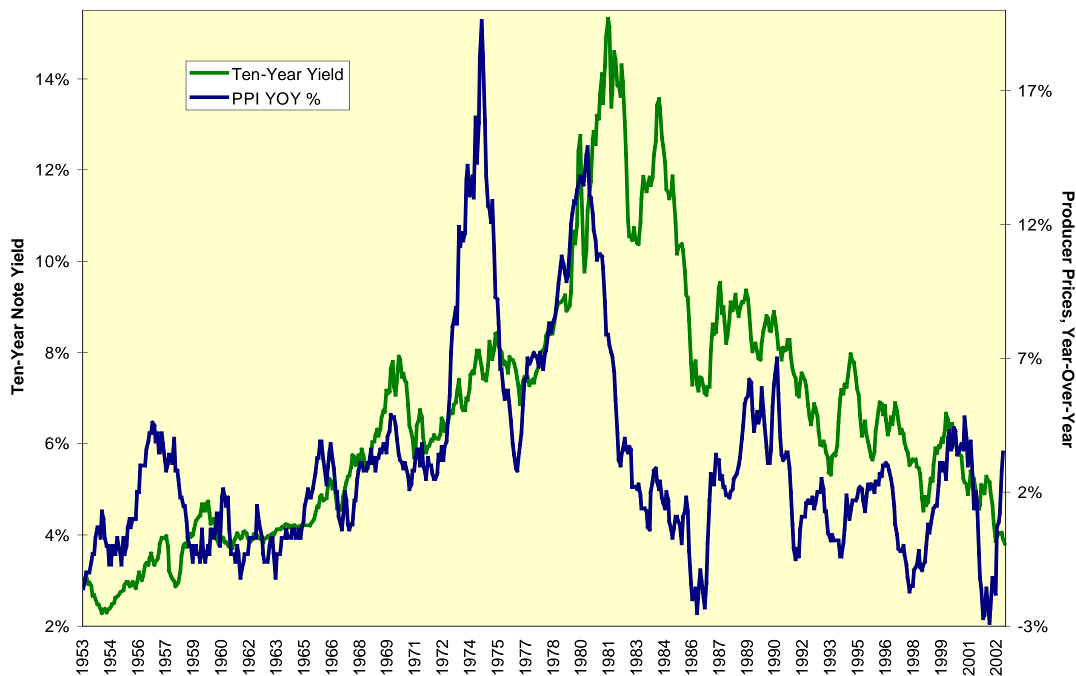
Thinking About Inflation

This may seem like an odd time to think about inflation. Gold prices have retreated from their pre-war highs, with the cash bullion price threatening a breach of support at $319 per ounce. Crude oil prices have retreated from their flirtation with $40 per barrel, the dollar has stabilized near 1.07 per euro, and bond yields are still scraping 40-year lows. The economy is - charitably - sputtering, almost no industry is encountering production bottlenecks, and the growth of the monetary base is well within historical norms. Why worry?

As a wise man once said, "when there is not a cloud in the sky, be careful where you step."

On a more practical level, the 21-year bull market in bonds, which supported an 18-year bull market in stocks, will come to an end someday. When it does, look out: The last bear market in bonds lasted for three decades. It did not break until inflation was broken by the Reagan/Volcker combination of fiscal stimulus and monetary contraction, a policy mix advocated by Nobel laureate Robert Mundell.

They Shoot Bulls, Don't They?



Measuring Stick

A long-ago chemistry professor of mine posed a question to the room: What is temperature? After about twenty minutes, he established to everyone's satisfaction that this common metric (cool word; we should use it to value industries we don't understand someday) that everyone understood intuitively was nearly impossible to define. Inflation is similar.

The common indices, such as the PPI used above or the consumer price index, are bandied about by the eternally sophomoric, and their monthly announcement usually prompts an interesting parody of some Three Stooges slapstick in the bond futures pit, but they are poor measures of the underlying process. Neither recognizes the effects of technological improvement, price elasticity of demand, the dynamics of substitution or the impact of non-price discounting. Technically, they are Laspeyres indices that measure the change in price of a fixed basket of goods and services.

