# The Money's Got To Go Somewhere

*"Inflation is always and everywhere a monetary phenomenon" – Milton Friedman*

*"Money, so they say*
*Is the root of all evil today" -- Pink Floyd*

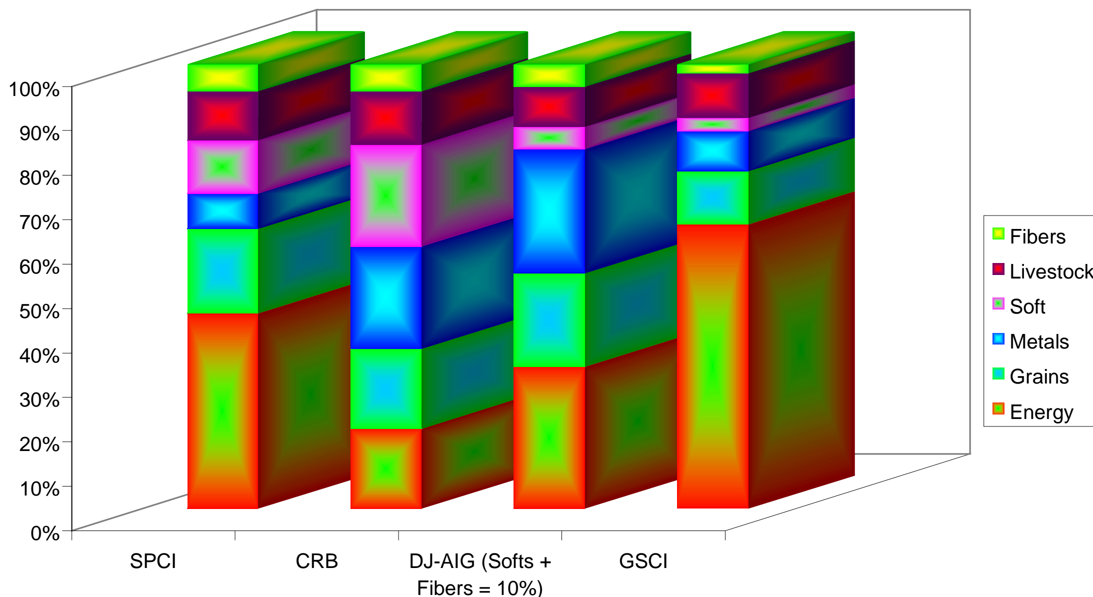
Follow the money. Show me the money. From all of the catch phrases involving the coin of the realm, you'd think people actually cared about the stuff. But, care we must. Just as indiscriminate buyers of technology stocks during the dearly departed market bubble found out that it's never different this time, some sector of the economy will relearn the eternal lesson of reflation attempts by the central bank, and that is monetary expansion eventually produces inflation somewhere. The monetary largesse of the Federal Reserve in the mid-1960s led to the collapse of the Bretton Woods fixed exchange rate regime and a decade of inflation in the 1970s. By the latter part of that fetid decade, condominiums were appreciating at 1.5% per month and three-bedroom stucco patio homes in Los Angeles were tipping the scales near $400,000. Similar lassitude by the Bank of Japan in the 1980s produced their infamous twin real estate and stock bubbles.

Since American real estate buyers were burned at start of the 1980s, and since American stock investors were burned at the start of the 2000s, let's take a guess that the present burst of monetary creation will find a different sector to inflate. Will this sector be commodities?

**Everyone Has An Index**

Don't have a commodity index of your own? Go ahead and create one: With the New York Board of Trade's addition last October of a commodity index future based on the S&P Commodity Index (SPCI), we now have four senior averages from which to choose. The SPCI is based on consumable commodities weighted by their economic importance; gold is excluded on the grounds it is not consumable. The other commodity indices are the Bridge/CRB (CRB), the Dow Jones-AIG (DJ-AIG) and the Goldman Sachs (GSCI). Both the CRB and SPCI are geometrically weighted, while the Dow Jones-AIG and the Goldman Sachs (GSCI) indices are arithmetically weighted. The industry weighting schemes of the indices are quite different as well.

