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Global Value and Income Dispatch

What if the Fed has inflation completely wrong?

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Highlights

Recent financial market volatility was to a large extent driven by uncertainty around how the Federal Reserve may respond to future inflation.

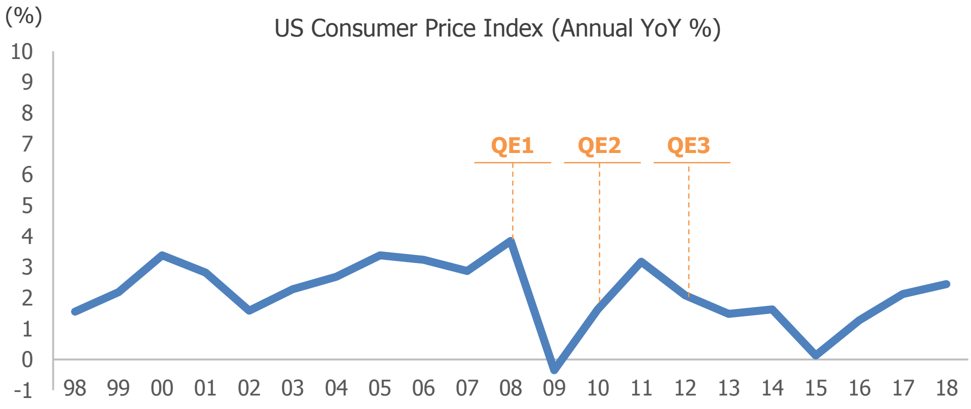
Conventional wisdom views higher interest rates as the cure for inflation; "Neo-Fisherians" credibly argue the opposite and raise difficult questions.

We think investors should focus on bottom-up opportunities and be prepared for policy mistakes and more swoons in sentiment.

Investors have just endured a period of exceptional volatility. In the fourth quarter of 2018, global equities fell more than 13% percent, only to rise 11% by the end of February. Credit markets followed a more muted but similar path. From our perspective, the events of the fourth quarter were largely a crisis of confidence in policy makers around the world, on key areas of concern ranging from Brexit to US/China trade relations. But, arguably, the most important contributor to the market's nervous breakdown at the end of 2018 was the Fed. Jerome Powell's public communications received broad-based criticism. At first he indicated support for a program of quantitative tightening that appeared to be rather blind to economic developments ("autopilot"). Subsequent assurances that the Fed will react in a "data-dependent" manner restored investor confidence.

The Fed's inclination to tighten appeared motivated by a desire to normalize interest rates in a period of economic strength but also represented a response to recent inflationary signals. Among all the macroeconomic and geopolitical concerns with which we have had to contend over the past decade, subduing inflation is not a topic that has really preoccupied investors or policy makers in the U.S. The fact is, we just haven't seen much. Since the Great Financial Crisis, we have only had one year (2011) in which CPI growth exceeded 3%. This followed and perhaps corrected for two years of below trend CPI changes (1.6% in 2010 and -0.4% in 2009). The lack of clarity around how the Fed intends to handle a problem that has not existed in recent memory weighed heavily on investor sentiment.

Inflation: the dog that hasn't barked



Source: Bloomberg, as of December 31, 2018

This extended period of low inflation was not necessarily anticipated ten years ago. As financial markets were melting down and Ben Bernanke's Fed was beginning its unprecedented journey into quantitative easing, inflation alarm bells were ringing loudly. In October 2008, famed investor Jim Rogers warned of an "inflationary holocaust" and the demise of the U.S. dollar. Despite mild deflation in 2009 in the wake of the market crash, 10-year U.S. Treasury yields (which to a large degree reflect future inflation expectations) ended 2009 at 3.8%. (This was higher than they have ever been since and over 1% higher than current yields.)

More than a decade after "Helicopter Ben" fired up the printing presses, inflation remains quite low by historical standards.

Picture of a 100 trillion Zimbabwe Dollar note issued during the last days of hyperinflation during 2009 global financial crisis

As QE was rolled out, the price of gold bullion, considered by many an inflation hedge, continued its ascent that began in the early 2000s. From year end 2008 to its peak on September 5, 2011 at $1,900 per troy ounce, the gold price increased over 115%. (Gold today is more than 30% below those peak levels.) Cartoon images of Ben Bernanke throwing bags of money from a helicopter filled the pages of the financial press, and seemingly every other television commercial was advertising gold bars delivered to your door.

