. economy promptly slid into a "double dip" recession in 1937, from which it did not recover until World War II. Various economic indicators support the notion that our economy is stabilizing and beginning to recover. Could the growing paranoia over inflation prompt a premature policy move that nips the recovery in the bud? That, perhaps, should be the proper focus of people's concerns.

At a minimum, prices should rise from depressed levels. Those price increases could serve as a manifestation of economic recovery. So, in a certain sense, a little inflation at this juncture might not be such a bad thing. Global economies experienced a shock like never before, and policy responses needed to be aggressive and massive. To the extent these measures prove to be inflationary, one could invest in some hedges – e.g., allocate some percentage of portfolios to gold, precious metals, commodities and Treasury Inflation Protected Securities (TIPS). An excessive allocation, however, might prove costly. **CS**