

Second Quarter 2009 Knowledge College

To Inflate or Deflate, That is the Question...

Market participants are vigorously debating the inflationary or deflationary prospects of the U.S. economy. Although the Consumer Price Index¹ (CPI) increased 0.7% in June 2009, it is still down 1.4% over the last 12 months, causing wide dispersion in future expectations. The following summarizes the possible drivers of inflation and deflation, given the current state of the U.S. economy.

The Case for Inflation

The Federal Reserve's recent action to buy long-dated U.S. Treasuries to push yields down and reduce consumer and business borrowing costs has placed inflation expectations front and center for many investors. As exhibit 1 illustrates, the monetary base has ballooned from \$850 billion to \$1.7 trillion over the last year at a rate incomparable to any period over the past 50 years.

Exhibit 1

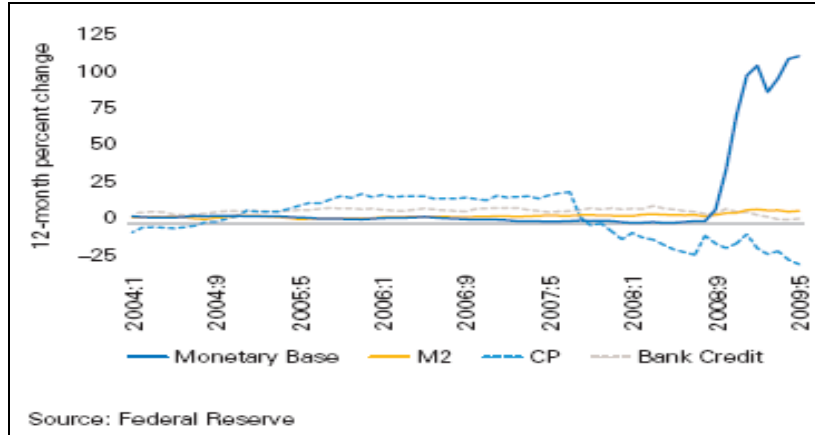


Financial institutions loosening credit (from their abundance of excess reserves) can stimulate aggregate demand and produce inflationary pressures. With the Fed Funds at 0.00 – 0.25%, policymakers encourage borrowing and consumption. However, for the increased money supply to spark inflation, it must meet demand from consumers and businesses.

M², the broadest measure of money supply, rose 9% during the 12 months ending June 2009 (see exhibit 2). To put this in perspective, the monetary base nearly doubled throughout the same period (+94%). Moreover, currency-in-circulation, which typically comprises 95% of the monetary base, rose by a mere 9.3%. As a result, currency-in-circulation now only makes up 45% of the monetary base and the M2 multiplier (M2/monetary base) nearly halved to 5.2 from 9.2 a year ago. The declining multiplier can be attributed to deleveraging in the financial system. If the newly printed money gains traction in the economy, we would likely see an increase in M2, which could lead to a climb in interest rates and inflation.

¹ Seasonally adjusted CPI.

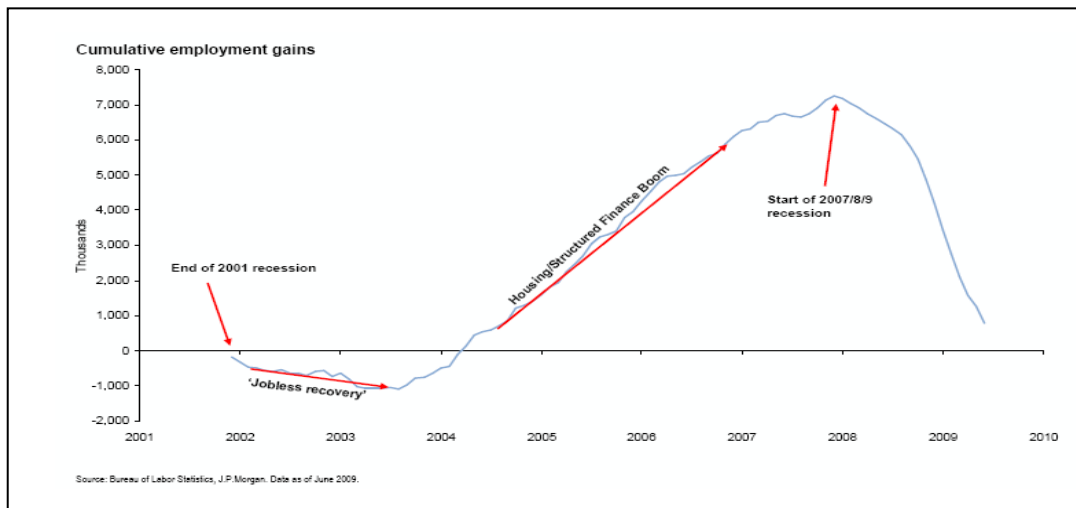
² M2 consists of M1 plus savings deposits, small-denomination time deposits, and retail money market mutual funds.



