Where Has All the Money Gone? Keeping an Eye on Inflation

Gregory (Scotland Yard detective): "Is there any other point to which you would wish to draw my attention?"
Holmes: "To the curious incident of the dog in the night-time."
Gregory: "The dog did nothing in the night-time."
Holmes: "That was the curious incident."

—Sir Arthur Conan Doyle, "Silver Blaze"

Since 2008, US money supply (M2) has increased by $3.6 trillion (48%), the Federal Reserve's balance sheet has grown by $3.3 trillion (358%), and the federal government has run cumulative deficits of nearly $6 trillion. US CPI, meanwhile, has risen a miserly 11%. While one can quibble with CPI weightings—housing makes up a whopping 41% of the index—it is hardly a stretch to say goods and services inflation is the dog that did not bark. Not surprisingly, most economists and policymakers currently express far more fear of *de*flation than *in*flation.

The reasons for this are relatively obvious in hindsight—US dollars have been vacuumed up by the US current account deficit, rising asset prices (e.g., US high-tech stocks and Asian real estate), and massive growth in US banks' excess reserves. US wages, meanwhile—which make up a substantial fraction of corporate costs—have remained stagnant.

However, just as the crowd is often wrong at inflection points—recall that the dominant fear in mid-2008 was an inflationary spiral, with talk of a "superspike" in oil prices, right before prices crashed—the current complacency on inflation may be missing something. Though mostly anecdotal to this point, President Obama's call for a higher minimum wage has sparked a

discussion of wage rates—with several large employers either voicing support for the idea or pre-emptively raising wages—and while it is still early days, we can't help but flash back to the dreaded "wage-price spiral" of the 1970s.

To recap, the wage-price spiral occurred when unions, looking to protect members against rising prices, negotiated large-scale "cost-of-living" increases, thus driving up wages … and ultimately prices. Most analysts have written off the possibility of another occurrence given the plunge in union membership since then—private sector union members currently make up less than 7% of the workforce, compared to more than 25% in the early 1970s (public sector rates have remained stable in the mid 30% range). Workers in general (particularly low-skilled workers) have seen bargaining power plummet in recent years thanks to low-wage competition from emerging markets and new technologies. Further, while the official unemployment rate is 6.7%, everyone "knows" the true rate is much higher, as the number of workers not in the labor force (up nearly 13 million since 2008) and collecting disability (up about 2 million) are not counted in the statistics; including them pushes the rate into the low teens.

Why Worry About Inflation?

Broad-based inflation requires two things—an increase in the money supply … and a mechanism for getting it into the economy. We have clearly had the former but not the latter in recent years; rising wages could change that. And given the swelling government push for higher wages, along with an increasing number of companies apparently willing to "play along," this may be a higher probability event than most think. In the words of Tyler Hay of Evergreen Capital:

> [QE has] made a lot more money for those on Wall Street than Main Street. Policy makers know this, and there is little doubt in my mind that the prerequisite for future decisions is to find a way to reverse these unintended consequences. We've seen a tax increase on those in the top income bracket. Now, the momentum is gaining for an increase to the federal minimum wage. Where this will stop is anyone's guess but, if I had to bet, it will not slow until we begin to see a contraction of the nation's income gap.

Hay also points out that while a mere 2.5% of employees make minimum wage ($7.25/hour) nearly 30% make less than $11. A minimum wage hike would almost certainly push up wages broadly, although this could be muted by job *losses* (employers could instead choose to make do with fewer workers at higher wages).

And if the pool of available workers is smaller than most assume (i.e., people who have left the workforce never come back), that could drive up competition for those who

remain. The recent trend toward "insourcing" could exacerbate this competition as US companies bring operations back from overseas. The Fed has already backed off its 6.5% unemployment "target" for when it would begin to raise rates, and has started using the phrase "persistent [economic] headwinds" to justify keeping rates extraordinarily low for an indefinite period. The risk of a significant policy mistake in this area seems high to us.

