

## The Inflation Threat

*If the public comes to believe that the Fed will not do what is necessary to preserve price stability—then inflation can rise quickly regardless of the amount of so-called slack in the economy.*

—Charles Plosser, president of the Federal Reserve Bank of Philadelphia

*Throughout history, what the political class has done is they have turned to the central bank to print their way out of an unfunded liability. We can't let that happen. That's when you open the floodgates.*

—Richard Fisher, president of the Federal Reserve Bank of Dallas

*The Federal Reserve will not monetize the debt.* —Ben Bernanke, Federal Reserve chairman

On the evils of inflation, economists generally agree. On its causes, however, division predominates, and since the Federal Reserve's extraordinary rescue measures began in 2008, economists have disagreed sharply over the likelihood of its return. The 1970s revealed much about the source of inflation, and a broad consensus now exists that excessively loose monetary policy can be at least a contributing factor. Chairman Bernanke has, nevertheless, assured the public that quantitative easing (QE) won't generate pricing pressures that are "super ordinary." Many others disagree, recalling economist Milton Friedman's maxim that inflation is "always and everywhere a monetary phenomenon."

The next few years may serve to resolve this disagreement, but in light of the battle over the 2012 federal budget, the next few months could be critical. Investors may soon learn whether the Fed can continue to ease without endangering its credibility and whether the public's expectations of low inflation are about to become "unanchored."

Offering their views on the prospects of a return to high inflation are **Lord Abbett Partners Zane Brown, Fixed Income Strategist; Milton Ezrati, Senior Economist and Market Strategist;** and **Walter Prah, Director of Quantitative Research.**

### HAS THE MATCH BEEN LIT?

Fears of inflation began to emerge with the unprecedented size and scope of the fiscal and monetary measures taken in response to the credit crisis. These measures amounted to 18% and 11.9% of gross domestic product (GDP), respectively, according to *Grant's Interest Rate Observer*, for a total of nearly 30%.<sup>1</sup>

Putting these figures into perspective, *Grant's* estimates that fiscal and monetary efforts to fight the Great Depression amounted to only 8% of GDP. Measures taken to counter the 1969–70 slump came to 2.7% of GDP, and fighting the 1973–75 recession cost 4% of GDP.<sup>2</sup>

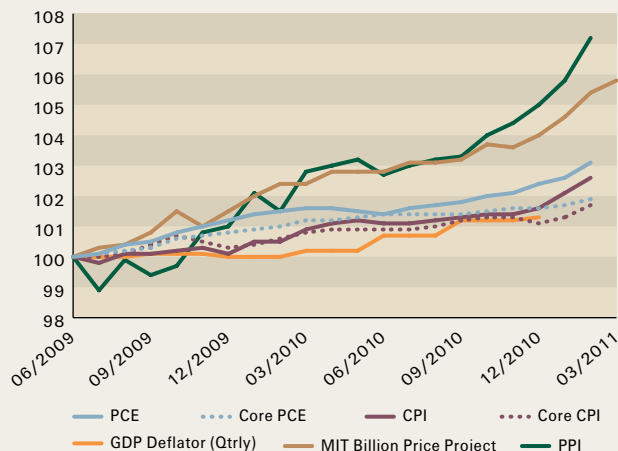
Of monetary policy and fiscal policy, monetary is more troubling. The link between inflation and money supply as measured by M1<sup>3</sup> is particularly evident. Historically, accelerations in the M1 have always led to rises in the Consumer Price Index (CPI),<sup>4</sup> though with varying lag periods, said Milton Ezrati, Lord Abbett Partner, Senior Economist and Market Strategist. "History shows that such activities, if they go on too long, will lead to inflation," he added.

A surge in M1 in the 1960s, for example, was followed by high inflation in the late 1970s, while moderate money growth in the early 1980s reduced inflation to comfortable levels. A temporary money surge late in the 1980s caused inflationary pressures to rise in the early 1990s. This pressure waned in response to moderate expansion of M1 later in the 1990s. And from 2005 to 2008, inflation rose again following an uptick in money growth between 2001 and 2004, Ezrati said.

