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CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENT

WHITHER INFLATION?

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Whither Inflation?

Why are so many market watchers convinced U.S. inflation is set to rise? Looked at over a long timeframe (see Table A), it is clear current inflation levels are scraping the bottom when compared with the last several decades. Yet a number of observers, having got over their deflation fears of nary a year ago, now seem consumed with inflation. Anecdotally, a number of recently published articles have suggested the Federal Reserve is behind the curve and overly complacent about signs of budding inflationary pressures. While this may be logical given current central bank and government proclivities to flood the economy with a seemingly endless stream of new money, it is unclear to what degree these reflationary policies will push prices higher given the strong deflationary headwinds that remain. For the moment, most pundits seem to believe inflation will return to historical average levels, but some believe we could enter another era with the sort of runaway inflation that clobbered markets in the 1970s. We think it likely recent stimuli will produce at least a modicum of inflation, but also recognize that the threats of high inflation and deflation both remain.[1]

In general, the arguments for inflation and deflation break down as follows:

Inflation: The arguments used by those expecting very high inflation typically center around the ability of modern central banks to create unlimited quantities of money and thus destroy their own currencies. The Fed will almost certainly continue on this path, as recent papers and speeches from Fed officials indicate they view the failure of U.S. and Japanese policymakers to reflate their economies after burst bubbles as largely a result of the unwillingness of policymakers to drop rates quickly enough and hold them at low levels for an extended period. Furthermore, wartime spending historically has been inflationary, and there is little reason to expect this time will be much different.

The recent surge in oil and other commodity prices, meanwhile, appears sticky and should not be overlooked. Unless China hits a significant speed bump, demand for commodities is likely to remain high and prices could continue to rise. While it is true labor costs are a far more important issue in the United States than commodity prices, sustained high prices for commodities would almost certainly trickle through to the U.S. economy at some point. Indeed, largely as a result of the uptick in commodity prices, the crude and intermediate goods components of the Producer Price Index—often considered leading indicators of inflation—are rising significantly faster than the Consumer Price Index (CPI); such pressures should eventually work their way through the system and be reflected in consumer prices. This would likely be exacerbated by a continued easy stance by the Fed; many believe the high inflation of the 1970s was not a necessary result of the rise in oil prices at the time, but rather stemmed from the Fed's monetization of high energy prices by keeping rates artificially low.

[1] Japan serves as a reminder that more than a decade's worth of fiscal and monetary ease can have little discernible effect on an economy plagued with chronic deflation. While there are significant differences between the U.S. and Japanese financial systems, we use the example of Japan simply to note that massive government spending and rock-bottom interest rates do not always cause inflation.

Further, a continued decline in the US$ against other major currencies could have inflationary consequences for the United States, as it *could* drive up import prices. Rising prices are not an automatic consequence of a falling dollar, however; because the United States is such a large consumer, non-U.S. suppliers may be willing to tolerate lower profits rather than raise their price in US$ and risk losing sales to the world's largest economy. Such a strategy, of course, depends on the matter of degree: while suppliers may be able to stomach the effects of a 10% currency depreciation, for example, a continued drop in the greenback would *at some point* force them to raise prices.

Deflation: The world is currently experiencing a torrent of strong deflationary forces. Most notable among these is the impact of China, which through its virtually unlimited access to cheap labor has been able to supply much of the world with progressively cheaper manufactured products.[2] In addition, the continued spread of technology and the productivity benefits associated with it puts unrelenting pressure on prices. The advent of the Internet, for example, has sped the process of globalization and put ever-increasing pressure on suppliers, while simultaneously providing an enormous boon to consumers who can now choose from a rapidly increasing menu of options, and also benefit from falling prices for a variety of products and services.

Indeed, one of the arguments commonly made to support the notion that *inflation* will rise is that the falling share of gross corporate product going to labor must eventually revert to trend (see Table B), and when it does, corporations will be forced to raise prices. Yet this argument ignores the rapid globalization of labor now underway: as millions of Chinese and Indian workers continue to flood the workforce, companies are more likely to be able to hold the line on labor costs. Thus, even if commodity prices continue to rise, corporations will likely be able to absorb the additional costs by cutting expenses in other areas such as labor.

