TrendMacro

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MACROCOSM

Inflation in Fashion

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Donald Luskin

A less risky economy, Yellen, and the politics of her confirmation put inflation back in play.

There was something about a story in the Sunday *New York Times* that really got our attention, a feeling that it could be one of those innocent-seeming events in markets that turns out, later, to be highly significant. The headline was: "In Fed and Out, Many Now Think Inflation Helps." So the *Times* says inflation is now in fashion? That's not news. Mainstream economists have advocated and mainstream central bankers have targeted positive but low rates of inflation for decades. *What was attention-grabbing about the story was its time and place.*

- *The place* was the media's most precious real estate: the upper right corner of the front page of the "newspaper of record." Why would such a story be displayed so prominently?
- Because of *the time* -- immediately following the threat by Senator Rand Paul (R-KY) to put a hold on the confirmation of Janet Yellen as Federal Reserve chair. *A hold on Yellen would at least delay her confirmation, and possibly thwart it by requiring 60 votes for cloture -- and likely usher in another rancorous economics debate between the parties.*
- The story doesn't mention Paul at all, nor Yellen's coming confirmation -- indeed, it mentions Yellen only once, *en passant*.
- Yet this story is, without doubt, the first salvo in the Democrats' defense of Yellen. The idea is to establish inflation as the norm and, so, to demonize as extremists those who believe otherwise and oppose Yellen.
- To be sure, inflation *is* the norm for central bankers. No central bank that we know of has zero-inflation as its target -- they all target 2%, even Japan. But that's not to say it would be "extreme" to question the norm.
- *And Janet Yellen is no normal central banker. She is an extremist. It would be a dangerous start for her chairmancy if the politics of her confirmation camouflaged her as anything else.*

We know from personal experience with Yellen that, while she is vastly intelligent, she is extremely dogmatic (see "On Yellen for Fed Chair" October 9, 2013). And she is dogmatic about ideas that are both wrong and dangerous.

Update to strategic view

US MACRO, US FED, GOLD: Inflation has been no risk at all for several years, despite massive easing efforts by the world's central banks. But it is now, thanks to a confluence of personalities, policy and politics -- in a new economic environment without constant fear of financial contagion driving liquidity demand. Without that demand, the extreme supply of liquidity likely to be perpetuated by Janet Yellen -- a dogmatic neo-Keynesian being camouflaged as a mainstream central banker to smooth her confirmation process -- will create an inflationary imbalance. Tomorrow's FOMC, already largely under Yellen's control, will likely do nothing to alleviate our concerns. Having endured an almost 40% correction, gold at today's prices is an interesting speculation on the inflationary errors likely to be made by our new chairwoman.

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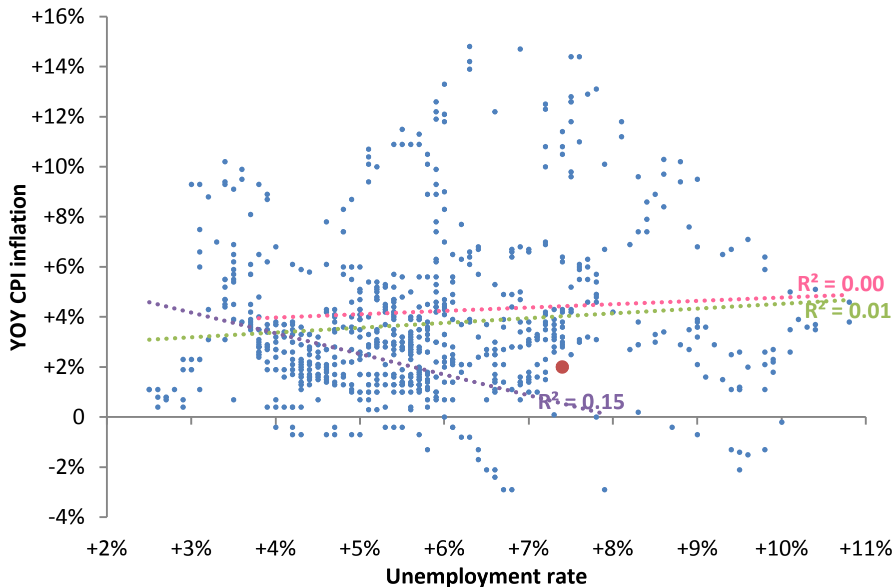
- She is a true believer in the Phillips Curve trade-off between unemployment and inflation -- despite strong contradictions of it in both directions, first in the 1970s and again in the 1980s and 1990s.
- The merest glance at a chart shows there is no meaningful relation in the Phillips Curve (please see the chart below). If there were anything here worth basing monetary policy on, it would jump off the page.

