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SHOULD WE BE WORRIED ABOUT INFLATION?

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Since the start of the pandemic, the Federal Reserve and Washington DC policymakers have injected unprecedented amounts of liquidity into the US economy. In recent weeks, clients have unsurprisingly asked the professionals at WT Wealth Management about inflation. Knowing how to understand inflation is important, especially for retirees, as anything that would impact purchasing power could also impact retirement lifestyle.

Old school Wall Street veterans, economists, and academics usually believe that injecting easy money into the US economy, combined with low-interest rates, leads to inflation.

But let's take a look back at the Fed Funds rate (defined as the interest rate at which banks lend uncollateralized, overnight funds to each other) to see what we can learn. During the financial crisis of 2008 & 2009, the Federal Reserve brought the Fed Funds Rate to 0.25%. It stayed there from 2008 until 2015 when it was moved 0.25% higher. Over those seven years, the average inflation rate was 1.39%. So, where was the predicted inflation after seven years of near-zero interest rates? It's a good question we'll answer later.

Inflation 2000-2020 [1]

Since that first rate increase in December of 2015, the Fed moved rates higher a total of nine times over the next three years in an effort to "normalize" interest rates and finally reached a range of 2.25% to 2.50% by December of 2018. Because the Fed Funds rate since 1990 averaged 4%, many would consider the entire period from December of 2008 through December of 2018 to be an easy monetary policy stance period.[2] However, from 2009 through 2019 the average inflation rate remained still very low at 1.58%.

YEAR	JAN	FEB	MAR	APR	MAY	JUN	JULY	AUG	SEPT	OCT	NOV	DEC	AVE
2020	2.49%	2.33%	1.54%	0.33%	0.12%	0.65%	0.99%						
2019	1.55%	1.52%	1.86%	2.00%	1.79%	1.65%	1.81%	1.75%	1.71%	1.76%	2.05%	2.29%	1.81%
2018	2.07%	2.21%	2.36%	2.46%	2.80%	2.87%	2.95%	2.70%	2.28%	2.52%	2.18%	1.91%	2.44%
2017	2.50%	2.74%	2.38%	2.20%	1.87%	1.63%	1.73%	1.94%	2.23%	2.04%	2.20%	2.11%	2.13%
2016	1.37%	1.02%	0.85%	1.13%	1.02%	1.00%	0.83%	1.06%	1.46%	1.64%	1.69%	2.07%	1.26%
2015	-0.09%	-0.03%	-0.07%	-0.20%	-0.04%	0.12%	0.17%	0.20%	-0.04%	0.17%	0.50%	0.73%	0.12%
2014	1.58%	1.13%	1.51%	1.95%	2.13%	2.07%	1.99%	1.70%	1.66%	1.66%	1.32%	0.76%	1.62%
2013	1.59%	1.98%	1.47%	1.06%	1.36%	1.75%	1.96%	1.52%	1.18%	0.96%	1.24%	1.50%	1.47%
2012	2.93%	2.87%	2.65%	2.30%	1.70%	1.66%	1.41%	1.69%	1.99%	2.16%	1.76%	1.74%	2.07%
2011	1.63%	2.11%	2.68%	3.16%	3.57%	3.56%	3.63%	3.77%	3.87%	3.53%	3.39%	2.96%	3.16%
2010	2.63%	2.14%	2.31%	2.24%	2.02%	1.05%	1.24%	1.15%	1.14%	1.17%	1.14%	1.50%	1.64%
2009	0.03%	0.24%	-0.38%	-0.74%	-1.28%	-1.43%	-2.10%	-1.48%	-1.29%	-0.18%	1.84%	2.72%	-0.34%
2008	4.28%	4.03%	3.98%	3.94%	4.18%	5.02%	5.60%	5.37%	4.94%	3.66%	1.07%	0.09%	3.85%
2007	2.08%	2.42%	2.78%	2.57%	2.69%	2.69%	2.36%	1.97%	2.76%	3.54%	4.31%	4.08%	2.85%
2006	3.99%	3.60%	3.36%	3.55%	4.17%	4.32%	4.15%	3.82%	2.06%	1.31%	1.97%	2.54%	3.24%
2005	2.97%	3.01%	3.15%	3.51%	2.80%	2.53%	3.17%	3.64%	4.69%	4.35%	3.46%	3.42%	3.39%
2004	1.93%	1.69%	1.74%	2.29%	3.05%	3.27%	2.99%	2.65%	2.54%	3.19%	3.52%	3.26%	2.68%
2003	2.60%	2.98%	3.02%	2.22%	2.06%	2.11%	2.11%	2.16%	2.32%	2.04%	1.77%	1.88%	2.27%
2002	1.14%	1.14%	1.48%	1.64%	1.18%	1.07%	1.46%	1.80%	1.51%	2.03%	2.20%	2.38%	1.59%
2001	3.73%	3.53%	2.92%	3.27%	3.62%	3.25%	2.72%	2.72%	2.65%	2.13%	1.90%	1.55%	2.83%
2000	2.74%	3.22%	3.76%	3.07%	3.19%	3.73%	3.66%	3.41%	3.45%	3.45%	3.45%	3.39%	3.38%