The large build-up of debt in the developed world—most importantly in the United States—is another important, but sometimes overlooked, deflationary force. Debt is deflationary for two reasons. First, debt in and of itself simply represents a shift in consumer time preferences: consuming more today in exchange for a reduction in future purchasing power. Thus, future demand will be sapped not only of the assets spent today, but also of the assets used to pay the resultant debt. Second, and just as important, is the effect of debt on currency markets. Because debtors must eventually put their hands on cash to pay off their debts, the level of debt in the U.S. economy could be considered a synthetic short position against the US$. As a result, the more debt that is created, the more dollars must eventually be demanded for repayment, and the higher the potential value of the currency.

Finally, the low level of capacity utilization in the United States seems likely to constrain any surge in inflation, as companies *should* be able to increase production without incurring significant new costs. (See Table C.)

Capital markets seem to recognize that both inflationary and deflationary forces persist and are pricing in expectations of only a modest degree of inflation. While break-even spreads between TIPS and nominal Treasuries have widened considerably over the past year—investors are now pricing in annual

[2] The consternation caused by China's currency peg to the US$ is, to us, much ado about nothing, as even with a 50% rise in the *yuan* China would *still* be the world's low cost supplier.

inflation of 2.69% over the next ten years, versus expectations of 1.74% a year ago—such a level would still put the CPI at a very tolerable level for investors.

What About the Money Supply?

It has been said that inflation is everywhere and always a monetary phenomenon, and we certainly are sympathetic to this view. After all, *ceteris paribus,* the most likely cause of rising prices for goods and services is an increase in the money supply. Still, even money supply data are inconclusive with regard to the outlook for inflation. (See Table D.) While M1 growth appears to be accelerating, M2, M3, and MZM are all decelerating from recent peaks, and all four measures are well within their long-term ranges.

The decline in money supply growth rates is curious, and another reason we believe inflation is most likely to be moderate. Considering that the Fed has held short rates at a self-proclaimed "emergency level" of 1% for nearly a year, it is somewhat surprising that money growth has remained muted. While there are a variety of explanations for this—including the recent decline in mortgage lending and selling of Treasury and agency securities by large banks—one possible explanation is that, for the first time since the 1930s, the Fed *may* be "pushing on a string," unable to stimulate demand for money even by holding its cost at an artificially low level.[3]

Thus, despite well-founded worries about a spike in inflation, we remain unconvinced high inflation is a necessary result of current conditions, and equally concerned the specter of deflation could again rear its head once recent stimuli fade. From an investment policy perspective, it is more important today than it has been for some time for investors to be certain portfolios are protected against the potential ravages of deflation *as well as* unexpected increases in inflation, both of which could have devastating effects on the ability to spend from portfolios without sacrificing future purchasing power.