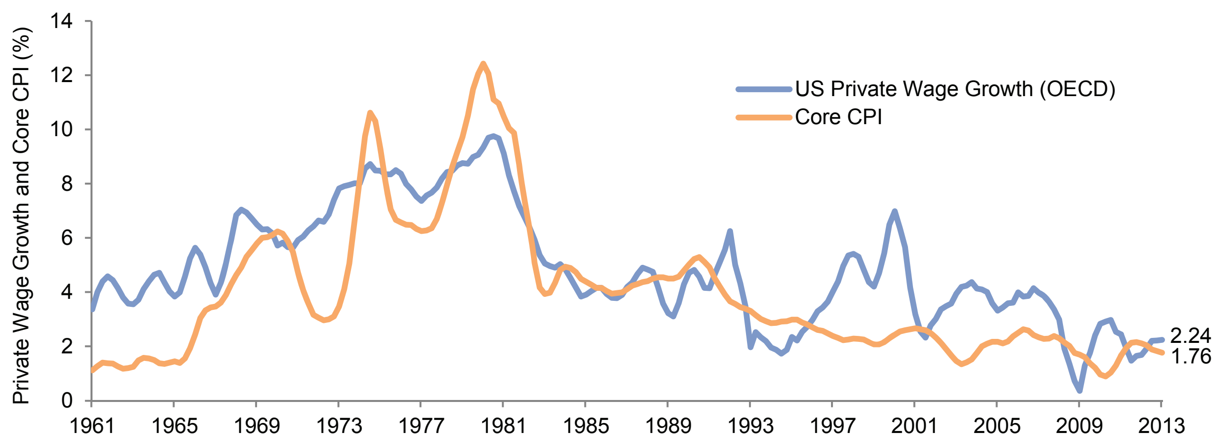
These factors could certainly slow or even reverse. And global macro conditions remain largely deflationary—Europe is stuck in a slow growth/recessionary morass, excitement over "Abenomics" has faded in Japan, and while some emerging markets are battling inflation as hot money exits and currencies fall, the risks of a Chinese credit unwind are growing. In the United States, the consensus is that recent weak US data are due to cold weather, but the economy could be following the traditional script of the past few years—perking up during periods of "QE" and fading as stimulus is removed.

It seems axiomatic that any renewed crisis or continued slow US growth would cause the Fed to reverse course on the "taper"—and calls for higher wages might well intensify in such an environment (particularly in an election year).

What to Watch For

It is often said that by the time inflation shows up in the statistics, it's too late to do anything about it. However, investors can watch certain signs for clues about brewing trouble.

Wage Growth. Wages are one of the best ways for excess money to make its way into the economy. Wage growth has been on a long-term downtrend, though for the past two years it has moved upward from 1.5% year-over-year growth to 2.2%. Any sustained move higher (e.g., a decisive rise above 3%) would be a warning flag.