**Various Index Sector Weights**



The GSCI and SPCI are weighted far more strongly to energy, while the CRB has a disproportionate weight in soft commodities and the DJ-AIG has a large weighting in metals. The reading of commodity price inflation depends on these weights. Since the end of January 2001, the CRB has declined 15.8%, while the GSCI declined 27.1% under the weight of lower prices for natural gas and gasoline. The DJ-AIG index fell 20.6%, and the SPCI 28.3%. The disparity between these readings renders any measure of commodity prices suspect; this would be like saying the temperature in a room is a function of the brand of thermometer. Moreover, we should know better than to associate 20%+ declines in commodity prices with general deflation anywhere near that level. Let's detour into other ways of measuring inflation and other topics before we return to the prospects for commodity price inflation.

**Is It Inflation Or Deflation?**

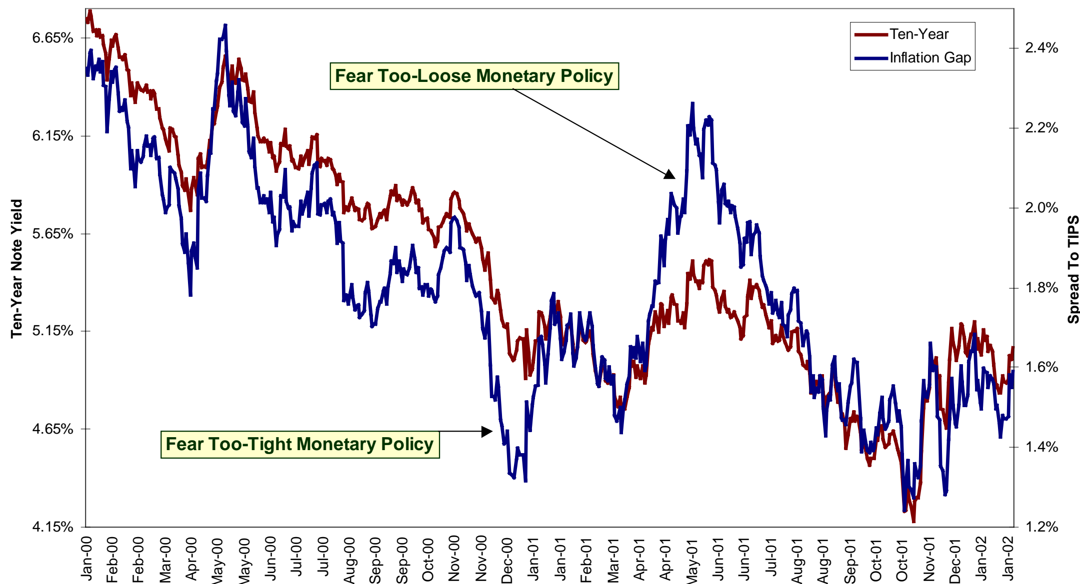
The Fed's aggressive series of rate cuts in 2001 have put the overnight fed funds rate down to 1.75% at the time of this writing, only slightly over the year-over-year rate of change of 1.6% for the consumer price index. On this basis, the real rate, the nominal rate less inflation, is quite low and quite stimulative, but that assumes some degree of accuracy on the part of the CPI. This venerable index is based on some very un-consumer like behavior. It assumes no substitution, no price elasticity of demand, no discounting, and no technological improvement in the market basket being tracked by Bureau of Labor Statistics clerks. Other than that, it's perfect.

The net effect is the CPI probably overstates inflation, which suits some people just fine. Many labor contracts and government programs are indexed to the CPI, and a low number is seen as the wrong answer, regardless of the question. The Reagan administration granted Social Security recipients a cost-of-living adjustment in 1986 even though the CPI contracted that year, and the Clinton administration rejected the findings of Michael Boskin's commission when they argued for a downward restatement of inflation as measured by the CPI.

Conclusions so far: Neither commodity price indices nor government price indices do a very good job of measuring inflation. Can market measures do better? While the government never had much use for financial writers, it left the door wide open to such types in 1997 when the Treasury began issuing inflation-protected securities (TIPS). Now these are not the perfect measure of inflation, mind you, as they represent protection against increases in the CPI.