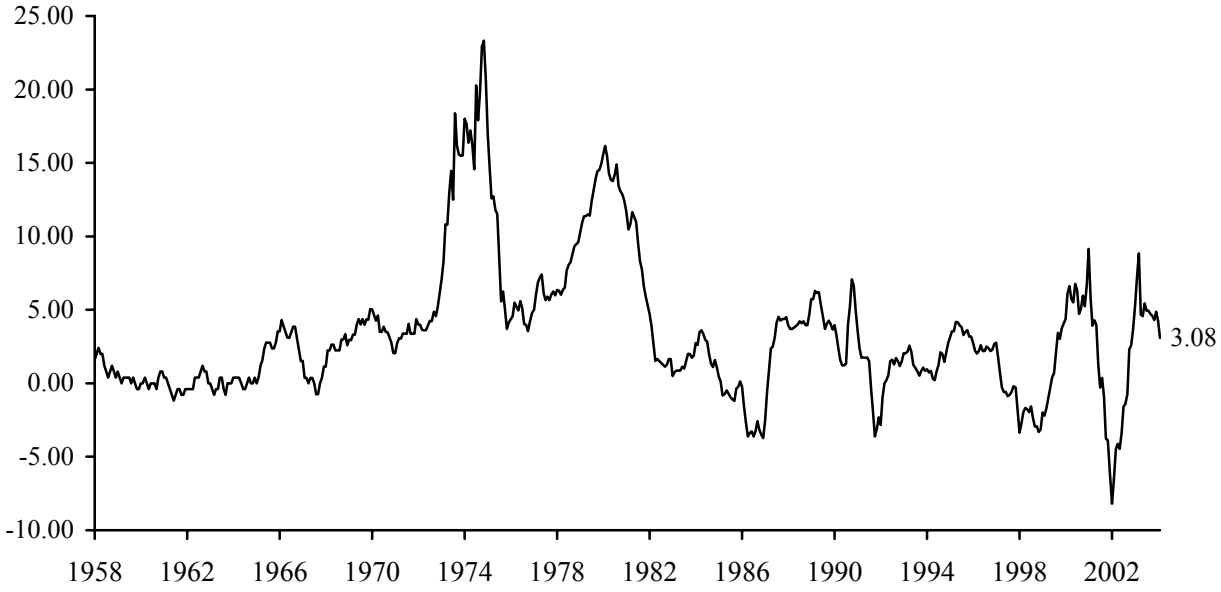
[3] For more details, see our February 2004 U.S. Market Comment: *Where Has All the Money Gone?*

Table A

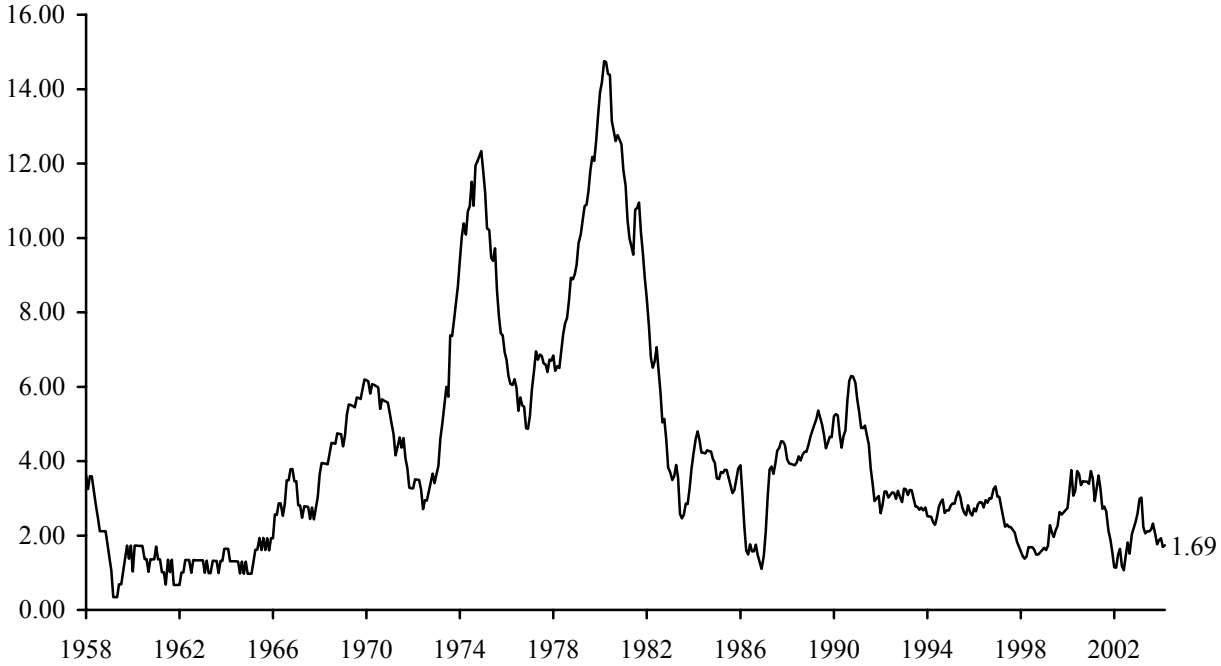
U.S. INFLATION MEASURES

January 31, 1957 - March 31, 2004

Producer Price Index



Consumer Price Index



Source: Thomson Datastream.

