Inflation: Gone Today, Here Tomorrow?

Executive summary

In the past five years, we’ve seen unprecedented efforts by the Federal Reserve (Fed) to stimulate U.S. economic growth with historically low interest rates and a tremendous influx of liquidity. The major concern raised was that these measures created a significant inflation risk. Yet the question many investors are asking today—to paraphrase folk singer Pete Seeger—is “where has all the inflation gone”? Many skeptics predicted that the Fed’s actions, combined with a burgeoning government deficit, would result in a new round of rampant inflation. Yet one common measure of inflation, the Personal Consumption Expenditure (PCE) Core Price Index, remains well below the Fed’s targeted annual inflation rate of 2 percent. In September, the PCE stood at 1.2 percent.

The lack of price inflation has occurred despite:

• A reduction in interest rates by the Fed from 5.25 percent in the third quarter of 2007 to 0.25 percent in January 2009, a level that has held firm for nearly five years.

• Efforts by the Fed to stimulate economic growth through its quantitative easing (QE) program. This involved the purchase of nearly $1.6 trillion in U.S. Treasury securities and $1.4 trillion in U.S. mortgage-backed securities since 2009.

• Significant fiscal stimulus by the federal government, illustrated by a soaring budget deficit, from $161 billion in 2007 to more than $1 trillion per year from 2009 through 2012. In that time, the national debt (held by the public) more than doubled from $5 trillion to over $11 trillion.

What explains the lack of inflation given this unprecedented level of stimulus and when might we see a change from the status quo? A variety of factors have created an economic environment that has helped keep inflation in check.

We expect that the environment, at least for the near term, will be little changed. The economic environment today is not likely to result in a significant alteration in the inflation landscape, but you should be aware that the situation can change. As a result, you may want to include in your investment portfolio asset choices that can help provide some protection over time.

What is inflation and why does it matter?

Before beginning a discussion about what the rate of inflation will be in the future, it can be beneficial to understand just what the measure refers to. At its most basic level, inflation is defined as the increase in the price of goods and services. The particular issue is how the price of goods and services relates to the money available to purchase those goods and services. If inflation is rising at a rate that exceeds the growth rate of their investment assets or incomes, then investors and consumers lose “purchasing power.” In other words, consumers with an equal amount of money over time will be able to purchase fewer goods and services. Investors need to be concerned about

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earning “real returns” that exceed the rate of inflation in order to maintain purchasing power as prices rise. Workers should seek to generate “real wage growth,” making sure their wages or salaries grow faster than the rate of inflation.

**Why inflation has remained muted despite record stimulus**

There are conflicting theories about what causes inflation rates to rise or fall. Strategies implemented by policymakers, either those who make spending and taxing decisions for the federal government or those at the Federal Reserve who establish monetary policy, may be influenced by differing theories.

Generally speaking, it is expected that fiscal stimulus (increased spending or tax reductions enacted by Congress) along with monetary stimulus (interest rate cuts and quantitative easing measures implemented by the Fed) will boost economic growth, ultimately resulting in higher rates of inflation. Despite significant fiscal and monetary stimulus in recent years, economic growth has been modest and inflation has remained benign. This is due in part to the restraint shown by banks to make credit available to consumers and businesses following the financial crisis of 2008-2009. Bank credit leveled off at that time and only recently has the amount of credit issued by banks returned to peak levels reached in 2008.

### QE has kept bank assets on long-term mend

![QE has kept bank assets on long-term mend](image)

Sources: Bloomberg and GaveKal; data: November 13, 2013

The credit tightening by banks has, at least in part, offset the impact of the Federal Reserve’s unprecedented effort to add liquidity to the economy. As a result, both economic growth and inflation rates remain low.

### Supply and demand effects on inflation

Another factor that typically contributes to higher inflation is related to how demand for goods and services matches supply. Typically, if demand is higher than supply, the value of goods and services can rise.

In the current recovery, we have yet to see an environment where demand has outstripped supply. Three factors could contribute to this form of inflation:

1. **Capacity constraints:** Since the economic recovery began in 2009, improvement in the labor market has been sluggish. The unemployment rate remains above 7 percent, higher than normal for this stage of an economic recovery. Another measure of unemployment from the U.S. Bureau of Labor Statistics, referred to as the U-6, also remains high. In addition to those included in the official unemployment statistic, U-6 measures the number of underemployed Americans (those working part-time but wishing to work full-time) and the number of discouraged workers (those who wish to work but no longer seek employment). In short, a strong supply of ready labor remains available to employers, which helps keep wage costs lower.