The Phillips Curve

● Latest   Linear trends: ··· Pre-74 ··· Post-74 ··· All



Source: BLS, TrendMacro calculations

- And Yellen explicitly believes that today's persistent high unemployment is cyclical, not structural. That's inexplicable, actually, considering that she acknowledges that reported unemployment is falsely low, masked by a collapse in labor force participation -- a unique phenomenon with no cyclical precedent (please see the chart on the following page).
- *Put these two beliefs together, and the result is Yellen's belief that continued extreme monetary ease will both (a) alleviate unemployment and (b) have no inflationary consequences.*

This belief is especially dangerous now for two reasons.

- First, by Yellen's own reckoning, Fed policy is *extremely* loose.
- The San Francisco Fed's version of the Taylor Rule that she started promoting in 2009 -- when, while she was SF Fed president, she was lobbying for QE2 -- is now calling for a funds rate of positive 0.09%. That's precisely where the funds rate actually is. *But* to comply with the rule, the Fed would have to completely remove of

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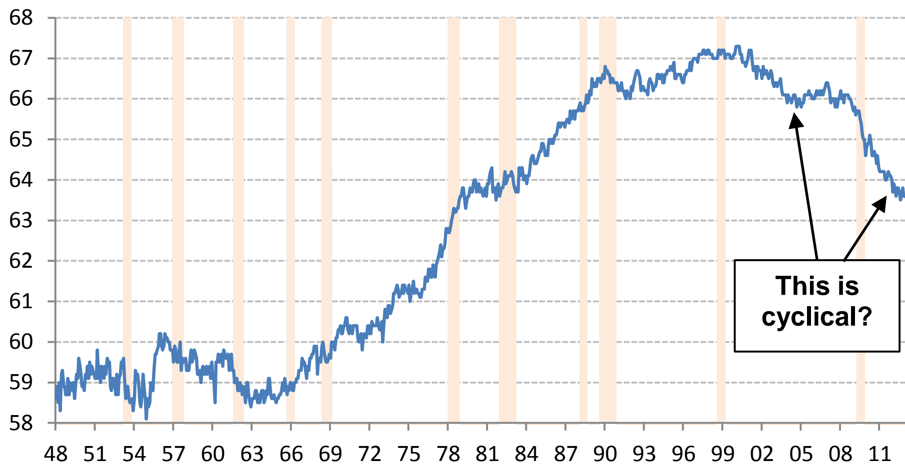
US labor force participation rate **Recession**

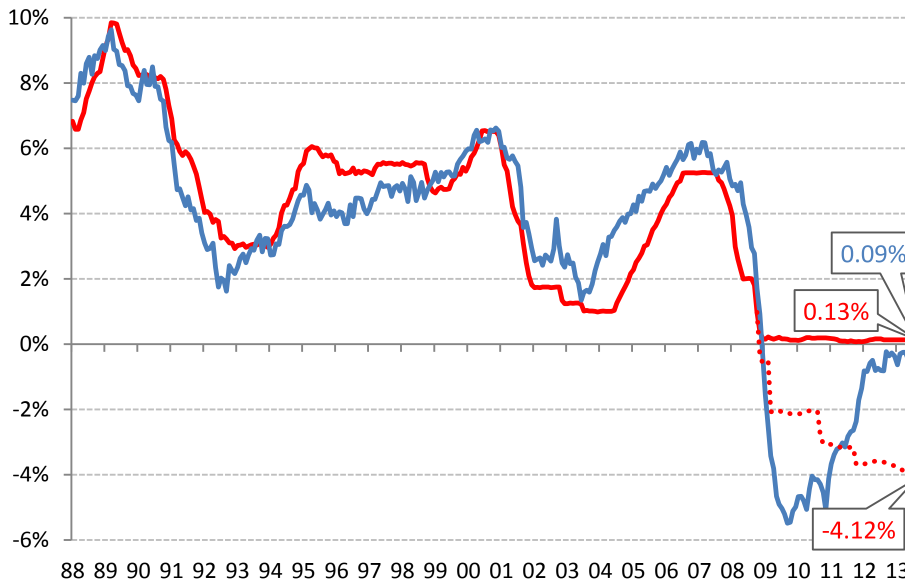


Source: BLS, NBER, TrendMacro calculations

all Large-Scale Asset Purchases and forward guidance. While those unconventional policy tools are left in place, the funds rate is effectively below negative 4% (please see the chart below).

