



The Week

Gary Thayer, Chief Macro Strategist

Long-term inflation risks

In our opinion, investors need to be concerned about inflation for two reasons. First, in the short run, inflation can affect Federal Reserve policy and the financial markets. Second, in the long run, inflation can affect the purchasing power of savings and investments. We believe near-term inflation risks remain relatively modest. However, investors wanting to protect against the loss of purchasing power from long-term inflation may want to assume that inflation could be higher in the future than it has been recently.

History shows that investors' concerns about inflation tend to rise and fall with the markets. When commodity prices are rising as they have during the past several months, investors' concerns about inflation typically increase. Of course, markets do not go in only one direction. Last week, the commodity markets, especially the crude oil market and the silver market, dropped sharply, suggesting that the previous rapid increase in these markets was not sustainable. With the oil and metals markets pulling back, near-term fears of inflation may also recede a bit. However, the long-term risks of inflation are affected by long-term factors not short-term swings in the commodity markets.

Investors looking into the future need to remember that long-term inflation risks are tied to trends in population growth, economic development and the financial health of society. Population growth and economic development feed the demand for scarce resources driving prices upward. For example, the demand for resources from young emerging economies with significant population growth tends to rise more rapidly than the demand from mature industrial economies with slow growing populations. History shows that inflation responds to these long-term fundamentals over time.

Looking back, many investors probably remember inflation in the 1970s. Prices increased at a rapid pace in this period in part because the European and Japanese economies were finally recovered from World War II and were competitive with the U.S. economy. This pushed their currencies upward and the dollar downward. At the same

time, the post World War II baby boom came of age, creating a growing demand for goods and services. Unfortunately, the Federal Reserve worried that inflation would boost unemployment just when there were more people looking for work. Consequently, the Fed aggravated the inflation risk by pumping a lot of money into the economy, keeping interest rates low, in order to fight rising unemployment. This combination of easy money, rapid population growth and stronger economic growth caused the dollar to fall and inflation in the United States to increase to double-digit levels by the late 1970s and early 1980s.

Some but not all of these conditions exist again. Therefore, inflation could increase in the decade ahead but is unlikely to increase as much as it did in the 1970s. Today, economic growth is being fueled by development in emerging markets in Asia and Latin America not industrial Europe and Japan. This has the potential to increase inflationary pressures as the demand for food, energy and other resources increases. However, at the same time, many developed countries burdened by high government debt and aging populations will probably see more moderate demands for goods and services. This slower growth in the developed world will probably offset some inflation pressures from emerging countries. Equally important, central banks have learned that easy money is only appropriate when economies are weak and is not appropriate when economies are strong. Therefore, central banks in China, India, Brazil and now even Europe are starting to withdraw excess liquidity. This means that inflation is unlikely to get out of control even though it may trend higher in coming years.

Investors need to remember that short-term and long-term inflation expectations can be quite different. When commodity prices increase rapidly, as they have during the past few months, short-term inflation expectations can rise above long-term inflation expectations. But investors trying to anticipate future expenses need to look at long-term factors like population growth and economic development rather than short-term swings in the commodity markets.

At this point, the breakeven expected inflation rate between 10-year Treasury notes and 10-year inflation-protected Treasury securities suggests that investors believe U.S. inflation will average

2.49% during the next 10 years. Separately, the widely respected Philadelphia Federal Reserve survey of professional forecasters sees inflation averaging 2.3% during the next 10 years. We have been saying that investors trying to anticipate future expenses should assume a long-term inflation rate of 2.5%. This has been in line with the current market expectation and a little above the professional forecast rate. However, going forward investors may want to assume that inflation could be slightly higher than this 2.5% rate in order to provide a cushion against unexpected events that could cause inflation to run a bit higher than the long-term fundamentals would suggest.

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