The political environment is also a crucial element in the inflation case. The U.S. Treasury Department reported \$94.3 billion in net outlays for June, which brought the cumulative federal deficit to a record \$1.09 trillion for fiscal year 2009. The Administration projects a \$1.26 trillion deficit for fiscal year 2010. When an economy faces high unemployment, stagnant growth, and a myriad of other problems; servicing higher inflation may be more politically justified than tax hikes or spending cuts.

The Case for Deflation

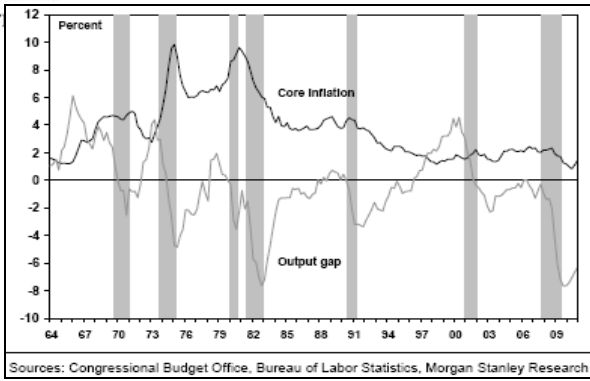
The labor market has deteriorated during the recession at a torrid pace. With unemployment approaching 10%, growing slack in labor is putting downward pressure on wages. As shown in exhibit 3, the cumulative employment gains between 2004 and 2008 have been erased.





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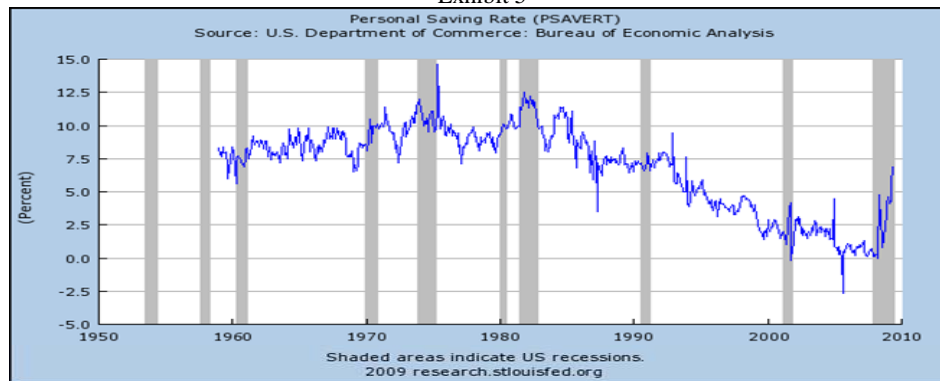
Exhibit 4



The output gap is the difference between potential and actual GDP. When aggregate demand is below productive potential, there is a negative output gap, which has historically been an indicator of deflation. Spare capacity creates slack in the economy and lessens inflationary pressures. Exhibit 4 shows the output gap currently at -6.3%, a level that, historically, leads to a disinflationary or deflationary environment.

The “deleverage and save” mindset of the consumer grinds against the “borrow and spend” incentive of low interest rates. The consumer’s mindset and banks’ tighter lending standards pose headwinds to the circulation of money into the broad economy, which may constrict inflation. Exhibit 5 displays the most recent trend in personal savings behavior.

Exhibit 5



Expectations are Important

When considering the case for inflation (or deflation), market consumer psychology is an important factor. When inflation expectations rise, greater outlays occur from the increased velocity of money. Households are incented to make purchases before prices rise further. This “anticipatory buying” can boost prices as too much money chases too few goods. On the other hand, deflationary expectations can choke off demand as households delay procurements in anticipation of lower prices. Soft demand then leads to declining prices, which cause lower corporate profits and higher unemployment. This drives down wages and further dampens demand, causing the cycle to repeat.

Short-term inflation expectations are more volatile than longer-term inflation expectations (exhibit 6). This volatility is also seen in the breakeven inflation rate—the difference between