

WEEKLY MARKET THOUGHTS

March 24, 2014

Inflation – Where Art Thou?

The Federal Reserve has maintained an extraordinarily easy monetary policy since the Great Recession. Interest rates, as all know, are extremely low – many portions of the bond market are yielding less than inflation, creating a negative real-yield environment. The surplus capital – or capital the real economy does not need to function – has served as a stimulant to higher asset values since 2009. Last week, Janet Yellen, the new Chair of the Federal Reserve, stated she thinks the Fed may start to raise short-term interest rates six months following the end of the current tapering of the third round of quantitative easing, the program known as QE3.

*Why would the Fed think of raising interest rates? The Fed raises interest rates for various reasons. One of the most common is a building fear of rising inflationary pressure. **While there is no inflation pressure on the current horizon, what could the Fed be thinking when looking forward? Do they see the potential for an inflationary push sometime after the first of 2015? This week we attempt to answer these questions, which we hope will provide material for capital thoughts as 2014 continues forward.***

Inflation Background – No Current Trouble

General price inflation is a distant memory. Rising prices, and rising wage pressures, are a thing of the past – a thing that happened during better times – times when our nation's economy was consistently growing above 3%, and unemployment was much lower than it is today. Now that growth in the gross domestic product (GDP), the sum of all goods and services produced by an economy, is stuck in the "Long, Hard Slog" environment of 2%, inflation is nowhere to be found.

We at Mariner have held the belief for some time that disinflation – rather than inflation – is currently a major driver of economic and capital market activities. The risk of falling prices is more present than rising prices as we wind our way through the Long, Hard Slog. Inflation expectations are very low. Most economists and central bankers measure inflation, but don't pay inflation potential much credence. *As a matter of fact, those who have, over the last few years, called for a significant rise in inflationary pressure have been fully discredited by others in the industry.*

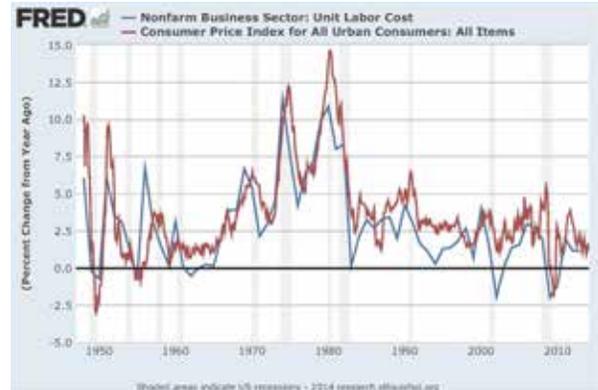
There are a number of pundits who believe inflation will never return – that those who worry about an eventual rise in inflationary pressure due to monetary policy or other factors are recalcitrant in their thought process and just don't "get it". Frankly, this type of thinking reminds me of the late 1990s. At that time, there were some who believed technology innovation and productivity gains had done away with the business cycle, and that those who thought otherwise just didn't "get it". Uh-huh.

Our View

We at Mariner believe inflation will, on balance, rise over the next three to five years to an average rate of roughly 2.6%. Recently, the folks at the Bureau of Labor Statistics (BLS) reported that inflation, as measured by the Consumer Price Index (CPI), has risen by 1.1% over the last 12 months. Consequently, if our 2.6% average rate is reasonable, sometime over the next three to five years inflation may eventually surpass 4%.

When is the last time we experienced inflation at an annual rate of 4%? As recently as 2008, inflation grew by an annual rate of 3.8%. Many believe inflation is a by-gone economic malady. Quite the contrary—annual inflation was in the 4% range as recently as six years ago.

While we also believe that an upward push in inflationary pressure can come from many different sources, the sustainability of inflation won't occur unless wages rise, along with general prices. One can argue that a rise in labor costs pushes inflation upward, or visa-versa. Either way, as labor costs rise, historically speaking, inflation is not far behind (see accompanying chart). Changes in Unit Labor Costs have been well behaved over the last five years – which has reinforced a very low inflation environment. Is this benign environment about to change?



Inflation and Unemployment – NAIRU

Along with the strong relationship between inflation and labor costs, there has also been a negative correlation between inflation and unemployment trends. If unemployment levels are low, inflation tends to rise. This relationship of higher inflation/lower unemployment has been represented in the Phillips Curve concept.

The late, renowned economist Milton Friedman (pictured here) believed the Phillips Curve concept was flawed. He introduced the economic world to a concept called NAIRU (Non-Accelerating Inflation Rate of Unemployment) which states that a decrease in unemployment from a high level does not in itself create inflationary pressure. Rather, unemployment levels need to be at a certain rate (lower than the Phillips Curve would at times represent) prior to the building of inflationary pressures due to rising wages. The NAIRU concept has become standard thinking at the Fed. Economists at the Federal Reserve have long held that the critical threshold in the NAIRU level is roughly 5%. In other words, unemployment levels can fall to 5% without having an impact on inflation. The official unemployment rate is now at 6.7%.