### Slack remains in U.S. labor market

![Slack remains in U.S. labor market](image)

Source: Bloomberg

Another measure of the risk of higher costs resulting from the current labor status is called “capacity utilization.” It measures how much production capacity in the economy, such as plants and equipment, is currently in use. Typically, as capacity utilization rises, so does inflation. But in today’s environment, although capacity utilization is increasing, inflation has not followed suit. Some attribute this to the increased use of automation in U.S. factories. The United States is second only to Japan in adopting robot technologies that potentially allow factories to operate at a higher capacity without adding workers, thereby reducing the risk of wage inflation.

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2. Economic inefficiencies: Although the United States needs to invest in its infrastructure (such as the energy complex, bridges, etc.), it does have tremendous structural advantages over many countries. This includes an interstate freeway system, a comprehensive rail network, internal waterways, airports and seaports. Logistics services to utilize this infrastructure, from shipping, rail and trucking companies to UPS and FedEx, are also well established. This creates significant economic efficiency within the United States.

Advancements in automation and robotics are adding to our country’s technological productivity leadership. Even an event like the recent government shutdown did not create any significant efficiency issues. Countries facing more structural inefficiencies due to bureaucracy and red tape or corruption might have seen more of an inflation impact from a similar event.

The U.S. labor market has also proved to be efficient. Real incomes for wage earners have been stagnant for five years. The lack of rising wages has played a major role in keeping inflation in check.

By contrast, emerging markets, Brazil and India for example, suffer from chronic inflation due in large part to economic inefficiencies combined with deficit spending and government subsidies. In Brazil, investment in transportation infrastructure has been limited, hampering the flow of goods. In addition, demand is high for soybeans, iron ore and other commodities, outstripping available supply. A prime example of Brazil’s inefficiency could be seen one day in March 2013, where a 15-mile-long line of trucks waited for hours to unload soybeans into more than 200 ships that were awaiting their load. India’s inflation can be attributed to generous government subsidies that have boosted aggregate demand, combined with inadequate investment in infrastructure such as transportation, manufacturing and agriculture. In addition, restrictive labor markets have led to more wage inflation pressures in both countries. These are the kinds of issues that are not a factor in the U.S. economy.

3. Supply shock: Inflation can, at times, be caused by a supply shock in commodities and other aspects of the economy. A prime example in our own country’s history is the impact of the 1973-1974 oil embargo by the Organization of Petroleum Exporting Countries (OPEC). Oil prices quadrupled, and the rampant inflation that resulted contributed to a significant recession in the mid-1970s. In contrast to those times, the U.S. today is experiencing an energy renaissance. New technologies have helped reverse a 25-year trend of declining oil production and rising oil imports. If current trends persist, the U.S. may actually produce more oil in 2014 than it imports, a sign that energy supplies, at least, are not likely to create an inflation threat.
Another commodity category worth watching is food. After doubling in price from 2004 to 2008, food price inflation has also stabilized. Current global food prices are comparable to their levels five years ago.

What happened to inflation?
Individuals may not always agree that inflation has become a non-issue. Selected consumer items (certain products at the grocery store, for example), gasoline prices and other major expenses like health care services and college tuition, have at times risen at a noticeable and often painful rate. But these are only some of the components that make up the broad measure of inflation across everyday living.

If five years of near-zero interest rates, $3 trillion in quantitative easing and $6 trillion in federal deficit spending hasn’t resulted in significant real economic growth or across-the-board price inflation, what happened to all of that money?

The answer is that much of it went toward stabilizing a U.S. economy that, in the fourth quarter of 2008, had shrunk by 8 percent. Unprecedented stimulus efforts played a large role in returning the economy to a relatively stable 2.5 percent growth rate since then. The accumulation of U.S. Treasury securities and mortgage-backed securities by the Federal Reserve helped offset what was a rapid decline in money “velocity” (the number of times money is used, or leveraged, to buy goods and services) as consumers deleveraged and bank credit became more restrictive.

One area where the Fed’s actions did lead to inflated prices is in the stock market. U.S. stocks (as measured by the benchmark S&P 500 Index) have tracked the increase in the Fed’s balance sheet since 2009.

Our outlook for inflation
Will the fears of higher inflation be borne out at some point in the near future? The factors we discussed above indicate that in the near term, inflation will continue at the same modest levels we’ve seen in recent years. One

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element that has changed since the period beginning in 2009 is that fiscal policy (government spending) is no longer stimulative. The U.S. budget deficit year-to-date through September 2013 was $387 billion, less than half the level of the same point a year earlier, and 60 percent below annual deficits from 2009 to 2011. Even with modest real growth in the nation’s Gross Domestic Product (GDP), the budget deficit-to-GDP ratio has dropped.

