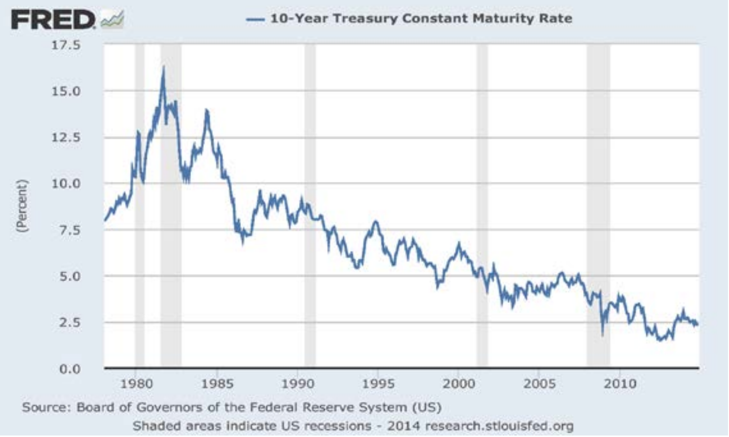
November 24, 2014

The Slow Grind of Higher Inflation

Memories run deep and fade slowly. I entered the investment management business in 1979, a time when consumer prices were increasing by more than 10% annually and the 10-year Treasury yield was heading towards a peak-yield of almost 16%, as shown in the chart below. Inflation was an economic malady that some believed the world would never escape. This is similar to the view that many hold today, that the world will never escape low inflation, low interest rates and disinflation.

In May 2013, I made the call (in our trilogy-piece entitled "Shifting Sands") that inflation and interest rates will slowly grind higher over the next number of years. I stand by that prediction – one that, if proven true, could dramatically effect returns in many asset classes over the longer-term.



With low interest rates over the last number of years, most investors have felt the ***need*** to take more risk in their investment practices than perhaps would have normally been the case. The Federal Reserve's monetary policies have fostered this ***need.*** Following the financial market meltdown during 2008-2009, the Fed pursued policies that enticed investors to extend their risk profile.

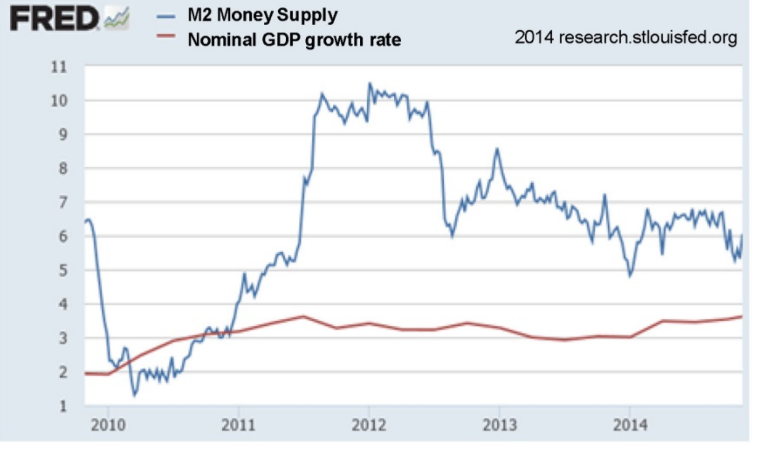
During this period, rising inflation pressure has been largely absent from the global economic scene. We have commented consistently over the last number of years that global ***deflationary forces – those forces where there is excess supply relative to demand –*** have provided downward pressure on inflationary trends. ***We continue to believe that the deflationary forces present in Europe and Japan are a more clear and present danger to overall economic and financial market performance than rising inflation over the next year or so. Nonetheless, we sense that building inflation (and rising interest) rate pressures may continue to slowly grind higher during the upcoming year, primarily in the U.S.***

History Lesson
When I predicted that inflation (and interest rates) would slowly grind higher over the long term, the 10-year U.S. Treasury bond yielded 1.6%. Currently, rates are higher, as the 10-year Treasury yields 2.3%. Additionally, inflation, as measured by the Consumer Price Index (CPI), bottomed in October 2013 at an annualized rate of 1.0%. Currently, the CPI has risen by 1.6% over the last 12 months.

Inflation pressures driven by commodity price movement (food and energy) tend to be volatile and non-sustainable. On the other hand, ***inflation accompanied by rising labor costs tends to be much more "sticky".*** We have seen improvement in the labor market over the last year and, surprisingly to some, nonfarm ***unit labor costs have risen by 2.4% over the last 12 months. Unit labor costs were declining by an annual rate of 2.1% as recently as 18 months ago***. The average annual increase in unit labor costs has been 2.8% annually since 1950. So, ***labor costs are currently rising by a level which is close to the average over the last 60 years***. Going back over that 60+ year period of time shows that when unit labor costs rise by between 1.2% and 7.2% annually, inflation has risen by 3.4% on average.