Collectively, we could perhaps be forgiven for having worried that aggressively dovish monetary policy—"money printing" as we still conceptualize it—would debase our paper currency and make things more expensive. How could it not? Yet, despite our worst fears, hyperinflation—along the lines of the Weimar Republic, or Zimbabwe during the Second Congo War— never arrived. Bernanke's successor, Janet Yellen, did not seem to have a good explanation. In 2017, she confessed that the lack of even mild inflation in the United States was "a mystery."

Monetary policy 101 – the received wisdom

Perhaps this is a good moment to revisit the relationship between monetary policy and inflation.

Conventional wisdom holds that easy money (low interest rates) translates into higher prices. How is this supposed to work? The transmission mechanism is typically described as follows: Central bankers cut interest rates, and demand is stimulated. It is now cheaper to borrow money, which is used for consumption and investment. Demand for goods and services increases, which drives up prices once economic slack is absorbed.

This demand-driven inflation narrative resonates with our own deeply ingrained mental models around human desire and excess. For millennia, moral authority figures have warned of the horrible consequences of overindulgence (consider the seven deadly sins: pride, greed, lust, envy, gluttony, wrath and sloth). Cutting interest rates is often likened to plying a child with candy. A little sugar is okay, but too much leads to hyperactivity and headaches (inflation)—the only solution is to put away the candy (raise rates).

In the United States, the excess demand story around inflation and interest rates dovetails neatly with our Puritan heritage. (H.L. Mencken wryly defined Puritanism as the "haunting fear that someone, somewhere, may be happy.") But Americans are also known for their pragmatism and deference to empirical evidence. Over the past ten years, empirical support for the story seems lacking, not just in the United States but throughout the developed world. In Europe and Japan, where we have seen sustained low short-term interest rates (even negative interest rates in some cases) paired with unconventional strategies to suppress long-term rates, inflation indices have remained stubbornly close to zero for many years. Could the notion that we just haven't seen the inflation yet—that the day of reckoning has not yet arrived, but we must continue to repent for our sins—perhaps be ringing a bit hollow a full decade later?

According to Neo-Fisherians, if we assume real rates of interest are stable, or at least generally independent of monetary policy, then by definition inflation rates must move in the direction of nominal interest rates.

Are we all Neo-Fisherians now?

Alternative interpretations of the interplay between interest rates and inflation have emerged and, from both a conceptual and real world perspective, merit some attention. These include the idea that higher interest rates may actually cause higher inflation (and that lowering rates is deflationary). Among the leading advocates of this position is Stephen Williamson, a visiting scholar at the Federal Reserve Bank of St. Louis, who has articulated the theoretical underpinnings of what he considers "Neo-Fisherite" thinking[1]. We encourage those interested to read his work directly, including this paper from 2018.[2]

Without wading too deeply into arcane academic questions, we would highlight what may be the key theoretical premise of the Neo-Fisherians: Real interest rates in an economy equate to nominal interest rates minus the inflation rate. If we assume real rates of interest are stable, or at least generally independent of monetary policy in the long run (a position which has significant support among economists), then by definition inflation rates must move in the direction of nominal interest rates[3]. Even for the layperson, it is a simple, straightforward and intuitive proposition.

An interest rate cut ripples all the way up the value chain and improves the cost structure of suppliers, suppliers to suppliers, and so on. An interest rate hike could have the opposite effect—increasing the cost of doing business for almost everyone in the economy.

As bottom-up investors and students of corporate behavior and competition, we can see how a direct (as opposed to inverse) relationship between interest rates and inflation works in practice. While low interest rates may stimulate demand, they also can have disinflationary impacts. Like corporate taxes, interest rates are an input cost, so a lower cost of debt, like lower taxes, should all else being equal translate into lower required prices for a business to earn its required return on equity. At the same time, lower risk free rates may reduce the required return on equity directly. Declining borrowing costs make it cheaper for a business to add capacity and, at least in the short term, improve the profitability of suppliers (who are able to recycle profits into expanding capacity). In this sense, an interest rate cut ripples all the way up the value chain and improves the cost structure of suppliers, suppliers to suppliers, and so on. An interest rate hike could have the opposite effect—increasing the cost of doing business for almost everyone in the economy. In competitive markets, prices are the mechanism through which businesses adjust for rising or falling production costs. As production costs, such as the cost of debt, rise, so should prices.