Allan Meltzer, a professor at Carnegie Mellon University and acknowledged authority on the history of the Federal Reserve, argues that "sustained inflation always follows increases in money-supply growth. Sustaining negative real interest rates [i.e., adjusted for inflation], as we have now, will cause this."<sup>5</sup>

"The triggering event," he said, prior to the Fed's second round of quantitative easing, which began in November 2010, "will be either a sustained increase in bank lending or a large increase in Fed purchases of government debt. Either one would trigger a sustained increase in money growth."<sup>6</sup>

## Frequently Cited Inflation Measures



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, and MIT Billion Price Project.

**Personal Consumption Expenditures (PCE):** This measure, along with the Core PCE, is said to be the preferred inflation measure of the Federal Open Market Committee (FOMC).<sup>\*</sup> The PCE measures the price changes in consumer goods and services. The measure consists of actual household expenditures, rather than a predetermined basket of goods and services. The **Core PCE** excludes food and energy prices.

**Consumer Price Index (CPI):** Changes in the CPI are used to assess price changes associated with the cost of living, such as those provided by Social Security benefits, as well as adjustments to the principal on Treasury Inflation-Protected Securities (TIPS). The CPI is calculated by taking price changes for each item in a predetermined basket of goods and services, which may change over time. The inputs of these goods and services are weighted according to their importance to consumers. The **Core CPI** excludes food and energy prices.

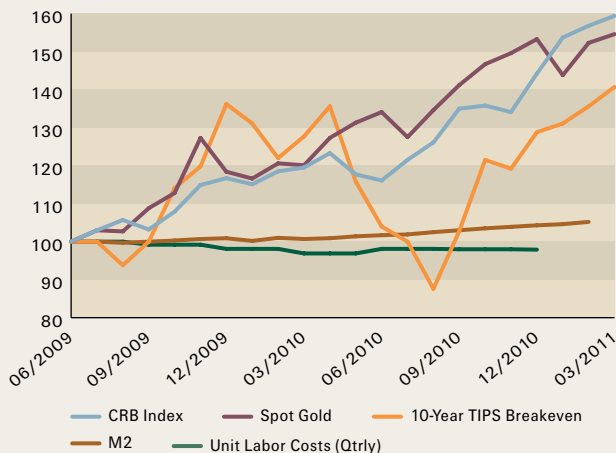
**Gross Domestic Product (GDP) Implicit Price Deflator:** The GDP deflator is published quarterly and measures the prices of all goods and services produced domestically, thus excluding imports.

**Massachusetts Institute of Technology (MIT) Billion Price Project:** The project's daily online price index measures price changes across the Websites of multiple retailers in several different categories, rather than prices in physical retail locations. The index uses a basket of goods that changes with the products and services offered on retailers' Websites.

**Producer Price Index (PPI):** An indicator of inflation at the wholesale level. The index tracks changes in the selling prices received by domestic producers for crude, intermediate, and finished goods.

<sup>\*</sup> "Monetary Policy Report to the Congress Pursuant to the Full Employment and Balanced Growth Act of 1978," February 17, 2000.

## Leading Indicators of Inflation



Source: Bureau of Labor Statistics, Federal Reserve, and Bloomberg.

**Commodity Research Board (CRB) Index:** Commodity prices are considered by many to be a signal of coming inflation. The CRB Index measures the movements of 22 basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions. Rising commodity prices could also lead to higher inflation expectations, which could have a self-reinforcing effect in pushing prices higher. On the other hand, others believe that if food and fuel, for instance, are more expensive, that can curtail consumer spending on other goods and services, which could eventually lead to economic stagnation and an environment of low inflation.

**Spot gold price:** Of all commodities, gold is considered preeminent as an indicator of, and hedge against, inflationary pressure. The spot gold price measures the current, dollar-denominated price for a troy ounce of gold.

**10-year TIPS breakeven:** TIPS breakeven rates are regarded as one way to measure inflation expectations. The 10-year breakeven figure equals the yield on 10-year TIPS subtracted from the nominal yield on 10-year Treasury securities.