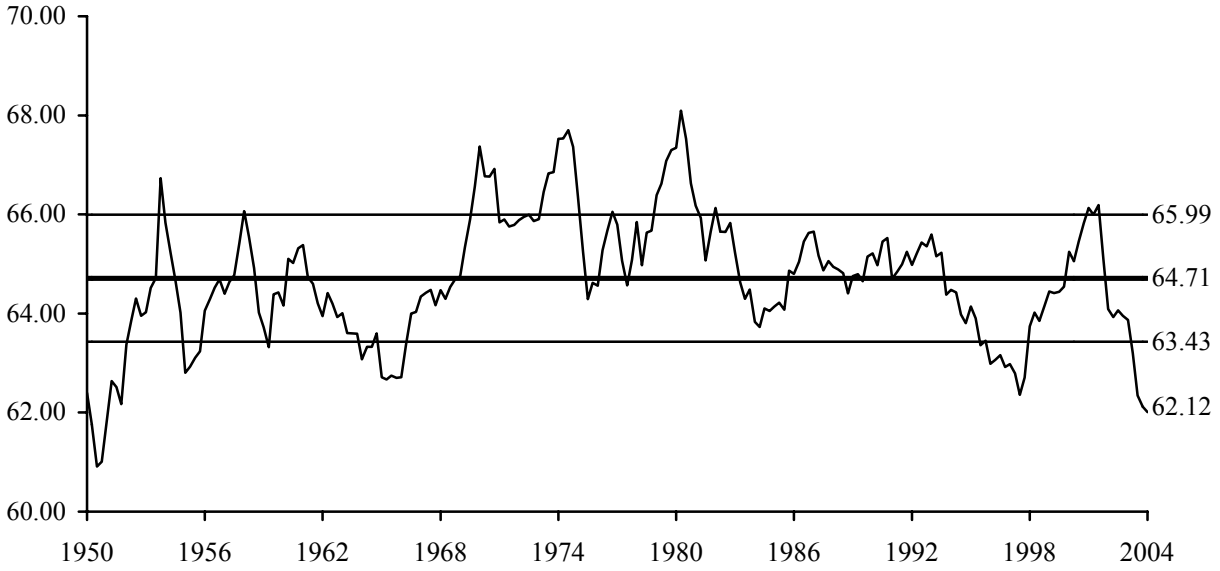
Notes: The Producer Price Index is through February 28, 2004. Charts represent year-over-year returns.