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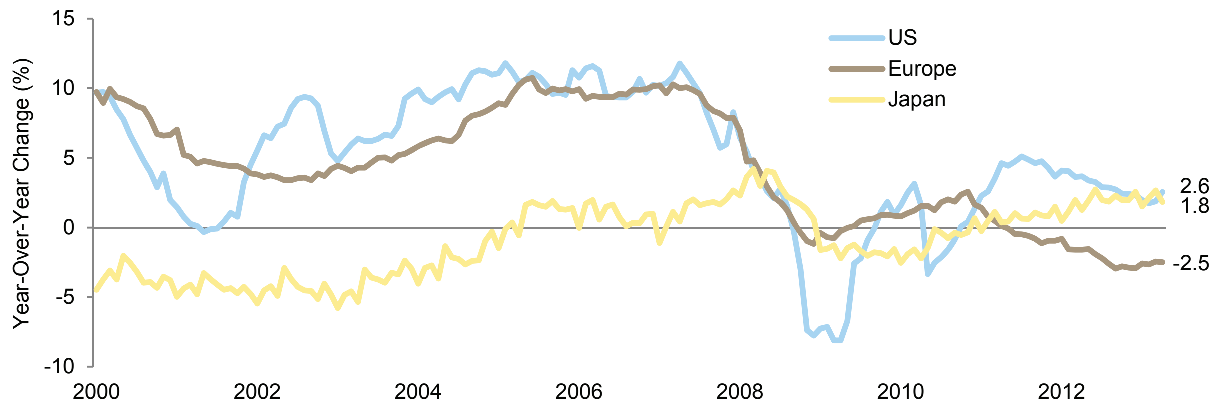
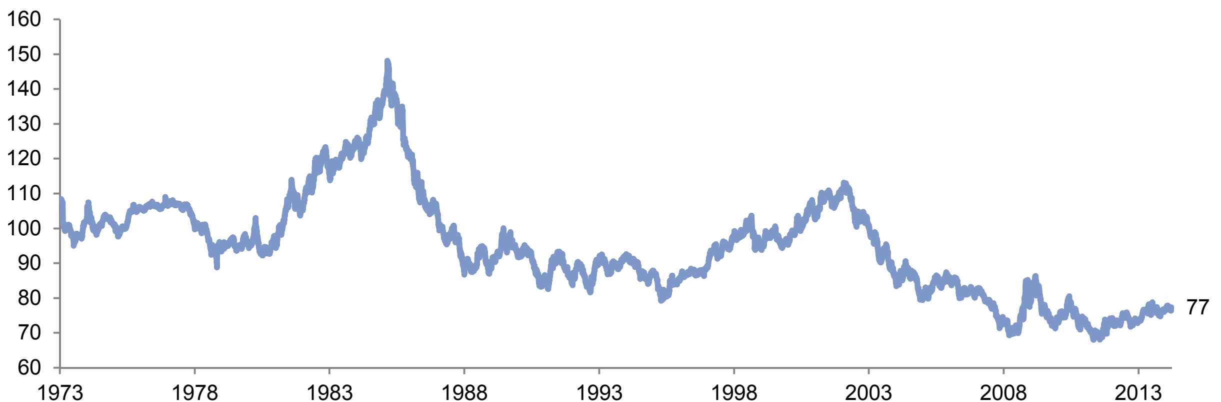
Bank Lending. Bank lending has remained moribund even as balance sheets have strengthened and excess reserves exploded. While higher reserves have little to no impact on lending[1]—banks will not be "forced" to expand loans due to high reserves—banks do have the ability to expand lending whenever they choose. Lending has been in a clear downtrend for the last few years; any change in this trend, in particular a move above 5% or so, would be another flag.

Bank Lending by Region
November 2000 – February 2014



US$ Weakness. As seen in Japan, a weak currency often results not in economic growth and rising wages, but rather in rising prices that stunt real growth. We consider sustained weakness in the US dollar to be a low probability event in the near term given the US dollar's continued status as the global reserve currency.

Trade-Weighted US Dollar Index vs Major Currencies
January 1, 1973 – March 31, 2014



[1] Excess reserves are largely irrelevant to bank lending under our current system. While beyond the scope of this brief, interested parties should read *Repeat After Me: Banks Cannot and Do Not "Lend Out" Reserves* by Paul Sheard of Standard & Poor's.

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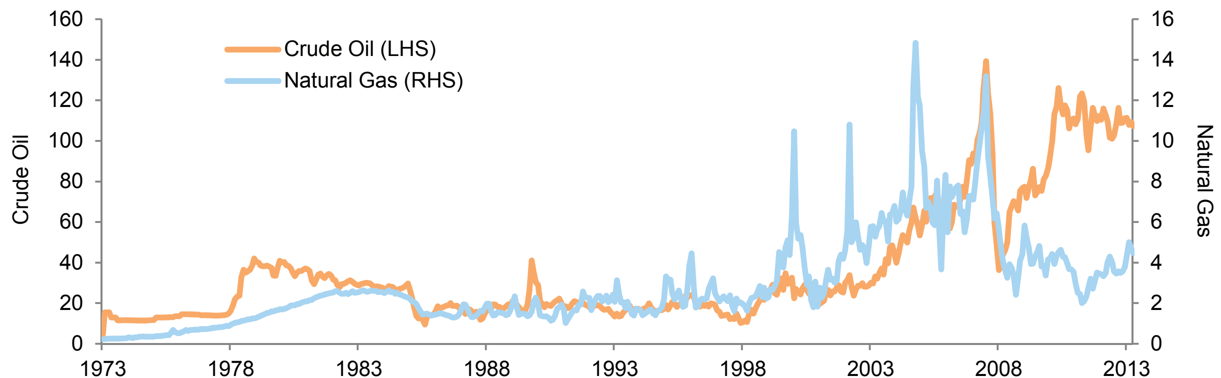
Oil Prices. While oil prices are clearly a less dominant force than they were in the 1970s, they remain a substantive input to a wide variety of goods. Even though energy, broadly speaking, makes up only about 10% of the CPI, a sustained spike in oil prices would almost certainly drive up prices across the economy. That said, we wonder whether such a spike is even possible today given the US shale revolution and that, as the saying goes, the cure for high prices is … high prices. A sustained oil price above $150, for example, would make economical a host of alternatives (e.g., tar sands) not feasible at current prices. The bottom line is that oil prices seem unlikely to act as the transmission mechanism to introduce excess cash to the economy, but could certainly rise *as a result* of rising wages or credit creation.