It is our contention that while over the long-term, 5% unemployment may be the non-inflationary level in our economy, in the short term, the actual level of NAIRU is much higher. We believe (as do the economic staff at other firms) the NAIRU level is around 6.5% - 7% – roughly where unemployment currently stands. If we are correct, we may start to see rising labor cost pressures, and attendant inflationary pressures, building by the end of this year. Are the decision makers at the Fed thinking the same thing? Perhaps this was one of the factors which drove Yellen to her comments regarding raising interest rates last week – that the Fed may be thinking that inflation, driven by NAIRU and rising labor costs, is on the horizon.

Why This Cycle is Different

The business cycle since the end of the Great Recession has been different than any other our country has experienced since the end of the Great Depression. The reasons are varied and still under debate, but the fact is that the unemployment level has remained very high during this expansion, which is about to celebrate its five-year anniversary. Normally, we don't see unemployment levels at 6%+ by the fifth year of an economic expansion.

The employment picture has been so tough that about 2% of the employment base (or 31% of those unemployed) have been unemployed for more than a year – some being unemployed for several years. With a rapidly changing, dynamic workplace these “terminally-unemployed” workers start to become “unemployable”. Consequently the actual, effective level of NAIRU is probably not 5% but more like 6.5% - 7% as the effective labor pool is actually much smaller than assumed.

If this is the case, the United States may start to witness a pickup in both labor costs and inflation by the end of this year/beginning of 2015.

It is our opinion that this new development may be weighing on minds at the Fed. This past week, Fed Chair Yellen commented that, depending on the data, the Fed may start to raise short-term interest rates by the first half of 2015. The prospective timing of these rate increases coincides with the timing of a potential inflationary shove brought forward by NAIRU.

Inflation – Good or Bad?

Inflation is a bad thing – right? Well, it depends. It depends on why inflation is occurring, the actual level of inflation and an economy's ability to adjust to higher inflation. If inflation is rising too rapidly, incomes won't be able to keep up, leading to diminished consumption levels. This leads to an eventual upward push in unemployment, potentially driving an economy into a "stagflation" environment – when inflation is present and growth is poor – a bad combination.

On the other hand, an upward push in inflation may at times be a good thing. A slight rise in inflation from low levels provides pricing flexibility to many companies. This flexibility can lead to higher revenue growth, which should lead to more employment opportunities. We hold the opinion that inflationary pressure to a limited degree is helpful when an economy is struggling for growth (as is currently the case). *The problem with this view is the assumption that something or someone actually has direct control over how high or low inflation will be – this isn't the case in a market-based economic system such as ours.*

Current Situation

We believe the U.S. economy's real GDP growth rate should approach 3% this year. During the fourth quarter of last year, non-farm productivity grew by 1.8%. If our outlook of 3% GDP growth rate is reasonable, the unemployment rate may fall below 6% by the end of this year. By many estimates, this unemployment level would be low enough to start fueling an upward push in labor costs.

In this scenario, we could see inflation rising from its anemic 1.1% current read to something around 2% - 2.5%. An inflation rate of this level would, in our opinion, not be a terrible development. Indeed, many companies would show an acceleration in top-line (revenue) growth, driving continued improvements in bottom-line (profit) growth rates.

In this environment stock investments should outperform traditional, longer-duration bond investments as the renewed upward push in inflation propels interest rates to higher levels. Some asset classes which historically have been viewed as inflation beneficiaries should also perform well. For example, certain types of real estate investments may perform well if inflation were to start accelerating.

Goldilocks Inflation

It is important that we emphasize what we are not saying in this piece. We are not expecting inflation to ratchet upwards as was the case in the 1970's – early 1980's. The western world's demographic profile and probable growth rate won't support a significant upward push in inflation. If prices start to rise too quickly, growth in final demand should be negatively affected, leading to a shutdown in inflationary pressure.

If inflation starts to re-enter the economic environment, it should be rather tame by historical standards—hot enough to provide some degree of business pricing flexibility but cool enough so as not to force dislocations in demand. In other words, we see inflation in the sense of the Goldilocks children's story – initially neither too hot nor too cold.

Shifting Sands

Early last year in our trilogy *Shifting Sands*, we documented our thinking that interest rates would start to rise. We at Mariner have been advising our clients that risks persist—that rising interest rates would bring new return profiles to portfolios. The first change occurred last year as interest rates (measured by yields on the benchmark 10-year Treasury Bond) rose from 1.6% to 3.0%.

Now trading at 2.73% yield, we expect Treasury yields to rise to around 3.25% by the end of the year. If this yield change occurs, the price of the 10-year Treasury bond will decline by 4.5%, and the bond will provide a total return to holders of -2.4% by the end of the year.

Last year, we experienced the first wave of rising interest rates in the Shifting Sands saga. We expect to see the start of the second wave of rising rates later this year.

Just For Fun

Given that we suspect we will see inflationary pressure building over the next 12 months, it seems appropriate to share the thoughts of others on the issue of inflation.

Inflation is the one form of taxation that can be imposed without legislation.

--Milton Friedman

I do not think it is an exaggeration to say history is largely a history of inflation, usually inflations engineered by governments for the gain of governments.

--Friedrich A. von Hayek

Inflation is the crabgrass in your savings.

--Robert Orben

And finally...

Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair.

--Sam Ewing

Next week, we will provide our new quarterly economic and capital markets outlook.

A handwritten signature in black ink, appearing to read "WBGreiner".

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