Now, we are not calling for inflation to spike to 3.4% from the current read of 1.6%. However, we believe inflation will get back into the 2.0% to 2.5% range in the next 12 months, cemented by rising unit labor costs. If this outlook is reasonable***, it is hard to understand why 10-year Treasury yields will collapse back to the 1.6% level we witnessed in 2013.***

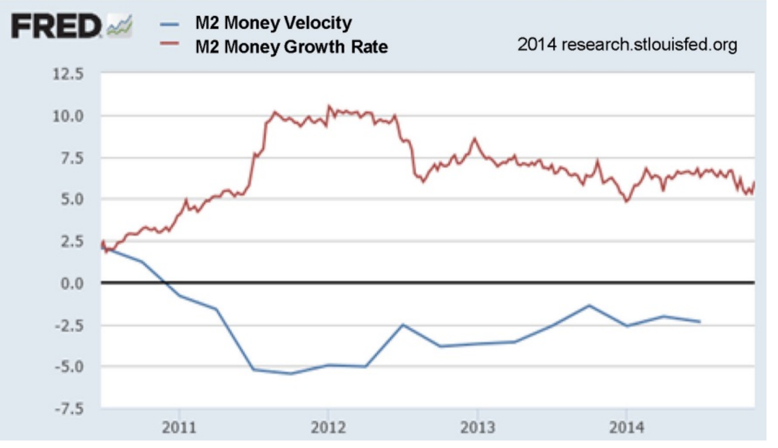
Monetary Policy Ease and Low Inflation
Some pundits have been concerned about rising inflationary pressure due to the Federal Reserve's ultra-easy monetary policies installed between 2009 and 2014. Three rounds of quantitative easing activities massively bolstered leverage on the Fed's balance sheet. ***Milton Friedman, the Nobel Prize awarded economist stated, "Inflation is always and everywhere a monetary phenomenon."*** In other words, inflation occurs due to a rapid rise in money supply. This view is due to the simple reality that more money chasing the same amount of goods leads to rising prices.



As can be seen in the chart above, since 2011, M2 (money supply – the blue line on the chart) has consistently risen more rapidly than nominal GDP growth (red line). This is a classic display of excess money being "printed" by the Fed at a rate over and above the monetary needs of the economy. Over this period, inflation has been largely nonexistent. Was Milton Friedman wrong? No.

Velocity of Money
The economy has been growing very slowly – to the point where demand for capital has been lackluster. The private sector of the U.S. economy has been busy since the Great Recession, paying down debt and not taking on more. This explains why demand for loans has been so weak. The velocity of money is basically a measure of bank loan growth, representing how much of the

created money supply is moving away from the banking system and into the real economy. If money supply is locked in the banking system and not working in the real economy that money supply may not be inflationary by itself. The chart below shows the M2 growth rate, represented by the red line, and velocity growth, represented by the blue line.



As can be seen, M2 has been growing by 5% to 10%, while the velocity of that money has been at a negative level, representing low demand levels for money. This explains why we have yet to see an upward surge in inflation while money supply has been rising very rapidly.

It is interesting to note that while overall loan demand from banks has been rather weak, ***commercial and industrial loan growth, at 12.4% over the last year, has been among the strongest we have seen in the last 15 years! Could this represent the first real surge in loan demand from the banking system? Perhaps.***

Bottom Line

So, what are the bottom line thoughts as to inflation pressures going forward? In the end, building labor demand will push inflation upwards in a grinding, slow fashion. ***I don't believe the world will see rapidly rising inflation pressures over the short term due to excess productive capacity and low levels of demand growth. But, we also need to expect that the employment picture is improving, which may lead to a slow, upward grinding push in domestic inflation pressure.***

I expect U.S. stock prices to rise in a choppy fashion over the next 12 months, but the price return of the U.S. stock market may be limited by earnings growth. We currently expect earnings growth to be in the 6% to 8% range over the next 4 quarters.

Just for Fun

One of my favorite holidays is upon us – Thanksgiving. I fully enjoy Thanksgiving, a time when friends and family gather to give thanks for our many blessings. Below are some quotes regarding Thanksgiving.

> *Be thankful for what you have; you'll end up having more. If you concentrate on what you don't have, you will never, ever have enough.*
>
> *Oprah Winfrey*

> *There is one day that is ours. Thanksgiving Day is the one day that is purely American.*
>
> *O. Henry*

And finally….

> *Thanksgiving, man. Not a good day to be my pants.*
>
> *Kevin James*

We will be back next week.

William B. Greiner, CFA
Chief Investment Strategist

More Information

[FirstPoint Financial](#)

[FirstPoint TV](#)

[Market Insight](#)

P. S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.