**Money Supply (M1, M2):** Money stock measures are often regarded as inflationary indicators. When the money supply increases, this can eventually increase the demand for goods and services, thus pushing prices higher. **M1** is constructed by summing currency, travelers' checks, demand deposits, and other checkable deposits. **M2** is a broader measure than M1. It is constructed by summing savings deposits, small-denomination time deposits, and retail money funds, and adding this result to the supply of M1.

**Unit labor costs:** Many observers regard unit labor costs as one of the more accurate indicators of inflationary conditions. Unit labor costs describe the relationship between compensation per hour and productivity, or real output per hour, and can be regarded as an indicator of inflationary pressure on producers.

Among others most sympathetic to the view that quantitative easing raises the threat level are Federal Reserve Bank presidents Jeffrey Lacker (Richmond), Charles Plosser (Philadelphia), Richard Fisher (Dallas), Thomas Hoenig (Kansas City), and former Fed governor Kevin Warsh.

#### OR ARE INFLATION FEARS OVERBLOWN?

On the other hand, many analysts believe the danger, while not negligible, is remote.

New York Fed president William Dudley, in particular, finds the image of banks sitting on piles of excess reserves ready to lend at a moment's notice flawed. "Banks have always had the ability to expand credit whenever they like," he said. "If banks wanted to expand credit that would drive up the demand for reserves, the Fed would automatically meet that demand by supplying additional reserves as needed to maintain the fed funds rate at its target rate . . . [I]t makes no difference whether the banks have lots of excess reserves on their balance sheets or can source whatever reserves they need from the fed funds market at the fed funds rate."

Moreover, despite the monumental fiscal and monetary stimulus, the abundant slack in the economy almost ensures that if inflation arises, it will not do so for at least a couple of years. There is so much excess capacity in the economy that companies don't have the leeway to raise prices yet, said Zane Brown, Lord Abnett Partner and Fixed Income Strategist. "And with close to 9% unemployment, and more people waiting in the wings to join the labor force, that suggests we're not likely to have upward wage pressures any time soon."

"Even if we were to generate growth of 300,000 jobs per month," said Dudley in a recent speech, "we would still likely have considerable slack in the labor market at the end of 2012."

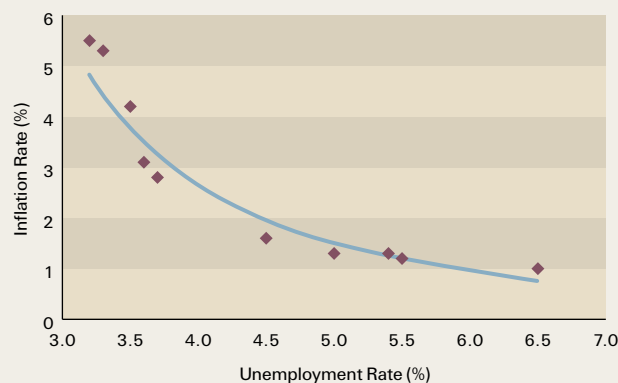
In addition to Dudley, others at the Fed who believe the central bank's current policy presents little danger include Fed vice chairman Janet Yellen and Fed presidents Eric Rosengren (Boston), Charles Evans (Chicago), and Dennis Lockhart (Atlanta).

For those who believe inflation is inevitable, the difficulty comes in explaining how it would take hold, said Walter Prah, Lord Abnett Partner & Director of Quantitative Research. "The difficulty is that one has to describe the mechanism by which this inflation dynamic is communicated into the economy," he said. "How do you get inflation in the face of a persistently soft labor market?"

Monetary policy can contribute to upward pricing pressures, but the problem comes in knowing in real time when a policy is mistaken. Detecting a misstep is often possible only in retrospect, said Prah.

It's not clear, therefore, that the Fed's current policy is wrong. Although it has pumped an extraordinary amount of liquidity into the system, it's fighting against a strong deflationary force. "When the economy is being pulled in a

**Chart 1. The Phillips Curve Shows That Unemployment Falls When Inflation Rises**



Source: Lord Abnett.

deflationary direction, that's like a magnet, and Bernanke is correctly fearful of that magnet," Prah said. "And the notion that the economy is suddenly going to go in the other direction—it's not as simple as that. What more often happens is that you pull against that magnet, and either you fail or you pull away from it gradually."