Crude Oil and Natural Gas Prices

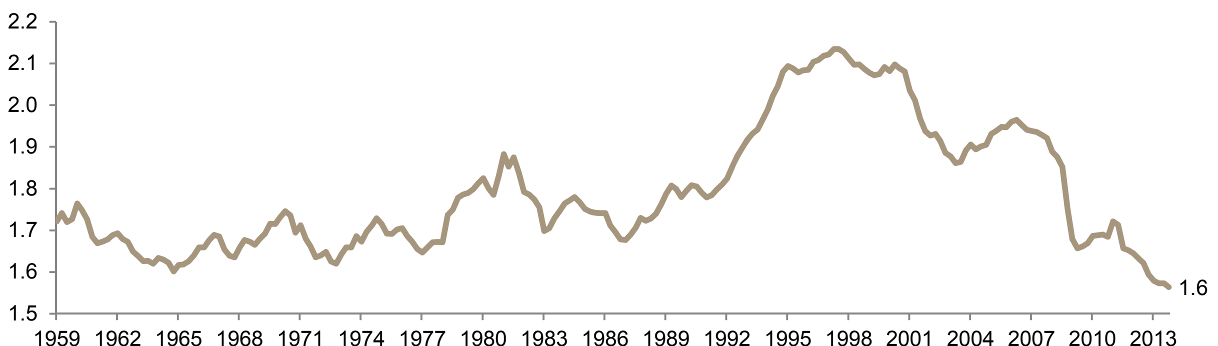
December 31, 1973 – March 31, 2014



Velocity. We have always viewed velocity as something of a red herring. In the words of Paul Sheard, "the money multiplier has not collapsed because it was never there in a meaningful sense to begin with. Rather a ratio of two loosely connected numbers has fallen dramatically because the denominator [bank reserves] was dramatically increased." Similar to oil prices, we would view rising velocity as a function of some other transmission mechanism, rather than a *deus ex machina*.

M2 Velocity

Fourth Quarter 1959 – Third Quarter 2013



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What to Do

Investors concerned about inflation have few good options at the moment. Most traditional hedges are either expensive (e.g., commodities and TIPS) or illiquid (e.g., private energy and real estate). One exception—gold and gold miners, which were both hammered in 2012–13, but have shown significant strength in 2014, and would likely be big beneficiaries of an inflation scare. Another option is cash, which, while not benefiting from the inflation, would provide spending support with the added benefit of protecting against richly valued asset markets and/or a deflationary downturn. ■

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Exhibit Notes

US Private Sector Wage Growth and Core Inflation Chart
Sources: Bloomberg L.P. and OECD.
Note: Wage and inflation growth are calculated on a rolling one-year average.

Bank Lending by Region Chart
Source: Thomson Reuters Datastream.

Trade-Weighted US Dollar Index vs Major Currencies Chart
Source: Federal Reserve.
Note: Trade-weighted US dollar data are daily.

Crude Oil and Natural Gas Prices Chart
Source: Thomson Reuters Datastream.

M2 Velocity Chart
Source: Federal Reserve.

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