If we take the yield spread between the benchmark Ten-year note and one TIPS, the 4.25% due January 15, 2010, from its January 2000 issue date onwards, we can read the bond market's inflation fears. The Fed was criticized widely in 2000 for remaining too tight for too long, and we can see this in plunging inflationary expectations. The rapid series of rate cuts in early 2001 led to fears that the Fed has over-stimulated, and that strong economic growth and credit demands were just around the corner. This expectation was dashed by the end of May 2001. Both ten-year interest rates and inflationary expectations fell into September 2001, and both reached climatic lows following the terrorist attacks. At present, the ten-year inflation expectation of 1.6% is virtually identical to the CPI reading, and this, too, is apparent confirmation of the Fed's stimulative stance.

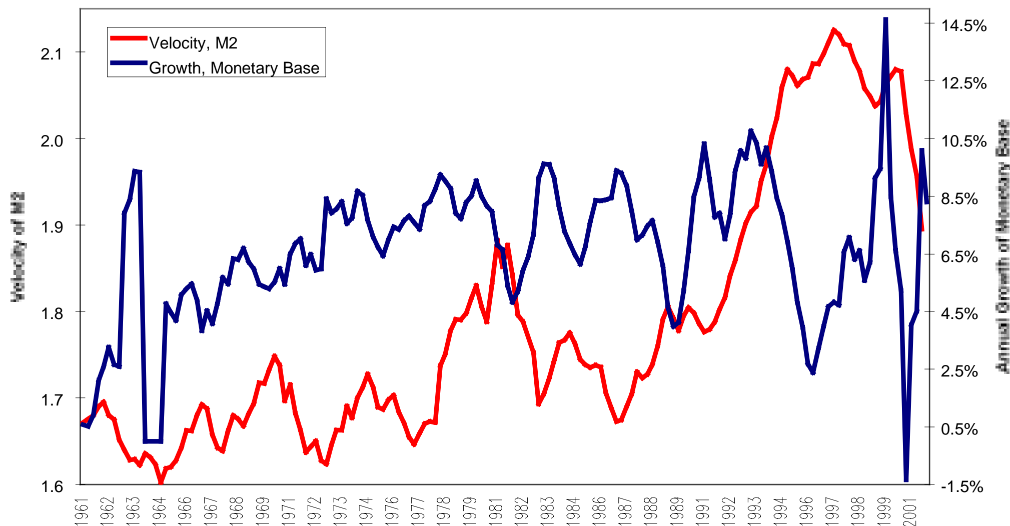
**Ten-Year Note Yields And Spread To TIPS**




The chart of inflationary expectations resembles the path of the S&P 500 over this period, and this is unsurprising. The stock market associates economic growth with increased profitability, and the bond market associates economic growth with inflation. The stock market's view is correct up to the point where growth creates economic bottlenecks, but the bond market's view is difficult to reconcile with known data. Growth can be high, as it was during much of the 1980s and 1990s, with inflation subdued. Growth can be low, as it was during the 1970s, with inflation out of control. Something else is at work.

**Slowdown In Velocity**

The monetarist macroeconomic model is [Money supply * Velocity] = [Price level * Transaction volume]. Velocity, here defined as the ratio of GDP to the money supply, can accelerate without triggering inflationary pressures so long as either productivity growth remains high or the growth in the monetary base remains constrained. Any growth in productivity, economic output per man-hour, also offsets any upward pressure on price levels.




Velocity moved steadily higher between the spring quarter of 1987 and the fall quarter of 1997, while the growth in the monetary base, defined as currency in circulation plus reserve deposits at central banks, moved in two distinct phases. After the Fed tightened credit in 1994, monetary growth eased into 1996, and then exploded higher, reaching a peak of more than 14.5% by the end of 1999. The coincidence of this monetary growth and the stock market rally is no accident. Why wasn't there inflation? The answer lies in equally strong productivity growth; between 1996 and 2000 productivity growth was 2.5%, 2.0%, 2.7%, 2.3% and 3.0% for successive years. Those were the good times.