Table B

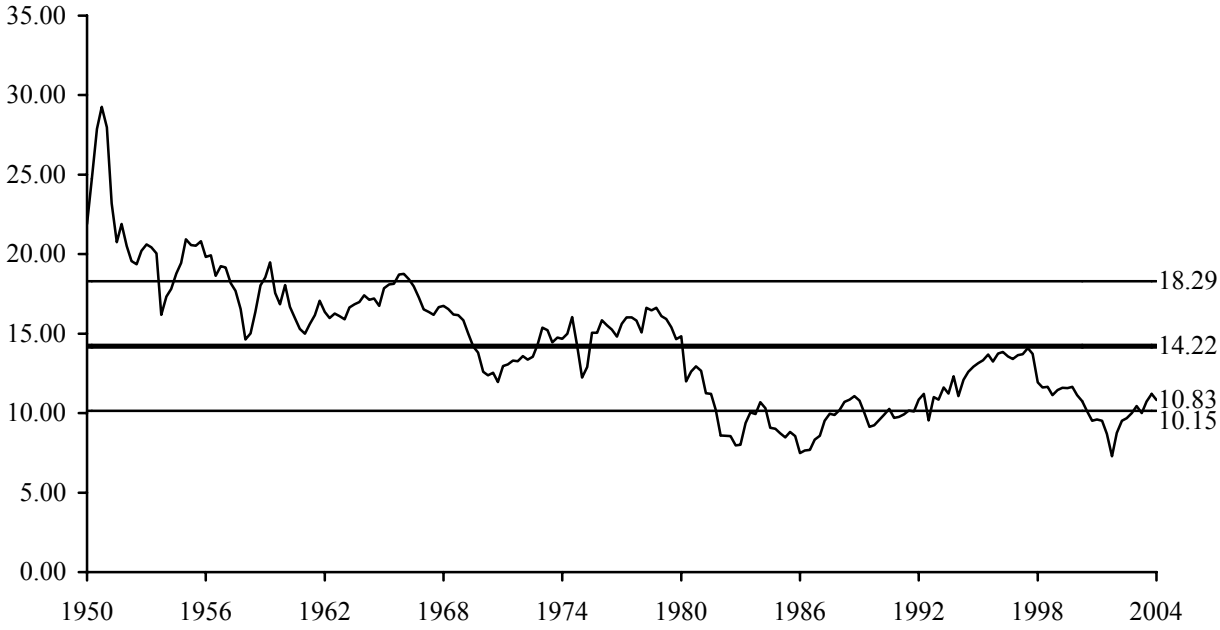
COMPENSATION AND PROFITS AS A PERCENTAGE OF GROSS CORPORATE PRODUCT

March 31, 1950 - March 31, 2004

Compensation



Profits



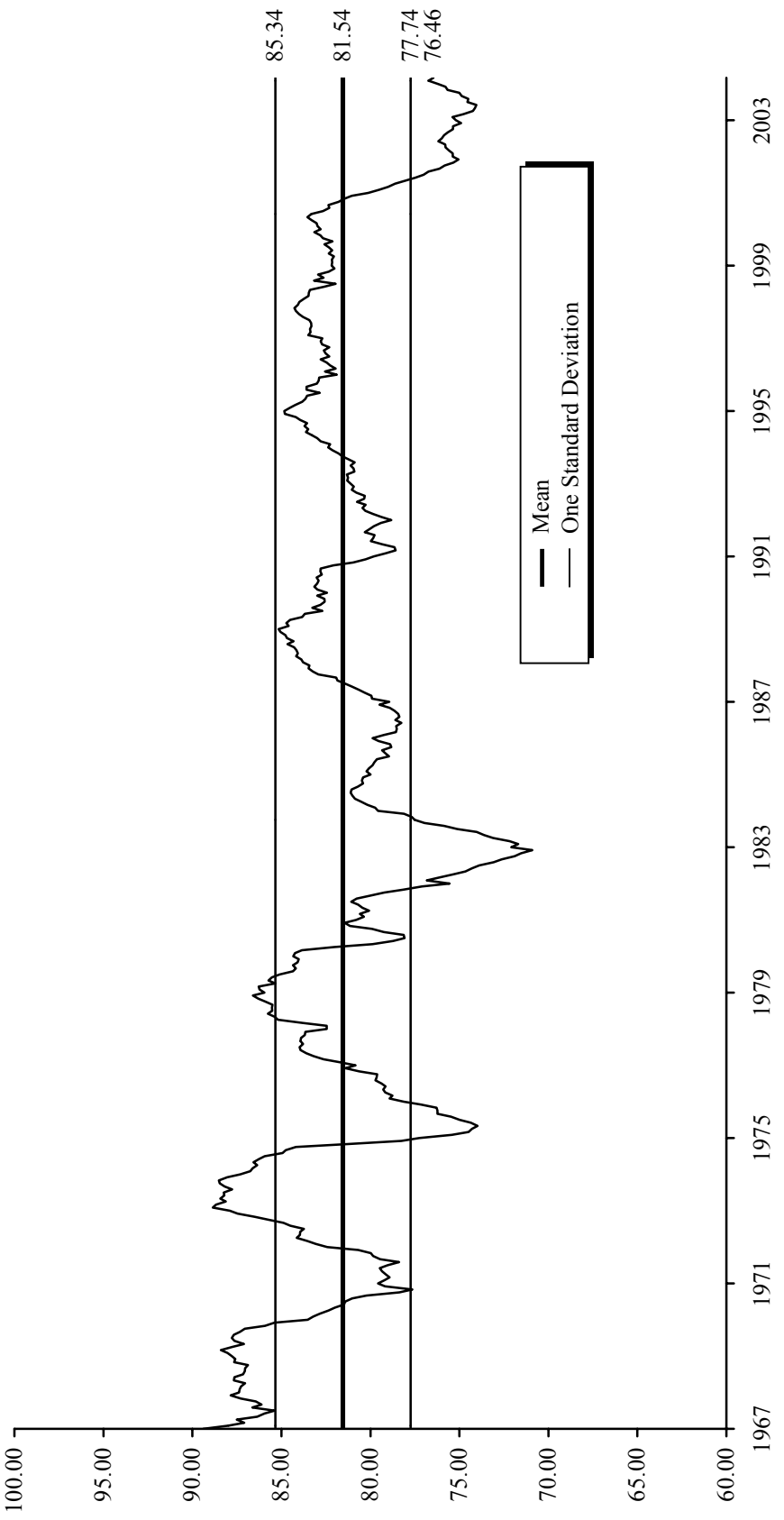
Source: Thomson Datastream.

