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'Slow and low' strategy triumphs either inflation or deflation

GUEST COLUMN

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Anyone who owns a bond needs the answer to a single, critical question: Will the economy inflate or not? With the 30-year Treasury bond yielding 4.75 percent at this writing, inflation of even 4 percent leaves the long bond investor netting a return of less than 1 percent a year — not sufficient to account for the volatility that investment dishes up.

On the other hand, if inflation stays subdued or if prices actually decline, that 4.75 percent would look like a princely sum several years hence.

Presently, a majority of analysts believe that inflation is on the way up, either soon or in a few years. A minority worry that rather than inflation, we will experience deflation, a la Japan, which has struggled with falling prices for two decades now. Signs abound to support both camps.

On the "inflation-rising" side are large government deficits and short-term interest rates down near zero. Both of these factors are typically associated with fast economic growth, which, when it slows up, can result in demand for goods outstripping supply. That puts upward pressure on prices.

Furthermore, inflation offers a politically expedient way to deal with government deficits: inflation does not need to pass through the legislative process and it allows for repayment of debts in devalued dollars. The temptation to let the economy inflate to deal with deficits is mighty powerful, which is why investors are obsessing over exactly when the Fed will act to increase interest rates.

A willingness to increase interest rates would signal to the bond market that the Fed is serious about keeping prices under control. The longer the Fed waits, the more credence we can give to the inflation camp.

The potential for commodity shortages can also cause inflation. Oil, with most of the easy finds behind us, stands to become more expensive as China puts thousands more autos on its roads, and India joins the trend. Many experts also believe that crop production is reaching a boundary, and that basic foodstuffs will rise in price over the coming years.

Turning commodity price inflation into widespread price inflation involves a special set of circumstances, however; more likely we will experience "bursts" of inflation due to commodities.

Factors favoring the "deflation" camp include huge unused capacity in manufacturing plants, office and retail space, and labor, which makes raising prices very difficult. Even if the economy were to improve dramatically, corporations have significant opportunity to raise production and increase the supply of goods before running into constraints.

Early signs of economic improvement usually translate to increased work hours for existing employees, then hiring temporary help, and finally ratcheting up to permanent hires. Only after most of the available qualified employees are hired can wages begin to increase too fast. The US economy has barely begun the first round of this process — the expanding workweek — so plenty of room for expansion still exists.

Also supporting the "deflation" camp is the particular nature of this recession. Rather than being an income recession, where the Fed's hikes in interest rates cause unemployment and lower family income, the current environment can be categorized as a balance sheet recession.

That is, it began with an implosion in housing prices, causing steep declines in the value of family assets. Only later did unemployment surge. In this, we are like Japan, where the early 1990s recession was prompted by steep declines in both stock and property prices.

When a recession involves big price declines in real estate, the time frame involved in healing the economy is much longer. Real estate cannot simply be traded to the next owner at a lower price in a week's time. Instead, price discovery can take years, stymieing the healing process.

Meanwhile, the value of family wealth remains depressed, putting a damper on consumption. These factors and others have kept Japan in a two-decade funk that it can't seem to shake. After considering these criteria, the uncertainty of the eventual outcome — inflation or deflation — becomes evident. However, there is another path that could become reality, and that is a return to the low and relatively steady inflation of the late 1990s and early 2000s.

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This camp has virtually no supporters, as investor opinion has polarized around the two more extreme possibilities. But a scenario supporting the "low growth, low inflation" outcome can be easily designed: high debt in an economy tends to suppress growth; low growth in turn tends to keep price inflation under control; controlled inflation keeps interest rates down.

The mere fact that most analysts and investors are not even considering this scenario makes it worthy of contemplation. If "slow and low" comes to pass, we can expect interest rates on 10-year and later bond maturities to hang around current levels, fluctuating modestly in a tight range.

Short-term interest rates would "normalize," coming up to the 2 percent to 3 percent level (so investors would finally earn a buck or two on money market funds). And that would be it: no 7 percent long bond, no huge losses on bond portfolios, but no huge returns either.

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Time will tell which way the scales tip and how disruptive the outcome will prove to be, but there's no doubt that a return to "slow and low" would be preferable to either inflation or deflation.

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