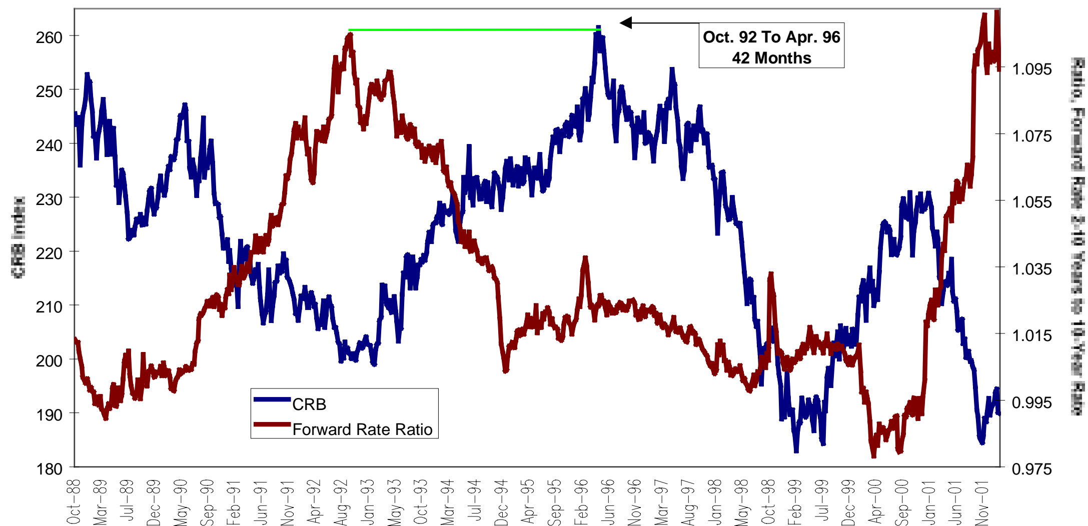
Then the Fed raised rates in 1999 and 2000. The growth in the monetary base turned negative, and velocity turned lower. Both components of the monetarist macroeconomic model were now pointing lower, and the stock market followed suit in March 2000. The currency market answered the question of whether there was sufficient liquidity: Between March 2000 and January 2002, the dollar gained 9.2% against the Canadian dollar, 10.6% against the euro, and 26.8% against the Japanese yen. Gold rose a scant 1.25% over the same period.

A widening of credit spreads in the bond market and a dearth of IPOs accompanied the breaking of the speculative bubble in equities. Since productivity growth depends on risk-accepting new investment, these developments are negative for future U.S. economic growth prospects. Moreover, lower productivity growth will lower the threshold at which growth in either monetary expansion or higher velocity will produce upward inflationary pressures. This is the tinderbox situation that prevailed during the early 1970s. All that's needed now is a continuation of low interest rates, a policy accident, or any growth in overall loan demand in the banking system, and price levels could move higher quickly.

**Warning Bells**

Maybe not now, and maybe not even next year, but eventually we will see commodity price inflation as a consequence of present monetary policies. If we look at the shape of the yield curve, here defined as the ratio of the forward rate between 2 and 10 years (the rate at which we can lock in borrowing today for a period starting in year 3 and extending to year 10) to the 10-year rate itself, we see how it leads commodity prices eventually. The last cycle between peak monetary loosening and peak commodity prices took 42 months. If this cycle is repeated – and there's nothing magic about 42 months – we'll see a period of rising commodity prices between now and mid-2005.

**Steep Yield Curves Have Consequences**




## Investing Implications

Who is going to be helped by a combination of rising inflation and rising commodity prices? The answer is the same globally. Debtors, including governments, are helped by inflation as they get to pay back their obligations in depreciated currency. Primary commodity producers, be they wheat farmers in Kansas, coffee growers in Colombia or copper miners in Chile also benefit from the short-lived monetary illusion that they somehow have acquired an advantage in the terms of trade.

Forget about investing in any of these markets for the long-term. Commodity consumers can add far more value than can commodity producers (see "Next Civilization, No Commodities!," *Futures*, July 2001). But long-term verities need not get in the way of short-term opportunities to make a raid into the debtor/commodity producer/emerging market sectors.

The bear market in stocks has created a bull market in cash and government debt. Turn the yield chart over, and we're in irrational exuberance time for short-term rates. Unless events conspire to produce an economic collapse, risk is underpriced, and accelerating credit demands are going to convert recent monetary largesse into higher price levels. High-yield bonds, primary metals such as copper and nickel, and the debt of commodity-linked emerging markets all could benefit from an inflationary burst.

Is this the state of affairs to which we aspired a few short years ago? No, but that's why we have cycles. We lurch from one type of market to the next within the great trend channel of life. Past performance does not predict future results, it simply creates the environment in which they will exist.