The odds of inflation occurring without a period of robust recovery, therefore, may be slim. Such instances are "very rare in the history of the world economy," said Prah.

#### THE PHILLIPS CURVE AND THE GREAT INFLATION

Because of the experience of the 1970s, economists today widely agree that inflation arises at least in part because of excessively expansionary monetary policy. Prior to that period, known as the "Great Inflation," a broad consensus held that pricing pressures arise when demand grows beyond the capacity of the economy to meet it. As long as demand remains below this capacity, there is excess capacity, or slack, in the economy, which keeps pricing pressures at bay. In addition to this "demand-pull" inflation is the "cost-push" variety, which can emerge if production capacity is reduced.

One indicator of slack in the economy is the level of unemployment. Prior to the 1970s, many believed that a stable inverse relationship held between inflation and unemployment. This led to confidence that, with the right policies, one could be traded for the other. This trade-off was depicted by the Phillips Curve (see Chart 1).

The Great Inflation, however, demonstrated that instead of always moving in opposite directions, unemployment and inflation could move in sync (see Chart 2). For some economists, that invalidated the earlier Phillips Curve thinking. Others still hold a modified and more nuanced view.

Instead of using unemployment to measure slack, some economists utilize a version of the Phillips Curve that employs

the “output gap.” The output gap measures the difference between actual production and the amount of production that would occur if the economy were operating at full capacity. In other words, it’s the difference between actual GDP and potential GDP.

Measuring the output gap is difficult, however, and even if done accurately, the data are backward-looking. So basing policies on this concept can be problematic. One theory about the Great Inflation of the 1970s argues that officials overstimulated the economy with rapid monetary expansion because they had overestimated the size of the output gap.

In the current environment, it’s unclear to some how much slack exists. Factory utilization remains well below the historical average of around 80%, and along with the high unemployment rate, this suggests that the economy has plenty of unused capacity.

But even an apparently straightforward measure like unemployment may not be an accurate measure in this regard. It’s not obvious, for example, that all of the 20 million unemployed really represent surplus capacity. They may, in fact, no longer be employable. If they are mortgage brokers, construction workers, or others hired as a result of the housing bubble, then their skills might not match up well with the skills needed in newly created jobs. If that is the case, then the economy may be much closer to full capacity than the high unemployment rate implies, and pricing pressure may be a greater threat than inflation doves believe.

Yellen notes that if mismatches accounted for the bulk of the joblessness, “we would not expect to see high rates of unemployment across the vast majority of occupations and industries. Instead, I see weak demand for labor as the predominant explanation of why the rate of unemployment remains elevated and rates of resource utilization more generally are still well below normal levels.”<sup>8</sup>

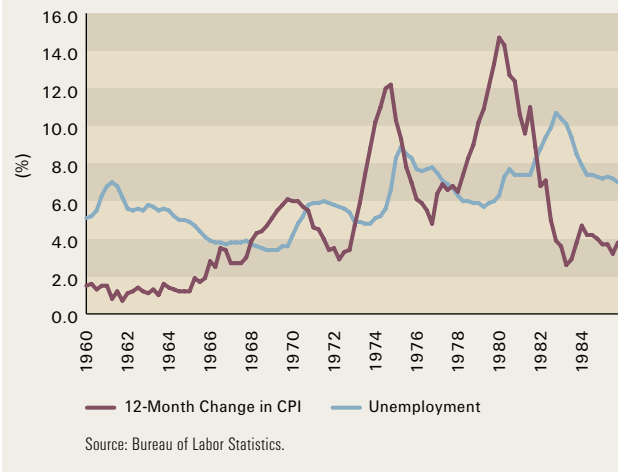
Even allowing for the imprecision of unemployment figures, Dudley believes the high jobless rate points to abundant slack, estimating that the rate might have to fall to 6–7% before inflationary pressures would begin to build.<sup>9</sup>

#### INFLATED IMPORTANCE?

Even those who downplay the inflation threat don’t dismiss it entirely. One possible avenue, they believe, is through commodity imports. If prices for oil and other production inputs continue to climb, domestic producers could eventually begin to try to cover those increased costs. Airlines, for example, have been adding surcharges to cover higher fuel prices.