The quarterly GDP deflator, which is announced too late and infrequently for Wall Street's if-I-don't-trade-something-soon-I'm-going-to-bust crowd, is a Paasche index, which measures the change in price not of the original basket of goods and services, but of the final basket of goods and services. As an aside, the Laspeyres index was

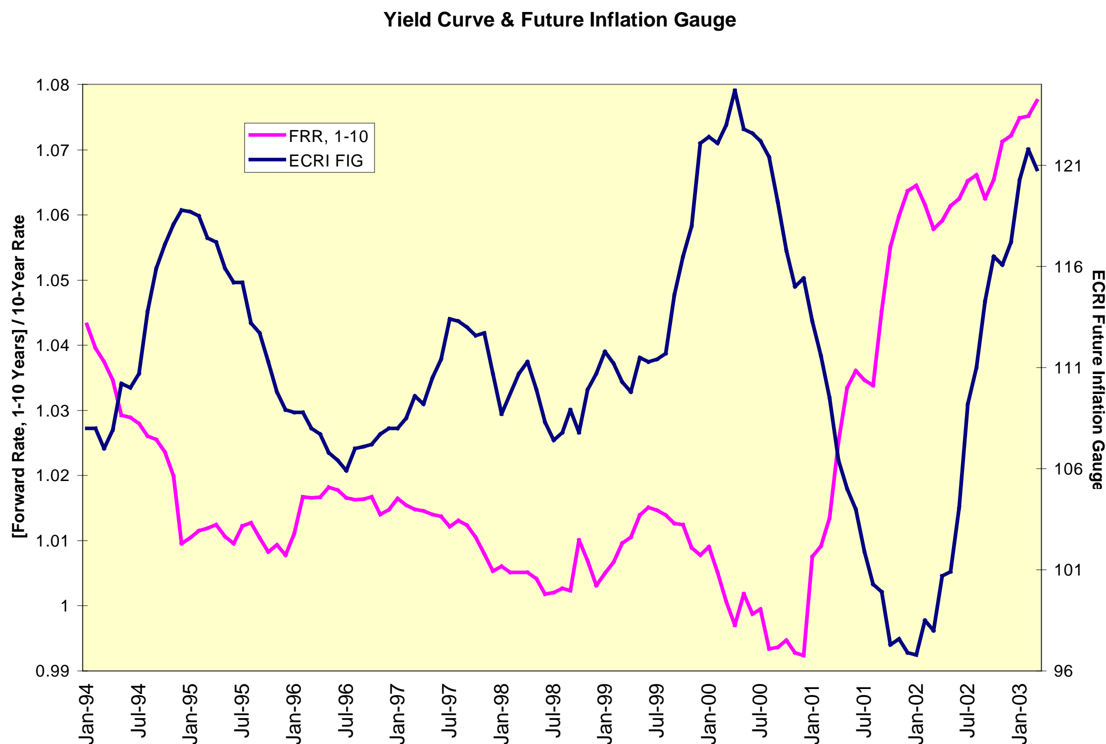
developed way back in 1864, while the Paasche index is a relative newcomer from 1874. And they call economics a dismal science!

Looking Ahead

But markets are supposed to look ahead at what is going to be, not behind at what was. The Economic Cycle Research Institute (ECRI) has developed a forward inflation gauge (FIG) that uses:

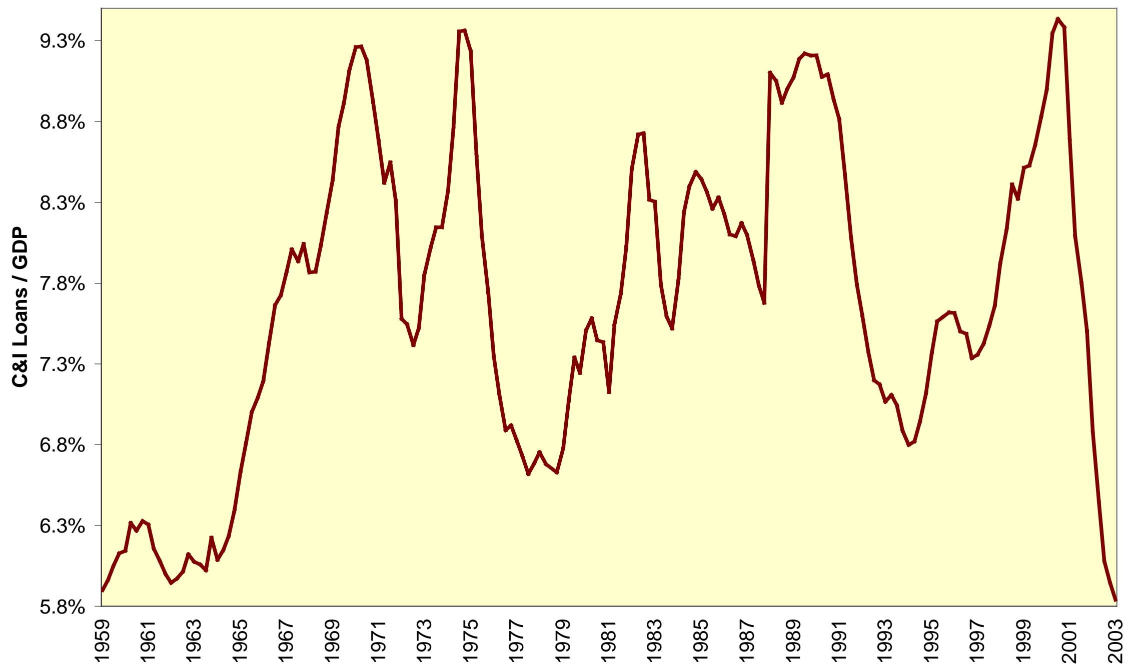
1. The Journal of Commerce materials price index
2. Growth in real estate loans
3. The insured unemployment rate, treated on an inverse basis
4. The yield spread between the 10-year note and the 6-month bill, also treated on an inverse basis
5. Growth rate in civilian employment
6. Growth rate in federal and non-federal debt
7. Growth rate in non-fuel import prices, and
8. Percentage of purchasing managers reporting slower deliveries