Note: All data is in real terms.

Table C

U.S. CAPACITY UTILIZATION

January 31, 1967 - March 31, 2004



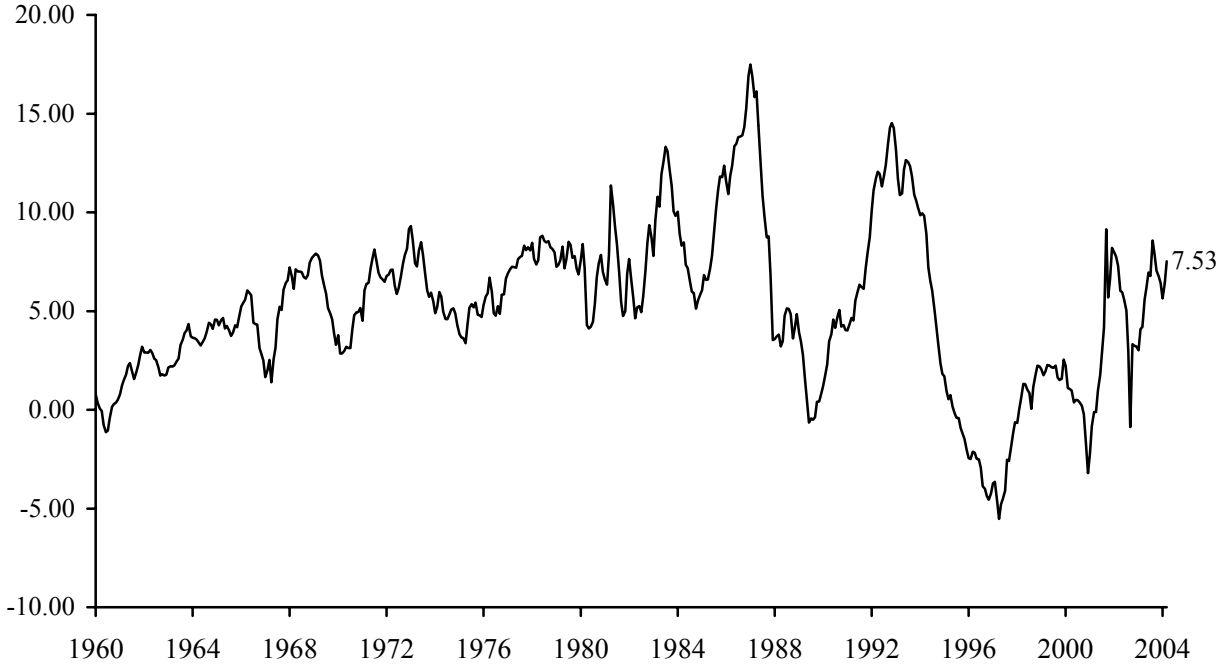
Source: Thomson Datastream.

