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Inflate This

Astronomers generally believe that the universe was very compact until a cosmic explosion, the big-bang, took place, almost 14 billion years ago. Ever since the universe has been cooling and inflating. While that inflation may be good in astronomical terms, creditors and investors traditionally abhor that which destroys the value of their capital.

Some astronomers believe eventually the universe will stop expanding and then, over billions of years, it will deflate and once again become very compact only to set the stage of another big-bang. Six months ago, investors and creditors were fearful of deflation as the House of Finance imploded.

It appears that policy makers have been so successful in alleviating the fear of deflation that now aversion has returned to deflation. This has produced a profound effect on psychology and asset prices. The financial and economic crisis is a striking break from the Great Moderation of the past quarter century, where the business cycle looked tamed and the role of government seemed largely circumscribed. There appears to have been a parallel development in investor psychology. Expectations for growth, inflation and the dollar seem to show greater variance than usual.

Keeps 'em Up at Night

That said, in my unscientific survey of investors and money managers, what keeps them up at night is the fear of inflation. Some see inflation as a consequence of the monetary and fiscal policy mix. Others see a more sinister situation where a highly indebted government and private sector pursue inflationary policies as an expedient way to ease the debt burden and impose a stealth form of default.

The US reported both consumer and producer price indices in recent days, and given the anxiety, we should take a close look at the reports. Economists and policy makers often look at core inflation which excludes food and energy, not because they believe people do not consume these things, but rather, because they are traditionally volatile in the short-run. However headline inflation moves to core inflation overtime, rather than the other way around.

Core producer prices fell 0.1% in May. This was the first decline since October 2006. While the year-over-year headline rate has fallen 5%, the core rate has risen 3.0%. Yet there is reason to expect that in the coming months the headline rate may begin recovering, while the core rate eases. The rise in oil prices points to further increases in the energy component of the headline figure. At the core level, the pace of increase is already slowing sharply. Over the last six months, the pace of increase (on an annualized basis) has been halved and over the past three months, it has been flat.

Headline consumer prices rose 0.0096% in May while core consumer prices rose 0.0145% and they were both rounded to 0.1%. Headline consumer prices have fallen 1.3% over the past 12-months. With energy prices rising, the low point of inflation is behind us. Over the last three and six months, headline inflation is flat. At 1.8% the year-over-year core rate increase is spot on its six-month average.

The risk over the next couple of months is that the core rate eases. There are at least three considerations that point in that direction. First, and arguably the weakest of these considerations, is that the government's measure of auto prices showed an increase in May while auto sales remain weak and other indicators suggest that dealers are having problems clearing show rooms for next year's models. These reported price increases may be unwound. Second, a tobacco tax helped lift the core measure in March and April and this upward bias is no longer operating. Third, there is a benchmark effect. Last June and July core consumer prices rose 0.3% each month. These strong readings will likely be replaced with more moderate figures. Bottom line core CPI may fall to 1.5% if not below here in the third quarter.

Where's the Money?

Various credit spreads, like LIBOR-OIS and TED would suggest there has been a dramatic improvement in capital markets. The rally in the stock market points in the same direction and a handful of banks have returned TARP money. But the sad truth of the matter is that the deus ex machina of credit creation is still terribly impaired.

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And to appreciate this is partly to understand another reason why inflation fears are overstated. The Federal Reserve's balance sheet has expanded to $2.055 trillion from $871 billion last May. The expansion has been financed primarily in two ways: Extra Treasury bill issuance by the Treasury Department which is in essence given to the Fed, and by creating reserves, "printing money" in the vernacular. Therein is where many see the inflation risk.

The reserves in excess of what is required, hence they are called "excess reserves, are the fuel for inflation, the monetarists amongst us argue. The key though seems to be what the banks are doing with these reserves. The short answer: nothing. That is to say, that the banks are sitting on a virtual mountain of excess reserves which are kept with their creator, the Federal Reserve itself.

In the most recent two-week bank statement period, these excess reserves stood at almost $800 billion—yes, a little more than the entire TARP allocation. Prior to the crisis, excess reserves were minimal—a couple of billion dollars. What this means is that nearly two-thirds of the dramatic expansion of the Fed's balance sheet that so worries many investors is still with the Fed itself. It is not chasing assets or goods. It has not truly entered the circuit of capital. In essence, the inflation risk is being exaggerated because the "real effective" expansion of the Fed's balance sheet is being exaggerated.

FOMC

The Federal Reserve's Open Market Committee concludes a two-day meeting on Wednesday. There is no doubt that it will leave the Fed funds target at the current 0-25bp. To the extent that the market is really looking for anything from the accompanying statement it lies in two commitments by the Fed.

The first is the commitment to keep rates low for some time. Since late May the effective Fed funds average has drifted toward the upper end of the range. After recent meetings the FOMC has stated that it expected economic conditions to warrant a low level of Fed funds for an extended period of time. There is some talk that officials may want to reinforce this message by giving a timeframe, like some other central banks have done. It could say, for example, that it does not anticipate a rate hike before H2 2010.

The second is the commitment to buy $300 billion worth of Treasuries by the end of the third quarter. Even though the Fed is only half way toward fulfilling this commitment, there continues to be some expectation that the Fed could announce an increase in its purchases or otherwise extend the program. Otherwise it would seem to paint the Fed into a corner and raise expectations for the August FOMC meeting, the last one before it would finish its purchases.

Federal Reserve officials, however, need to drive home the point and, arguably, repeatedly, these purchases are not meant to target any particular interest rate. Surely some rise in interest rates must have been anticipated as the economy stopped its free-fall, the credit crisis eased, and the dreaded deflation dragon was beaten back. Meanwhile, the Fed has to tread carefully. The kind of signals that investors may be looking for to give some sense of an exit strategy may be undermined if the Fed announces an extension of its long-term asset purchases at the same time.

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