But the chance that even widespread commodity price pressures could spread across the entire economy without a prior economic upturn may not be as great as some believe. “I think that some who have this view don’t appreciate just how unusual that occurrence would be,” Prahl explained. “We don’t really have many instances in the history of the world

**Chart 2. In the Great Inflation, Rising Unemployment Followed Rising Inflation**



economy in which inflation was imported through the commodity channel in the absence of an overheating domestic economy.” Even in the 1970s, the inflation that occurred followed periods of strong growth, said Prahl.

Fed policy may not be driving global commodity prices, as inflation hawks believe. Yellen noted in an April 2011 speech that the recent global surge more likely has come from rising demand and disruptions in supply, and is probably temporary.<sup>10</sup>

Whether the Fed is responsible or not, studies by the central bank and others have shown that even substantial jumps in commodity prices don’t translate into inflationary pressures at the consumer level, Brown said. Between June 2006 and June 2008, for example, grain prices rose by 163% and oil prices essentially doubled. And yet the New York Fed found that a 10% increase in commodities generated a rise in the CPI of less than one-tenth of 1%, Brown added.

#### QE2, FISCAL 2012, AND INFLATION EXPECTATIONS

A rise in commodity prices may not translate directly into a broader rise in the price level, but if the increase persists, it could stir inflation expectations. Higher prices for food and energy are already being felt by consumers, and their short-term inflation expectations have risen.

Ignoring these expectations may be unwise. “One lesson learned during [the 1970s] is that inflation expectations can matter a great deal,” Philadelphia Fed president Charles Plosser said in a speech in 2009. “And if they become unanchored—that is, if the public comes to believe that the Fed will not do what is necessary to preserve price stability—then inflation can rise quickly regardless of the amount of so-called slack in the economy.”<sup>11</sup>

In the 1970s, inflation expectations gave rise to higher prices by bringing demand forward. Demand surged as consumers

and businesses, anticipating that prices would be significantly higher in the future, chose to make purchases immediately rather than delay them.

Critical to keeping expectations anchored is the Fed's credibility. This credibility rests fundamentally on its legally mandated independence from the federal government.

But this credibility may have been blemished by quantitative easing, particularly the second round. The law forbids the Fed from "monetizing the debt"—financing the government directly with newly created money. But with QE2, that, in effect, is occurring.

Bernanke's statement to Congress in 2009 promising not to do so amounts to "a vacuous statement," said Prah, "because as long as the Fed is expanding its balance sheet at approximately the same magnitude as net debt issuance, then in a certain mathematical sense, it is unequivocally engaged in debt monetization."

Fisher agrees. Under QE2, the Fed is buying "an amount that, annualized, represents the projected deficit of the federal government for the next year," Fisher said in November 2010. "For the next eight months, the nation's central bank will be monetizing the federal debt."<sup>12</sup> Departing from the usually measured language of central bank officials, Fed president Hoenig described QE2 as "a pact with the devil."<sup>13</sup>

While the Fed's stated goal for QE2 is to keep interest rates low in order to counter deflation, the policy has the same appearance as one in which the Fed drops its independence and cooperates with the government in order to deliberately inflate away the debt. While QE2 policy may be correct policy, given the continued threat of deflation, Prah said, the inflation hawks do have a point. "If the government fiscally, and the monetary authority in cooperation with that, was engaged in a long-term effort to inflate away the debt, that would be observationally equivalent to what is occurring *right now*."

For the time being at least, inflation expectations continue to be anchored. The five-year Treasury Inflation-Protected

Securities (TIPS)<sup>14</sup> breakeven rate (the difference between yields on five-year Treasury securities and yields on five-year TIPS) has risen, but has not exceeded historical norms. Likewise, surveys of professional economic forecasters fail to show significantly heightened concerns. And although short-term household expectations have risen, medium-term expectations remain anchored within the normal range.<sup>15</sup>

But the anchoring may depend on QE2's temporary nature. The Fed announced that the policy will end on June 30, 2011. If in the eyes of the Fed a third round of quantitative easing becomes necessary, expectations could become unmoored.

