Reflation With A Twist

Camouflage and mimicry are common evolutionary strategies, and for good reason. It is much more efficient for a potential meal either to hide from a predator or to look poisonous than to acquire all of the necessary armament for actual defense. And a word of warning to any of you contemplating a tropical rainforest excursion: Don't let your last words be "Oh, what a pretty frog!"

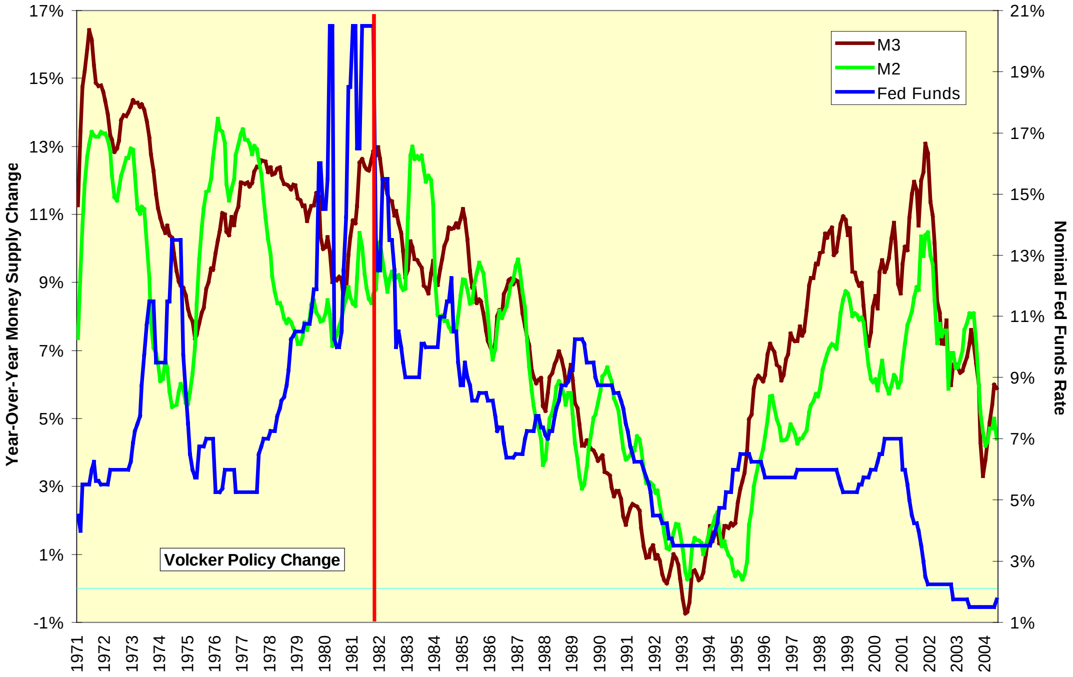
Markets, which often act as if their purpose in the divine comedy is to separate you from your money and nothing more, often conceal their actual character behind what Churchill termed, within the context of wartime espionage, a bodyguard of lies. Consider the difficulties we have had within the past two years of deciding whether we are in an epoch of deflation, forestalled deflation, reflation, regular inflation or the dreaded stagflation. And, to extend the evolutionary analogy, our government-data sensory mechanisms so necessary for environmental perception may have been hijacked by some sort of hallucinogenic parasite. Do not, I repeat, do not touch the mushrooms in the Bureau of Labor Statistics cafeteria.

The Fed, Money And Inflation

One thing is for certain, at least in the public mind, and that is 2003 was a year of remarkable monetary stimulus. After all, the federal funds rate was lowered to 1% and Federal Reserve officials were both warning about the dangers of deflation or insufficient inflation and promising neither would happen under their watch. Upon further review, however, the stimulative intent was not matched by growth in the monetary aggregates. This is the mirror image of a 1970s phenomenon, the combination of ever-higher federal funds and strongly growing monetary aggregates; that decade is now and forever associated with its resulting inflation.

What is remarkable about this symmetry is its occurrence on both sides of a major change in policy by the Volcker Fed in the early 1980s; they announced they would no longer be targeting monetary aggregates, but rather the federal funds rates. Once this change was effected, the high and volatile growth in the monetary aggregates started to fall, and both inflation and the federal funds rate fell apace.

