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ASSET MANAGEMENT

Inflation versus deflation: the Standish debate



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Standish is based in Boston, with offices in Pittsburgh and San Francisco, USA. Standish is one of the world's largest dedicated fixed-income managers with capabilities in absolute return and hedge funds, high yield and emerging market debt and structured products.



Despite the extraordinary monetary stimulus from the Federal Reserve (Fed) and massive spending programmes from the US federal government (this year's federal government deficit is about 12% of GDP), we argue that deflation, and not inflation, should be our immediate major concern. The inflation versus deflation debate consists of the monetarists view against two fundamental opposing issues: the 'output gap model' and the impact of the Fed now paying interest on bank reserves.

The output gap

Output gap analysis would suggest that inflation is caused by an excess of aggregate demand at or near the full employment level of output. In a booming economy, with aggregate demand pushing the unemployment rate below full employment, an economy's actual output (GDP) exceeds its potential, and the output gap is positive, with resources stretched leading to inflationary pressures. Conversely, in a recession, with excess manufacturing capacity and excess labour available, the output gap is negative, resulting in low inflation or even deflation.

The US currently has a large negative output gap following a significant negative demand shock combined with the massive expansion of the global supply chain. Past relationships based on output gap analysis and the concept of the 'non-accelerating

inflation rate of unemployment' (NAIRU) which is the low threshold level of unemployment consistent with stable prices implies a drop in core inflation. The Congressional Budget Office estimates NAIRU to be 5%. The gap today between the actual unemployment rate and NAIRU is well over 4%. Central banks focus on both the unemployment rate and the output gap as they are very well correlated with inflation. Past relationships imply that core inflation could drop by 2% to 3% over the next year. That would bring the US squarely into deflationary territory.

Unit labour costs

The US has an unemployment rate of 10% which is extremely high by historical standards. This has important repercussions on future unit labour costs which are a critical driver of inflation. If we examine the level of employment at the start of each of the past five recessions, we can see that with each successive recession it took much longer to get back to the previous level of employment. A real risk for the current expansion is how long it will ultimately take to reclaim all of those lost jobs. Will it take as long as the four years following the 2001 recession? We expect the large amount of excess labour supply to exert a substantial amount of downward pressure on wages. As a result, unit labour costs - the compensation per hour divided by output per hour - will probably decline and drive core inflation rates lower.

Supply side

As to the monetarist argument, while there may be a lot of money being created by the Fed, if inflation is too much money chasing too few goods, then the argument for inflation falls down on the supply side. There are 'not too few' goods – just the opposite. There is an excess global supply of goods. Moreover, the US household sector, accounting for a historically high 70% of GDP, has seen debt relative to income rise from 60% to 130%. For many years the global economy has been free-riding on the back of the indebted US consumer. Is there another region or buyer able to absorb the massive amount of goods typically exported to the US as the American consumer retrenches?

The implications of interest on Fed deposits

One other important argument against the monetarist viewpoint of inflation is the nature of any increase in the money supply. Balance sheets need to balance. The offsetting increase in the Fed's assets has come in the form of bank reserves,

which are a liability of the Fed, and accounts for the bulk of its recent money creation. The Fed has credited bank reserves by over US\$800 billion in the last nine months, but where is this money going? For reasons of both perception and reality, banks need to show capital strength. Banks are not deposit constrained, but they are capital constrained from making new loans. In a normal fractional reserve banking system, these deposits might be loaned out ten to one. That money multiplier could theoretically result in US\$8 trillion in new loans. While there is no doubt that in a US\$14 trillion economy that would be inflationary, it is not occurring. Moreover, the Fed can now pay interest on those deposits so it can easily raise short-term interest rates and keep those reserves from multiplying into new loans.

Risks remain

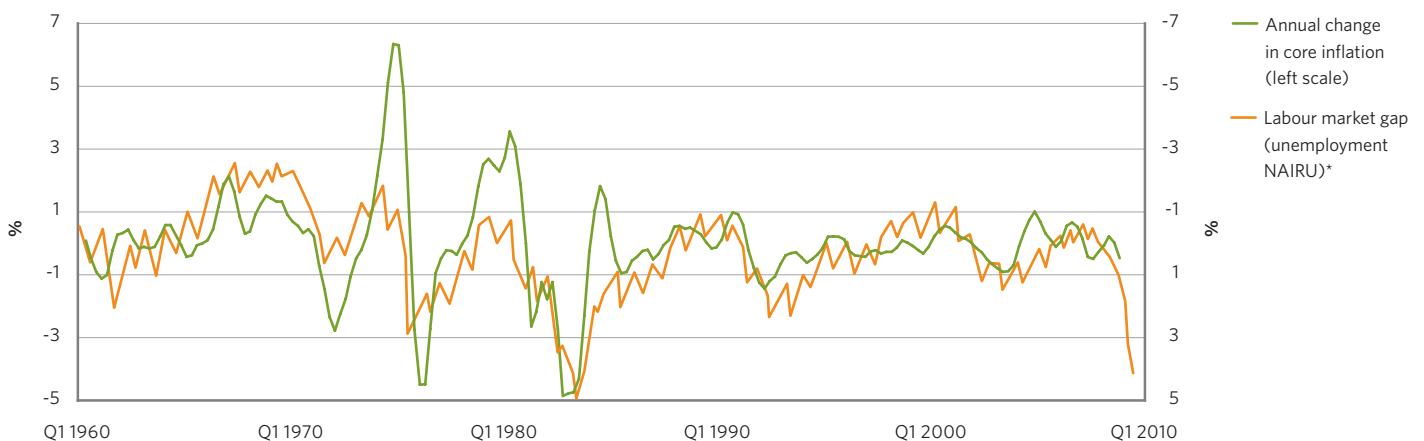
The main distinction between the deflation and inflation arguments may be one of timing. Over the next two to three years, given the economic backdrop, our base

case expectation is for inflation to hover close to zero for a number of years. We just think investors should focus on the immediate risk of deflation.

Beyond that, the danger of a policy mistake leading to higher inflation remains. The recent lack of independence of the Fed and the sheer magnitude of government involvement in markets and the economy give rise for concern. The probability of a policy mistake – too much spending, too little restraint, for too long a period – is high and could lead ultimately to higher inflation.

Over the long term, we believe that the spirit of innovation in the US will enable it to solve some of its government liability problems not only by a reduction in payments, but also through growth. In 1995, Canada had foreign debt to GDP of over 100% while today it is down to 65%. There are many examples of countries redirecting their liabilities without resorting to hyperinflation. Ultimately, we believe the US will be able to do the same.

THE UNEMPLOYMENT GAP AND CHANGE IN INFLATION



Source: Datastream, as of 31 August 2009 * Advanced 2 Quarters

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