3-D: Deflation, Disinflation, and the Dollar

There are many things that investors should worry about with the US economy. The federal deficit and debt, coupled with the weak finances of many state and local governments, the increasing tax burden on a shrinking number of households, regulatory uncertainty, and weakness in bank credit may be on many lists.

One issue that investors (and policy makers) do not need to worry about in the foreseeable future is inflation. On the contrary, powerful deflationary forces continue to grip the economy. This, in turn, is allowing the Federal Reserve the degrees of freedom to avoid the temptation of taking away the proverbial punch bowl too early as was arguably done in the 1930s in the US and again by Japan in the 1990s.

The Real Decoupling

One of the striking developments over the past 6 to 9 months has been the dichotomy between the emergence of disinflationary forces among most of the industrialized countries and increased inflationary pressures in a number of developing countries. There are of course exceptions to this generalization. Australia and Norway, for example, have already increased interest rates. Canada is likely to join this select group in June or July. Sweden and New Zealand are also likely candidates for rate hikes in Q3.

Among developing countries, Israel, Malaysia, and India have hiked rates. China continues to make monetary conditions less accommodative, but has thus far stopped shy of a formal rate hike. Taiwan and South Korea are also unwinding their extra liquidity provisions. Brazil may be the next developing economy to hike rates. A 50 or 75 bp rate hike is likely at the next meeting toward the end of the month.

Nevertheless, in the US, euro zone disinflationary forces are evident, whereas Japan continues to experience deflation. In February, core CPI in the euro zone stood at 0.8% year-over-year. Last April it stood at 1.8%.

Like Japan, where CPI has been negative since January 2009, some parts of the euro zone are experiencing deflation. In Ireland, on an EU-harmonized basis, consumer prices were off 2.4% year-over-year in February, the 12th consecutive monthly decline. Spanish inflation has been negative for 7 of the past 12 months, while Portuguese inflation has been negative in 10 of the past 12 months.

Fire or Ice? Resolved

A year ago, there was a debate among investors and other market participants whether the policy response to the horrific financial and economic crisis was going to be sufficient to arrest the deflationary forces and generate inflationary pressures. We framed the issue around Robert Frost's poem Fire and Ice.

The issue has been resolved. Since the middle of 2008, inflation pressures in the US have been roughly halved. Headline CPI peaked in July 2008 at 5.6%. As of February 2010, it stood at 2.1%. Core CPI also peaked in mid-2008 at 2.5% and in February was 1.3%.

To understand the current inflation readings in a larger historical context, we note that since 1990, headline CPI has averaged 2.8% (year-over-year) and core CPI has averaged 2.1%. Current inflation readings have fallen below these long-term averages.

March CPI figures will be reported on April 14, and a 0.1% rise over February is expected. If so, in Q1 2010 would have seen a 0.3% rise in headline CPI. This is half the gain recorded in Q4 2009 and would be the smallest increase since the 3.4% collapse in Q3 2008.

It is Bigger than Your House

Some observers play down these deflationary forces, noting that the weakness in the real estate market, lower rent and owner's equivalent rent, thus concealing the true extent of inflation. These housing costs peaked in mid-Q1 2007 with a 12-month rate of change of 4.5%. As of February 2010, the 12-month increase has slowed to 0.3%.

However, a recent study by the San Francisco Federal Reserve cautions against dismissing the deflationary forces because of the collapse of house costs inflation. The study focused on the differences in the deflator for personal consumption expenditures (PCE), with and without the housing-related component. It concluded that the drag on the core PCE deflator from housing was a minor 0.2% on the year-over-year rate.

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The study argued that the decline in housing costs was not isolated, but reflected the larger deflationary forces. It noted that various items like luxury goods, jewelry, luggage, multimedia equipment and other highly discretionary prices, like hotel accommodations, have experienced disinflation or deflation. This conclusion was supported by an independent calculation by the Dallas Federal Reserve. It found that 45.2% of the products and services in the government's PCE price basket fell in February 2010.

Resource Utilization

The Federal Reserve has cited slack resource utilization as a reason to expect inflation to remain low. There are two dimensions to the resource utilization issue—labor and industry. We are all familiar with the slack in the labor market; the high percentage of people who have accepted part-time work due to economic necessity even though they desire full-time work; the long-term unemployed and the discouraged. The unemployment rate remains high. The high unemployment and under-employment helps contain wages and salaries, a key component of labor costs.

Low utilization rates are also evident in industry. Since 1990, the average capacity utilization rate in the US has been just below 80%. Prior to the crisis, the US utilization rate was near that long-term average. It collapsed to 68.3% in June 2009, before recovering in recent months, standing at 72.7% in February 2010.

Yet even this exaggerates the utilization rate of American factories. There are three elements to US industrial output and capacity utilization rates: mining, utilities and manufacturing. The former are operating at higher utilization levels than manufacturing. The utilization rate in manufacturing has averaged 78.4% since 1990. It was just above there in late 2007 and collapsed to almost 65% by mid-2009. In February it stood at 69%.

Expectations

The Federal Reserve explained that it monitors resource utilization, inflation expectations and actual inflation to judge whether its monetary stance is appropriate. It appears that market indicators like the steepness of the 2-10 year yield curve, which is near record levels, or the 5-year/5-year forward, which at about 262 bp is almost 30 bp above its average since 1990 may point to some increase in inflation worries.

A separate study by the Dallas Fed recently found that market-based measures of inflation expectations are fundamentally flawed. There is the real rate and some premium. While the premium could be influenced by inflation concerns, there are other types of risk as well. Distinguishing among the various factors is difficult to do. Carlos E.J.M. Zarazaga, the author of the Fed study, wrote, "The disturbing property of risk premia that move around over time is that they can severely distort popular inflation-expectations indicators."

Nevertheless, by looking at surveys as well as market indicators, such as the break-even rates between conventional Treasuries and inflation-protected securities of the same duration, reasonable people, including those at the Federal Reserve, can conclude as the FOMC did last month that inflation expectations are stable.

Conclusion and Dollar Implication

As long as resource utilization rises slowly and inflation expectations, broadly understood, remain within already established ranges, and actual measured inflation and core inflation remains low, there is no urgency on the part of the Federal Reserve to hike interest rates. There is some risk that the ECB is under-estimating the deflationary forces in Europe.

The rise in US bond yields over the last six months or so appears to be a result of the increase in real interest rates. This rise likely reflects some combination of supply issues and a broadening and deepening of the US economic recovery.

One fundamental weight on the dollar had been that the interest rate differentials meant that investors were paid to be short the greenback. However, the rise in US interest rates in both the short and long-ends of the curve alters that incentive structure and we expect this to continue to give the dollar traction on a trend basis for some time. While the hike in the Fed funds rate is likely to be delivered after we initially thought (we had an August hike penciled in since the middle of last year), we still think the Fed will raise rates before the ECB, BOE, or BOJ.

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