The next several months could therefore be critical. As Congress debates the federal budget, the market will be looking for a credible solution. The market is smart enough to know that the federal government can't fix the deficit overnight, said Ezrati. But it wants to see a credible plan to correct the problem over the long term.

If it appears that federal deficits will continue to widen, foreign buyers of U.S. debt could begin to balk, causing interest rates to rise. This could threaten the domestic recovery and ratchet up pressure on the Fed to restart the debt-purchasing program.

It's not that the deficits themselves feed inflation. "I would argue that those deficits are not going to generate an inflationary response unless the Fed finances them," Ezrati said.

"That's why QE2 has frightened a lot of people, because that's just what the Fed was doing . . . The inflation threat comes from the pressure it puts on the Fed to finance the deficit."<sup>16</sup>

For those who share these concerns about QE2, Fisher suggests hopefully that they think of it as "a bridge loan to fiscal sanity." The Fed, he said, "has taken a leap of faith that our political leaders will forge a sensible budgetary and regulatory path . . . Otherwise, the effect of quantitative easing will, in my view, simply result in financial speculation . . . and ultimately 'super ordinary' inflation."<sup>17</sup> ■



<sup>1</sup> John Keefe, "What Causes Inflation? Lessons from the 1970s, Vol. 3," [www.moneywatch.bnet.com](http://www.moneywatch.bnet.com), May 26, 2009.

<sup>2</sup> Ibid.

<sup>3</sup> M1 consists of currency in the hands of the public, travelers' checks, demand deposits, and other deposits against which checks can be written. M2 includes M1, plus savings accounts, time deposits of under \$100,000, and balances in retail money market mutual funds.

<sup>4</sup> The Consumer Price Index (CPI) is a measure of the average change in prices over time of goods and services purchased by households. The index is published monthly by the Bureau of Labor Statistics (BLS). The CPI is based on prices of food, clothing, shelter, and fuels and other goods and services that people buy for day-to-day living.

<sup>5</sup> Allan H. Meltzer, "Ben Bernanke's '70s Show," *The Wall Street Journal*, February 5, 2011.

<sup>6</sup> Allan H. Meltzer, "The Fed's Anti-Inflation Exit Strategy Will Fail," *The Wall Street Journal*, January 27, 2010.

<sup>7</sup> William C. Dudley, "Prospects for the Economy and Monetary Policy," remarks at the New York University Stern School of Business, February 28, 2011.

<sup>8</sup> Janet Yellen, "Commodity Prices, the Economic Outlook, and Monetary Policy," speech at the Economic Club of New York, April 11, 2011.

<sup>9</sup> William C. Dudley, *op. cit.*

<sup>10</sup> Janet Yellen, *op. cit.*

<sup>11</sup> Charles Plosser, "Demystifying the Federal Reserve," speech at Lafayette College, September 29, 2009.

<sup>12</sup> Richard W. Fisher, "Recent Decisions of the Federal Open Market Committee: A Bridge to Fiscal Sanity?" remarks before the Association of Financial Professionals, San Antonio, Texas, November 8, 2010.

<sup>13</sup> Tom Raum, "Federal Reserve Now the Only Stimulus Game in Town," Associated Press, November 4, 2010.

<sup>14</sup> Treasury Inflation-Protection Securities (TIPS) are Treasury securities that are indexed to inflation in order to protect investors from the negative effects of inflation. TIPS are backed by the U.S. government, and their par value rises with inflation, as measured by the Consumer Price Index, while their interest rate remains fixed. Interest on TIPS is paid semiannually.

<sup>15</sup> William C. Dudley, *op. cit.*

<sup>16</sup> Milton Ezrati, "Why Do Deficits Matter?" (video), [www.lordabbett.com](http://www.lordabbett.com), March 10, 2011.

<sup>17</sup> Richard W. Fisher, *op. cit.*

**A Note about Risk:** Investing involves risk, including the possible loss of principal.

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