Over the past decade, there has been an ongoing struggle to regulate inflation and move it towards the Fed's medium-term target of 2%. Many economists live with the persistent fear that if some moderate level of inflation is not present in the US economy, deflation could occur. Price erosion is far worse than inflation, as it would immediately decrease consumer sentiment. Spending would decline, because consumers would hope to be able to pay less for something in the future than they would today. They inevitably would put off spending on consumer items, both large and small, and a recession would surely follow.

What is the Federal Reserve's Inflation Target?

The Federal Reserve believes that a 2% annual inflation rate over the long-term is the best way to maintain maximum employment and price stability. Higher rates of inflation over time erode purchasing power as wage inflation always lags price inflation. Conversely, deflation would lead to the previously mentioned unstable or falling prices, and create a weaker economy. Consumer spending would be deferred, with wages potentially falling, as employers struggle to maintain profitability. Either of these extremes would create a need for additional economic policy intervention.

The fact that 2% has been the Fed's inflation target in the past doesn't mean that it will be the goal indefinitely. There has been a recent debate on this topic. The low growth rates in the last years have the agency, and even central bankers in Great Britain, Europe, and Japan re-thinking their inflation goals. Some believe that raising the inflation target to 3% or 4% will give more room for nominal interest rates to rise without stifling economic growth.