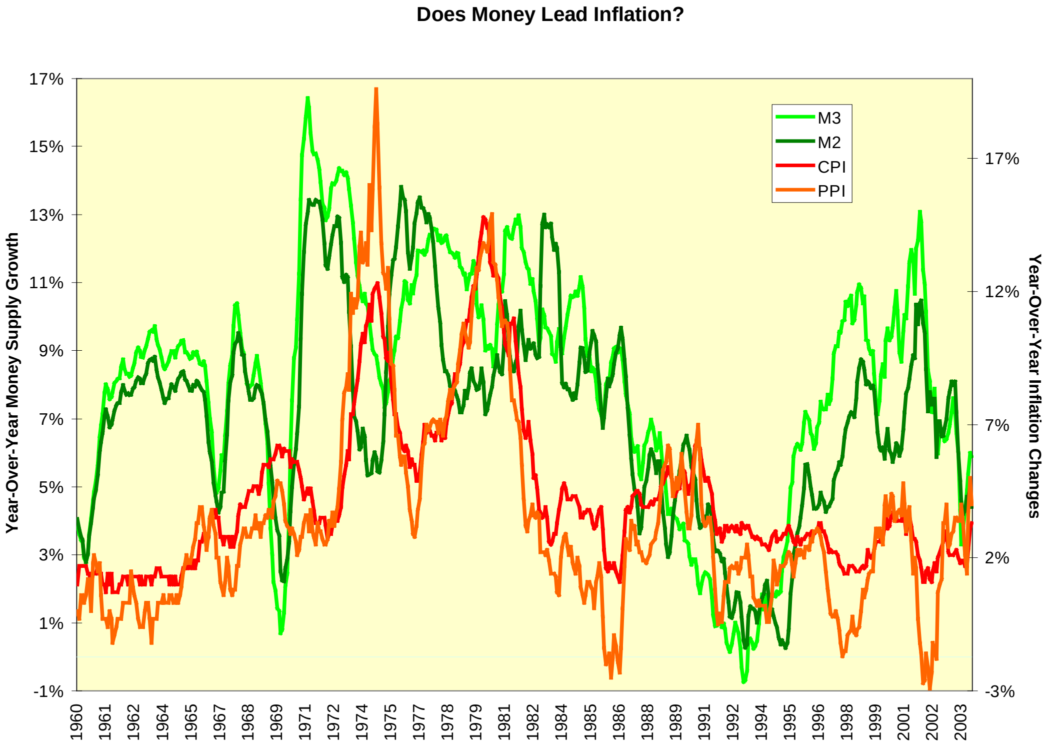
Does The Fed Control The Money Supply?



The relationship changed once again in the 1990s. After the rate hikes of the 1994 tightening cycle ended, growth in the money supply continued to surge and even ignored the rate hikes of the 1999-2000 cycle. As an aside, those who blame the Federal Reserve for fueling the bubble should glance at this chart and guess how high the federal funds rate would have to have been to squelch the monetary growth of this period.

Only the bursting of the stock market bubble led to a collapse in the bank lending so necessary for the expansion of the money supply. I feared in early 2001 that the aggressive rate cuts would lead to an expansion of economic activity and credit demands, which in turn would lead to strong money supply growth and eventual inflation. This was giving the Federal Reserve way too much credit - no pun intended - for their ability to influence the money supply. In retrospect, the Federal Reserve has been far more effective, probably unintentionally, in influencing asset prices as both the stock market boom of the late 1990s and the present real estate festival attest.

Moreover, the old monetarist assertion that inflation is everywhere and always a monetary phenomenon may need a little modulation. The rapid disinflation of the early 1980s was not led by a decline in money supply growth, and the experience of the 1990s showed high money supply growth need not produce subsequent inflation. At present we are seeing price levels rise after a period of rapidly slowing money supply growth.