Table D

U.S. MONEY SUPPLY

January 31, 1959 - March 31, 2004

M-1 Money Supply



MZM Money Supply

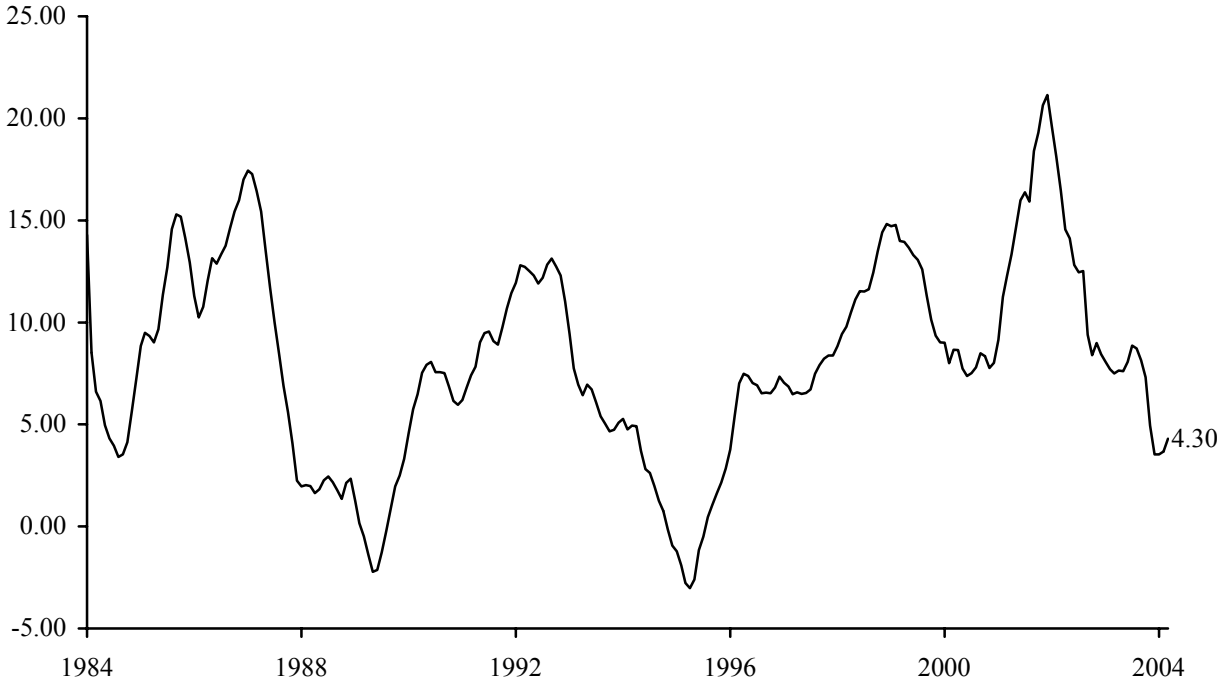
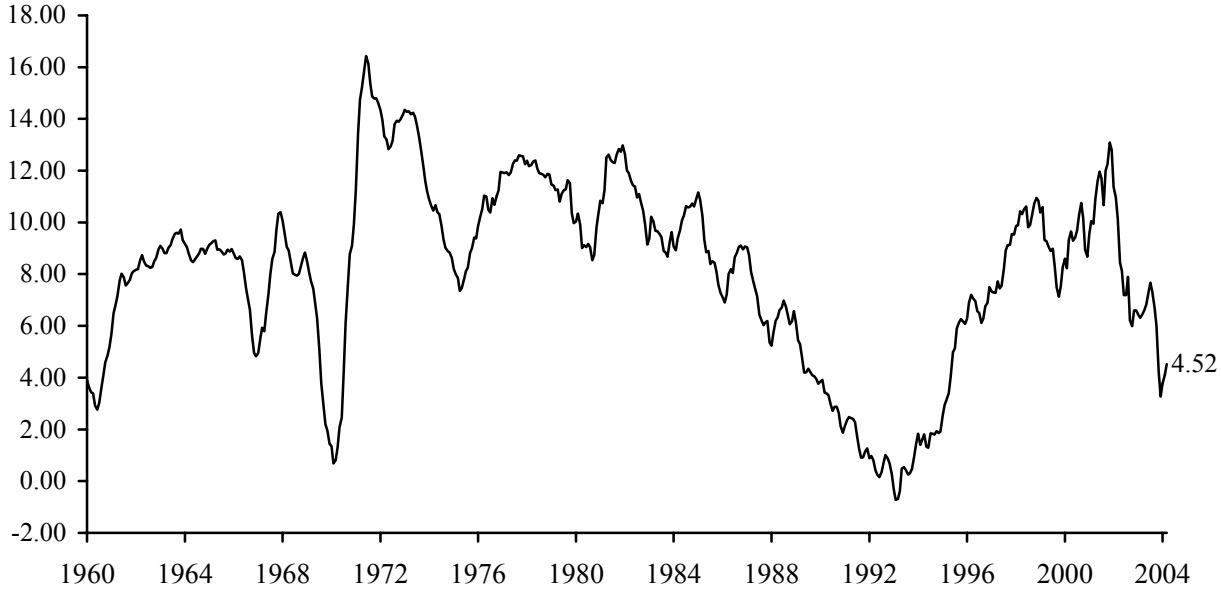


