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Is Inflation Inevitable?

Overview: The significant amount of stimulus being injected into the economy may have investors wondering what this will mean for inflation. The following discusses why inflation fears may be premature.

One of the most frequently asked questions regarding the stimulus being pumped into the economy is: What should we do about the resulting inflation problem we are going to face? While there is risk that the massive budget deficits and the monetary stimulus will translate into rising inflation, this outcome is not inevitable. One only has to look to Japan to see that inflation is not inevitable.

In 1990, the Japanese economy went into a tailspin. The stock market and real estate values collapsed, and the Japanese government took action by both adopting a zero interest rate policy and also embarking on a program of massive fiscal stimulus, including significant spending on infrastructure. The Japanese government ran large budget deficits, and the result is that the country's debt to gross national product ratio is nearly 200 percent. Yet despite the monetary and fiscal stimulus, the biggest concern for Japan has not been inflation, but deflation.

Regarding the United States, the velocity of money has been falling due to a rapid drop in spending. To offset the sharp drop in money velocity, the money supply must be increased, or the economy would collapse. And with banks, corporations and consumers deleveraging, the government is the only one left to offset deleveraging's negative effects (hence the fiscal stimulus).

Because of the collapse of consumer and business spending, there is no real threat of inflation in the short term. (In fact, the greater risk is deflation.) However, once the economy recovers and the velocity of money increases, the Federal Reserve will need to remove the excess liquidity it has injected, or inflation will soar. Hopefully, the Fed has learned from the mistakes of 2003, when it kept the real federal funds rate in negative territory. (The nominal rate remained at 1 percent while inflation was 2 percent, and the economy was already recovering from the recession.)

The need for fixed income investments remains unchanged. Investors should consider owning TIPS and high-quality, short- to intermediate-term securities to minimize the risks of unexpected inflation. In addition, TIPS provide the added benefit of having negative correlation to equities. Investors can also consider a small allocation to commodities through an investment in fully collateralized commodity futures as an inflation hedge. Commodities tend to have their best performance during periods of rising inflation.

Summary

While the size of the stimulus employed to counter the effects of the severe recession increases the risks of inflation, the Japanese experience demonstrates that the outcome is far from certain. Thus, investors should be wary about reacting to the noise from the “talking heads” advising them to alter their well-designed plans. Investors should check with their advisors to see how their investment plan is designed to address inflation fears. For those who are not adequately prepared for inflation possibilities, they should consider tailoring their fixed income allocations to address that need.

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