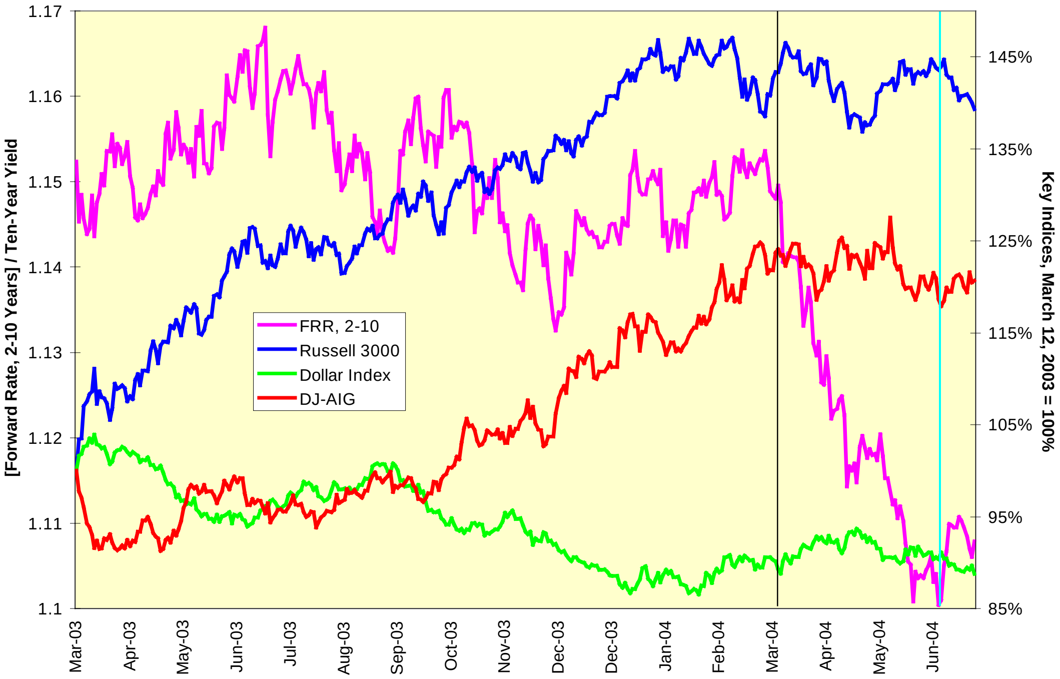
The Misdirection Play

The markets of 2003 looked like a reflation trade even though money supply growth was slowing and the reported price indices were quite tame. How else could we account for bond yields falling with the economy growing sharply, stocks soaring, commodities rallying, credit spreads contracting, the federal deficit deepening and the dollar hitting new lows against the euro on a fairly regular basis?

The logical extension of all this as we entered 2004 was that the Federal Reserve would have to remove the proverbial punch bowl in short order. The yield curve would flatten, inflation would continue to rise as the lagged effect of all that stimulus, stocks would do fine as profit growth would outweigh the effects of higher short-term interest rates. In addition, the dollar would firm on improved interest rate differentials and commodity prices would stall due to higher interest rates and a firmer dollar.

Several aspects of this scenario came to pass. The ratio of the forward rate between two and ten years, the rate at which you can lock in borrowing for eight years starting two years from now, to the ten-year rate itself fell precipitously in April and May. The closer this measure gets to 1.00, the flatter the yield curve. Both stocks as measured by the Russell 3000 and commodities as measured by the Dow Jones-AIG index, stalled.

What If The Flattening Stops?



That misdirection lasted for just over two months. A spate of weaker economic data have ended the flattening of yield curve, and while the weaker dollar and higher commodity prices of the past month were consistent with the 2003 experience, the weaker stock market most certainly is not.

If the Federal Reserve is a reluctant cop on the monetary beat, we may see a return to the accommodative policies and rhetoric of 2003 very soon. But do not expect to party like it is 2003: While bonds, commodities and foreign currencies will benefit, stocks will not. This reflation attempt, whether accompanied by rising monetary aggregates or not, will have higher reported inflation, notwithstanding last week's PPI/CPI reports, slower economic growth and profit growth and the prospects for higher federal taxation with which to contend.

The very worst mistake we could make at this juncture is to treat inflation, a scourge, as public enemy number one. Lurking behind this camouflage of higher prices is a worse danger, and that is a deflationary collapse of credit. All of these economic states are morphing into each other quickly, and it is understandable how advocating reflation to avoid deflation while risking inflation could be a little confusing. But the reward is avoiding a repeat of the 1930s or Japan in the 1990s, and that is worth a little time and effort.