Table D (continued)

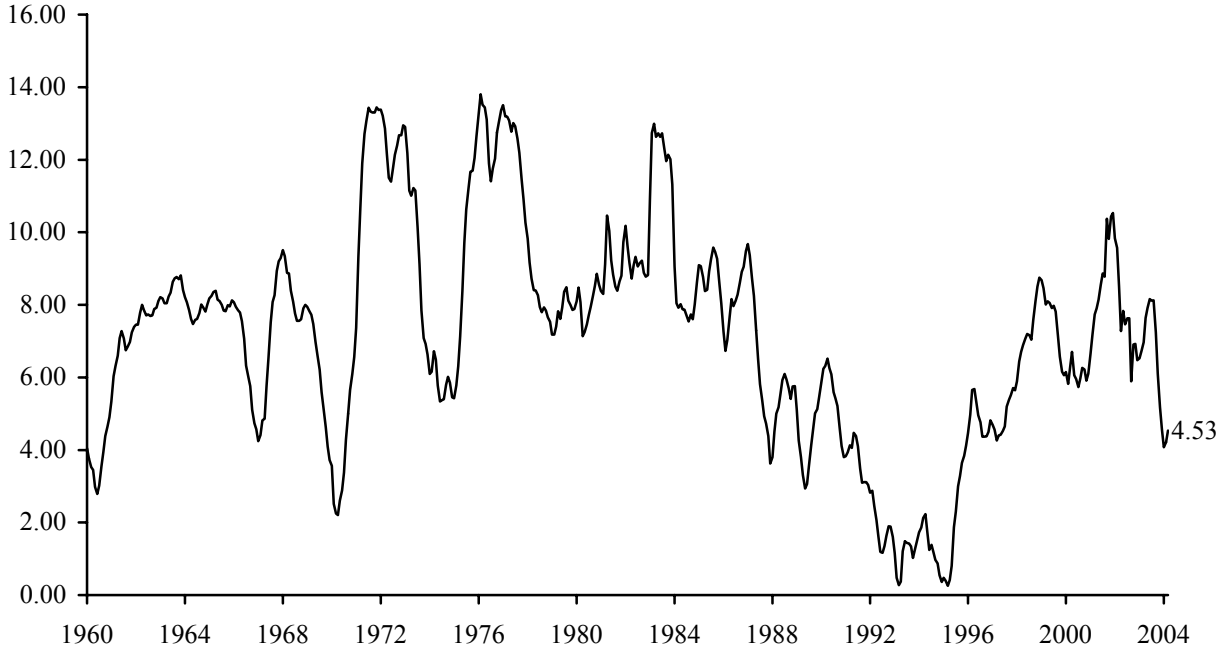
U.S. MONEY SUPPLY

January 31, 1959 - March 31, 2004

M-3 Money Supply



M-2 Money Supply



Source: Thomson Datastream.

Notes: All money supply data is seasonally adjusted and represents year-over-year returns. U.S. zero-maturity money supply begins January 31, 1983.