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Do You Remember Inflation?

Global Markets and Regions

	2st QTR	2014 YTD
US	5.2%	7.1%
Developed Europe	3.7%	5.9%
Asia	7.0%	3.8%
Emerging Markets	6.7%	6.3%

US Markets

	2st QTR	2014 YTD
Dow 30	2.8%	2.7%
Large Cap Cos.	5.2%	7.1%
Mid. Cap Cos.	4.3%	7.3%
Small Cap Cos.	2.1%	3.3%
Bonds	2.3%	3.4%

The “I” word is back. Where you might ask? Have you booked a flight or hotel room recently? The price of gasoline has been consistently close to $4.00 a gallon. Commodities of all types from food to raw materials have seen upward price pressures. But is it a bad thing? I’m not referring to that persistent double digit variety that those of us of a certain age can still remember. Inflation has been essentially non-existent as an investment theme for several years. Central banks have been working hard the last few years to actually create inflation for fear that the alternative, deflation, would result in a serious contraction of economic activity. The economy stagnates or even contracts as everyone does less waiting for lower prices. Shoppers spend less, businesses invest and build less and government collects less taxes.

The resulting unemployment and social disruption from this kind of general slowdown is the outcome to be avoided. Deflation was at the center of the Great Depression. We all know the Great Depression was bad. Just ask your grandparents how bad it was. In the most recent Great Recession deflation was the target of all the bailouts and stimulus actions. It appears the Central Banks around the world have been able to stave off that outcome. But now what?

The US Federal Reserve has focused on the unemployment rate and wage growth as determinates of future Fed policy, from asset purchases to interest rate hikes. Recent employment reports are showing signs of movement in the direction they would like to see. What will they do next and what will it mean for investors?

Modest inflation is actually good for investors. It supports asset prices. Stocks and home prices have been the most obvious beneficiaries of this modest inflation over the last few years. The Central Banks suppression of interest rates hasn’t necessarily been a good thing for savers. Witness the low rates paid on bank deposits, CDs and bonds. It has kept governments from defaulting and banks from failing. It has allowed companies to borrow cheaply and home owners to refinance or buy new homes. Even the ranks of first time home buyers are beginning to stir again.

Aggressive Central Bank monetary policies were first aimed at Governments to avoid sovereign defaults. They are now being aimed at banks to encourage lending and somehow create self-reinforcing economic growth. Ideally, it would be through more investment by business that would stimulate job and wage growth and thus consumption. Banks are showing signs of lending aggressively again. Credit card and car loan applications are rising again, which will lead to more consumption. All of which have kept deflation at bay and all of its attendant bad outcomes.

If a little bit of inflation is a good thing, what about a little bit more? If prices begin to rise will wages be far behind? Rising wages are a good thing aren’t they? Maybe that’s why governments all over the country are raising minimum wages. More workers with more money in their pockets will make it easier for businesses to increase sales and raise prices and expand profits. Is this a great country or what? I hope this inflation thing doesn’t get out of control. That might not be such a good thing.