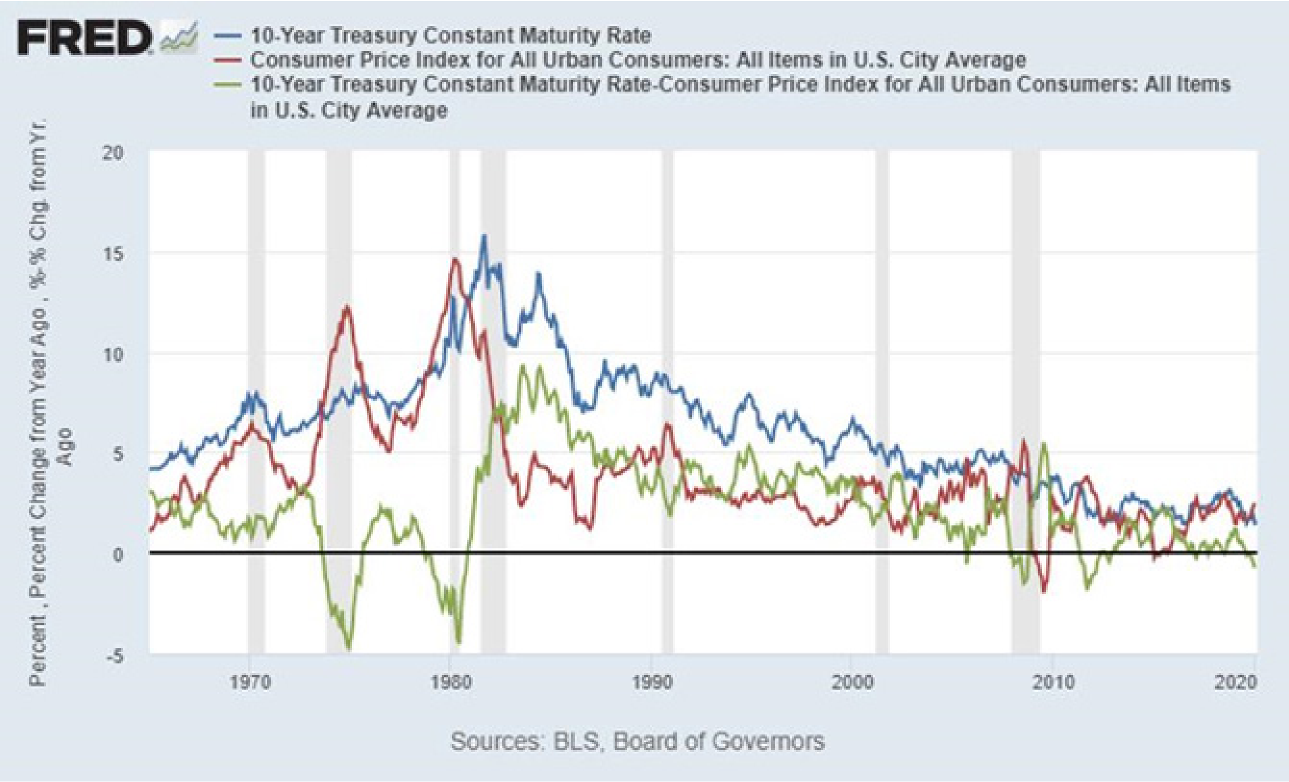
What the Future Holds for U.S. Inflation

Talk of the Fed and other central banks raising their inflation targets is still a debate topic today. The truth is that just getting and keeping inflation at the current 2% target seems a difficult enough task. That being said, Federal Reserve officials seem determined to get the inflation rate above their 2% long-term target.

As recently as December, New York Fed President John C. Williams stated that labor figures appear to indicate "full employment," and he expects both wage gains and inflation to rebound in the coming year. Then the pandemic hit and everything changed.

At the beginning of this paper, we asked the question: "where was the predicted inflation from 2008 to 2015 after seven years of near-zero interest rates?" In our opinion, technology has streamlined many industries and has automated or made more efficient many daily personal and business tasks. That phenomenon has become a driver of the low inflation we have been experiencing in the past 15 years. Inflationary tendencies in our day have been tempered by improving technology efficiencies.

In the chart below, history shows that a low interest rate environment (blue line) indeed need not be accompanied by high inflation (red line). As rates have declined steadily lower since the early 1980's, inflation has also declined.



The apparent results are counterintuitive to the long-standing opinion that lower rates -- and thus borrowing costs -- could increase both the consumer and business appetite to take on debt with the end result being increased prices (i.e. inflation).

In addition, it does not appear that a decade of low interest rates and “quantitative easing” programs from the Federal Reserve after the 2008-09 financial crisis and, what was then, the largest government bailout of the financial service and banking industry ($700 billion) resulted in measurable price increases to consumers.

Is inflation a fear?

At WT Wealth Management, we have a moderate near-term or medium-term fear of inflation. We are taking a wait and see approach.

The current unemployment rate is in the low/mid-teens, and there is a slow recovery for many businesses in the hospitality, food, and travel industries. We feel inflation is worth watching due to the unprecedented amount of stimulus. However, until we see some actual rise in inflation rates, we will assume the low inflation trend will continue.

SOURCES

(1) *https://inflationdata.com/Inflation/Inflation_Rate/HistoricalInflation.aspx*

(2) *http://www.fedprimerate.com/fedfundsrate/federal_funds_rate_history.htm*

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