- Second, the world has changed.
- Starting in 2007, the global economy was beset by constant threat of financial contagion. Markets needed a great deal of liquidity, and the central banks of the world supplied it. So long as this extreme money supply was in response to an equally extreme money demand, there was no inflation. *Inflation -- or deflation -- only*

The Taylor Rule (per Rudebusch 2009)
2.07 + 1.28 x 12-mo core PCE inflation - 1.95 x (UE - CBO natural rate)
Actual funds rate **Balance sheet-augmented funds rate**



Source: FRB, BEA, TrendMacro calculations

happens when the supply and demand for liquidity get out of balance.

- *For the last six years, it hasn't been unemployment that's been keeping inflation low -- it's been liquidity demand.*
- Now, we believe, the risk of financial contagion has ceased -- and markets are beginning to realize it (see "A Major Upgrade to our Strategic Outlook" September 12, 2013).
- We expect that the demand for liquidity will now begin to recede. To avoid an inflationary imbalance, it will be incumbent upon the world's central banks to reduce the supply of liquidity accordingly.
- We don't expect anything along those lines at tomorrow's FOMC. The meeting takes place within the reality distortion field of Washington DC, where the recent shutdown is taken as a systemic event, when in fact markets essentially didn't notice (see "On the Shutdown and Debt Limit Deal" October 17, 2013).
- And as was last month's meeting (see "On the September FOMC" September 18, 2013), the FOMC is effectively under Yellen's influence as chair-designate.
- *The problem is that unless the labor market gives Yellen exactly the signals required by her dogma, the only thing that will make her withdraw any liquidity would be an outbreak of inflation.*
- *And based on the norms being promoted by the New York Times -- norms embraced with a vengeance by Yellen, and integral to the completion of what will be, for her, an arduous and humiliating nomination and confirmation process -- the first signs of that outbreak of inflation will be greeted not as warnings but as welcome signs of her success and vindications of her dogma.*

It's been a long time since we worried about inflation. By and large our clients have stopped worrying about it, too. Indeed, in meetings and calls over the last several weeks, we've been struck by how many clients have argued, much as Yellen might, that inflation is now virtually impossible thanks to persistent high unemployment. The fact that the *Times* could run a front-page story wishing for *more* inflation shows you just how deep the no-inflation consensus is.

That's been right for a long time, but we are going to be contrarians and start worrying about it again. That's not to say we think it's a clear and present danger right here right now. Nor are we saying it is inevitable in a more distant future -- policy mistakes may or may not be made.

But we are saying it wasn't a risk, and now it is. We are now seeing the pieces fall into place -- a confluence of people, policies and politics, set against an economic backdrop evolving in unheralded ways -- to set up for the risk.

- By extension, it's been a long time since we've been interested in gold. For years it was a signature call for us, but at this point we'd gotten to where we hardly thought about it anymore. But we're changing on that, now.

- From its all-time peak above $1900 in 2011, gold has corrected as much as 38.5%. Now up about 15% from its correction bottom in June, we're beginning to think that bottom just below $1200 will hold, and that accumulating gold at these levels makes sense as a speculation on what may well turn out to be a most un-normal Fed chairwoman.

Bottom line

Inflation has been no risk at all for several years, despite massive easing efforts by the world's central banks. But it is now, thanks to a confluence of personalities, policy and politics -- in a new economic environment without constant fear of financial contagion driving liquidity demand. Without that demand, the extreme supply of liquidity likely to be perpetuated by Janet Yellen -- a dogmatic neo-Keynesian being camouflaged as a mainstream central banker to smooth her confirmation process -- will create an inflationary imbalance. Tomorrow's FOMC, already largely under Yellen's control, will likely do nothing to alleviate our concerns. Having endured an almost 40% correction, gold at today's prices is an interesting speculation on the inflationary errors likely to be made by our new chairwoman.