The emphasis conventionally placed on the demand side of the inflation dynamic, rather than the supply side, also runs counter to our own real-world observations across industries. In a flexible economy, it is the unavailability of supply or the cost of incremental supply that typically drives price changes, not changes in demand per se. When we see price increases occur at the companies we follow, they are very often driven by localized supply constraints or narrowly focused changes in production costs that affect a given industry. For example, we expect cement prices in Europe to rise materially this year as producers pass through higher electricity costs (resulting from environmental regulations). But volume growth should be mild at best.

Remembering the savers

Finally, we would note the almost singular attention paid to the improved financial position of the borrower within demand-focused inflation frameworks when it comes to the impact of lower interest rates on aggregate demand. But for every borrower paying lower interest rates, there is a lender earning less income. We shouldn't forget that for every improvident consumer being given an easier opportunity to spend money they don't have, there is also a prudent saver denied the opportunity to spend money they could have earned!

Throughout economic history, once sacrosanct ideas find their way to the dustbin.

The economist John Kenneth Galbraith famously quipped, "The only function of economic forecasting is to make astrology look respectable." If there is a legitimate dispute over an article of faith as widely accepted as the idea that you must hike interest rates to fight inflation, this raises important concerns for investors. It may disturb us, but it should not surprise us. In the 1930s, Keynesian tools were used in an effort to pull the U.S. economy out of the Great Depression. Some modern economists now suspect they only made matters considerably worse[4]. In the 1970s, the Phillips Curve, which posits an inverse relationship between unemployment and inflation, suffered a fall from grace following years of stagflation (although it nonetheless remains influential within orthodox views on inflation control).

Investors should try to prepare for and take advantage of macro volatility - not predict it.

Clearly, profound questions remain as to what set of macroeconomic conditions central bankers will face in the next decade, and how they should or will respond to them.

We would suggest drawing the following conclusions from this discussion:

1) **Be cautious on managers that rely too heavily on the macro** - Investment strategies that are driven by a manager's or investment committee's macroeconomic forecasts should be viewed with healthy skepticism. If we have learned anything from the economics experiment that was forced upon us by the Great Financial Crisis, it is that our practical understanding of even the most basic macroeconomic relationships remains imperfect, to say the least.

2) **Be prepared for policy mistakes** - If interest rates and inflation rates do not interact as central bankers generally think they do, the probability of a policy mistake in the future is arguably higher. If Neo-Fisherians are correct, one can imagine a scenario where central bankers attempt to cure inflation with policies that merely engender more inflation. The same risk applies to deflation, which might be more relevant in Europe and Japan.

3) **Focus on reasonably valued businesses that can thrive in all weather** - A bottom-up investment approach that focuses on competitively advantaged businesses that can survive and prosper under different macroeconomic conditions, paired with reasonable valuations, represents a sound strategy to preserve and compound wealth over time.

4) **Look for flexible and nimble investment solutions** - To the extent the global economy remains an untamed beast, beyond the control and perhaps even the basic understanding of policy makers, we should continue to expect bouts of volatility and episodic breakdowns in market confidence. An investment strategy that spans asset classes and does not have to be fully invested in risk assets at all times, particularly when valuations are stretched, can help protect capital in periods of market turmoil, while enabling investors to take advantage of attractive security prices that market dislocations can produce.

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1. Irving Fisher was an early 20th century "neoclassical" economist whose work heavily influenced monetarism.

2. https://research.stlouisfed.org/publications/review/2018/04/16/inflation-control-do-central-bankers-have-it-right.

3. A Federal Reserve Bank of New York staff report from September 2018, "Global Trends in Interest Rates," observes that real rates of interest around the world were "roughly stable at a bit below 2 percent for more than a hundred years… [but have] dropped significantly over the past three decades." The authors believe global growth and demographic trends have likely driven this decline. They also note that "country-specific trends [in real interest rates] have all but vanished since the 1970s." The latter is attributed to the greater ability of international investors to arbitrage away variations in real interest rates, leading to a global convergence. The report is available here: https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr866.pdf

4. UCLA economists Harold L. Cole and Lee E. Ohanian estimate that President Roosevelt's policies prolonged the Great Depression by seven years: http://newsroom.ucla.edu/releases/FDR-s-Policies-Prolonged-Depression-5409

Sources for all data: JOHCM/Bloomberg (unless otherwise stated).