If we are to believe that inflation is always and everywhere a monetary phenomenon, (hint: it is) then the Federal Reserve's aggressive rate cutting of the past two years should give us pause. The steepness of the yield curve, here measured by the ratio of the forward rate between one and ten years, the rate at which you can borrow for nine years starting one year from now, to the ten-year rate itself has led the rise in the FIG by about two years.



The FIG itself is higher than levels reached during the Fed's 1994-1995 rate increase campaign and is almost as high as it was after the Fed's 1999-2000 series of rate increases. That we have not yet seen an increase in inflation can be ascribed to a slowdown in commercial credit extensions.

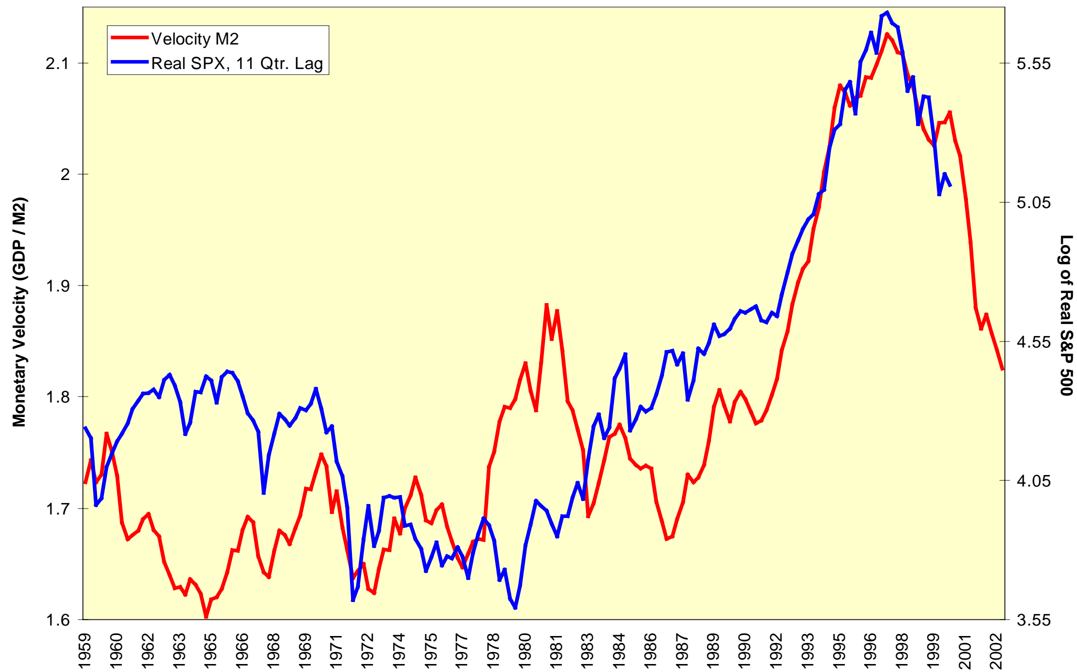
While bank loans are not as important as they once were to corporations - many prime borrowers go directly to the commercial paper market - they still reflect trends in the overall credit picture. If we take commercial and industrial loans as a percentage of GDP, we find that this number is the lowest since the Eisenhower administration. Bank loans are a lagging indicator; they rise only after the economy recovers and slack capacity disappears, and they remain high once a recession starts to finance inventories.



Once the economy turns higher, and it will someday, bank lending will recover and with it the rate of money supply growth. If the money supply grows faster than GDP, we have inflation.

Lack Of Speed Kills

We know that inflation raises interest rates and kills bonds. Is there any sort of benefit to stocks? Only if an upturn in inflation is accompanied by an upturn in velocity, a process that requires continued strong growth in productivity. Monetary velocity, the ratio of GDP to M2, is a barometer for the overall level of risk acceptance in the economy. Lately it has been falling off a cliff as investors have been fleeing risk and moving toward the perceived safety of cash and bonds.



Velocity has tended to lead equity prices by just eleven quarters: As risk acceptance increases, new ventures are formed, profits are generated and investors react. This process takes time. The continued plunge in velocity suggests we are a long ways away from this the beginning of this virtuous cycle.