WHY INFLATION REMAINS AWOL

Societal Aging, Technology, Aggregate Debt And Monetary Policy Keep Lid On Tight

By Scott Colbert, CFA®

We believed for some time that inflation was likely to continue trending downward. Undeniably, it remains surprisingly modest, even with the recent influx of trillions of dollars of government stimulus during the pandemic.

Some refer to inflationary trends related to the recent shock to the global economy due to the coronavirus as a "rich person's" problem in the near-term, but the specter of runaway inflation down the road can affect societies across the board.

In general, inflation has been trending downward globally and in the United States due to four primary factors:

1) DEMOGRAPHICS – As societies age they generally rotate from a consumption phase, through an investment period, and ultimately to savings, as people focus on retirement. This behavior tends to pull inflation down. We've seen this in Japan with the world's oldest average population (approximately 48 years) and year-over-year inflation of just 0.5% for the past 10 years. This was followed by Europe's (43-year average age) and 1.5% inflation, and ours in the United States (average age of 38 years) with trailing 10-year inflation of 1.7% as measured by the Consumer Price Index (CPI). We'd also note that China's population, while younger on average than that of the United States, is aging rapidly given their unique one-child policy. Simply put, as societies age, inflation tends to fall. As Japan went, so did Europe, and we are simply following in their footsteps here in the United States.

2) TECHNOLOGY – Technological development has kept prices at bay for multiple reasons, the most obvious being the substitution of direct U.S. labor with equipment and software. This in turn keeps domestic business costs constrained, since labor is the largest cost of production. More recent technology afforded almost unlimited access to overseas labor as well, with value-added design done in developed countries while the manufacturing and assembly of products (and even services) are provided by cheaper, emerging market labor. Technology applied through the "Amazonation" and "Walmartization" of the purchasing experience have kept prices down via competition. Technology even changed a commodity like oil, as fracking (more applied technology) uncovered more petroleum supply than need demanded. This in turn lowered the price to transport goods around the world through an ever more efficient transportation system (including giant cargo container ships, a faster rail system and cheap diesel fuel for trucks).

3) AGGREGATE DEBT – There is no free lunch, although it may feel that way today since the United States can borrow money for ten years at much less than 1%. Yet each incremental bit of deficit spending tends to provide less forward momentum, with a weaker multiplier in terms of future economic growth. Indeed, some argue that the current multiplier might actually be tipping toward the negative. Aggregate Federal debt to GDP bottomed around 30% in 1980 and has grown consistently for most of the last four decades, reaching 107% just prior to all of the recent fiscal stimulus provided to offset the coronavirus-inspired recession. In essence, we have been borrowing our prosperity forward. As such, each incremental expansion has been less and less forceful, offsetting any bounce-back in inflation.

4) RELATIVELY RESTRICTIVE MONETARY POLICY – Prior to the Great Recession of 2008, monetary policy in the United States had been restrictive as the Federal Reserve (Fed) attempted to wring inflation out of an economy that had been so damaged by stagflation in the 1970s. Within that time, real yields on overnight bank loans averaged a positive 2.5%, affording investors a positive inflation- adjusted return simply by saving cash from 1980 to 2008. More savings generally equals less spending and less inflationary push. This was the opposite of the 1970s when an overly accommodative monetary policy used to dampen OPEC-driven oil price shocks resulted in an inflationary spiral that encouraged further consumption since cash was being eaten away by rising prices.

So, has anything changed regarding forces affecting future inflation? Yes and no.

From a **demographic perspective**, we certainly continue to age. And in recessions birth rates typically decline, accelerating our aging trend ever more. **Technology** continues to become a larger part of the economy while the pandemic accelerated the importance of those mega-cap tech companies like Amazon, Apple, Google, etc. And **Aggregate debt** continues to explode as recent fiscal stimulus pushes our Federal debt to GDP ratio closer to 1.25 times, weighing down future growth potential.

The factor **that has changed over the last 12 years is monetary policy.** Clearly the Fed was very accommodative during the last Great Recession, driving interest rates down to near zero for the seven years and implementing "Quantitative Easing" for the first time in modern history. And they are right back at it today with even more ferocity. An alacritous Fed has once again boosted the money supply via Quantitative Easing. "Helicopter money" has been spread via deficit spending as nearly $3 trillion in direct transfer payments to individuals, businesses, health care providers and local governments gets absorbed.

All of that helped keep the initial shock of deflation at bay. In April, we saw the lowest monthly CPI report ever (-0.8%) followed by July's strong positive rebound of 0.6% (the largest monthly gain since 1991). On a year-over-year basis, the CPI low-water mark during the last Great Recession was a deflationary -2.1%. But this time, rapid accommodative monetary and stimulative fiscal policy combined to nip deflationary forces in the bud. Even though the current recession was more than twice as deep as any previous recession, the low tick on yearly inflation remained a positive 0.1%, and currently stands at a resilient 1%.

Despite this recent bounce back in inflation, most of the secular "dis-inflationary" forces remain intact. And since the Fed has an inflationary target of 2%, we are likely to see continued accommodative monetary policy for the foreseeable future, especially since inflation undershot its target for the past decade. So even if we get a further upward surprise in near-term prices, don't lose sight of the secular forces that remain in place likely keeping a lid on the longer-term inflation.

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