At the same time, the Fed’s continuation of a near-zero interest rate policy and quantitative easing measures is counterbalanced by a slack supply of (and perhaps limited demand for) bank credit. Capacity utilization has increased to 80 percent, but we expect that continued weakness in the labor market and the increasing role of automation to replace human labor will keep wage price inflation from rising quickly.

Potential inflation triggers

While the near-term outlook for continued modest inflation is positive, the risk of higher inflation is always a concern. What could cause inflation to rise? Some of the economic developments that could trigger higher inflation include:

- A decline in the unemployment rate
- Wages rising faster than productivity
- The continuation of a stimulative monetary policy that potentially results in unemployment dropping below its structural rate (estimated to be about 5 percent)
- A change in the credit markets, as credit becomes expansionary and the “velocity” of money rises
- A slowdown in productivity (this is usually caused by an increase in government regulations or bureaucracy)
- A slowing of trade (if protectionist measures were to be enacted by Congress)
- A rapid shift of money—currently “parked” in U.S. Treasury securities, money market funds and Federal Reserve deposits—back into the economy that the Fed fails to react to in a timely manner

Preparing for what may lie ahead

Our near-term base case scenario is for modest to subdued inflation levels to continue. Our current recommendation is for clients to focus on “nominal” investments such as equities relative to “real” investments like real estate or commodities.

However, nobody can rule out the risk of a steady rise in the rate of inflation or even an inflation “shock” stemming from an unforeseen event. Owning a well-diversified portfolio can help prepare you for such circumstances. The following assets may help provide some cushion against the impact of higher inflation, although keep in mind that each has its own set of sensitivities to other factors, such as rising interest rates, economic growth rates, currency fluctuations and credit conditions:

- **Cash/short-term fixed income:** Short-term investments held to maturity can be reinvested over time, ideally at higher interest rates, assuming rates rise as inflation rises.

- **Inflation-linked bonds (Treasury Inflation-Protected Securities or TIPS):** The par value of a bond is linked to changes in the Consumer Price Index (CPI), the commonly referenced measure of inflation. However, inflation adjustments occur with a lag as adjustments are made two months in arrears. In addition, prices of TIPS also reflect changing liquidity dynamics of supply and demand for securities, as well as market expectations for inflation, and prices may be volatile. Taxable investors should be aware that a current tax liability is created in the year in which inflation adjustments are made to the bond’s value.

- **High yield bonds:** In theory, companies that are highly leveraged can benefit from inflation as it allows them to, in effect, use cheaper dollars to pay back long-term loans. Because of their lofty yields, high yield bonds are less sensitive to rising interest rates than are higher-quality, lower-yielding bonds. Prices of high yield bonds tend to better hold their value in a stronger economy, a condition that typically exists if inflation rates are high.

- **Marketable bank loan securities:** Yields on bank loan securities typically are adjustable, so rates can rise in conjunction with market rates.

- **Foreign stocks and bonds:** Rising inflation in the United States has historically led to declining value in the dollar compared to other currencies. For U.S. investors, a falling dollar generally translates into higher returns from foreign-based assets included in their portfolios.
• **Stocks of companies with high barriers to entry or pricing power:** Companies that face limited competition due to the obstacles that prevent other firms from entering the same business have the ability to price products to keep pace with higher rates of inflation. The same is true of firms that experience consistent demand for their products and services. This allows earnings to continue growing on an inflation-adjusted basis.

• **Master limited partnerships (MLPs):** Many MLPs have a focus on the energy industry, often with long-term contracts to transport oil and gas, typically through pipelines. The rates MLPs charge energy producers to use these “toll roads” can be adjusted for inflation, creating purchasing power protection for investors.

• **Real estate:** This is viewed as a “real” asset that tends to change in value somewhat in line with the rate of inflation. This is true of both underlying property values and income generated by real estate. However, real estate is also sensitive to economic growth trends and interest rates. In an environment of rising inflation, interest rates can be expected to rise as well, creating a less favorable environment for real estate activity.

• **Commodities:** Some commodity items can have a significant impact on inflation (as we experienced with oil price shocks of the past). Many institutional investors view commodities as a hedge against rising inflation, and demand (and consequently, prices) often rises if an inflationary environment exists.

**Conclusion**

There are a variety of reasons why, despite significant stimulus efforts, inflation has remained mostly a non-concern. We expect the status quo to continue, but as always, recommend that clients remain prepared for potential changes in the environment. To find out more about what steps may be appropriate for you, talk to your Wealth Management Advisor.
Investments are:

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