

Perspective on ... Inflation

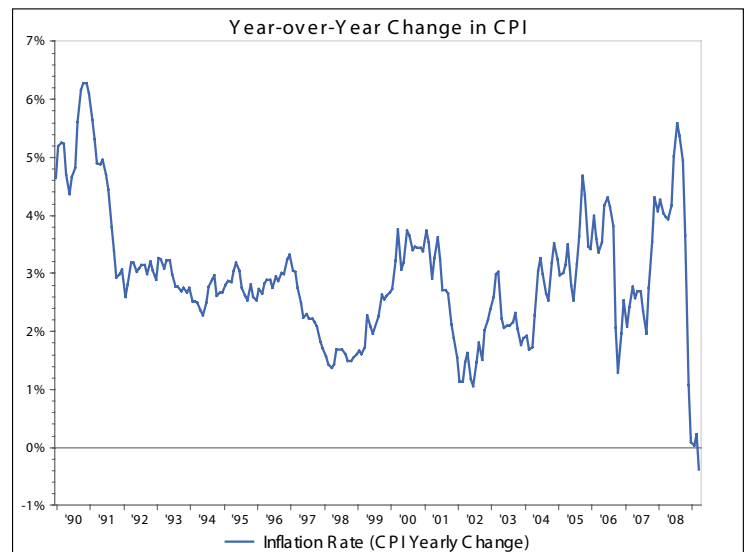
The current economic turmoil has raised a lot more questions than answers. While many major questions remain, some issues can be clarified. Manning & Napier has received numerous requests to explain the potential inflation impacts of current U.S. monetary policies. The following is an effort to provide a thorough look at the inflation backdrop in the current environment.

What is the current rate of inflation?

The standard measure of inflation is the year-over-year change in the Consumer Price Index (“CPI”), which examines the average price of consumer goods and services. **Through February 2009, the year-over-year change in CPI was 0.2%.** For comparison, inflation was 4.9% in September 2008 and 5.0% in June 2008. That means that over the past five months, the U.S. has experienced a period of “disinflation,” or a slowing in price increases.

If the CPI measure continues to grow over the next 5 months at the same rate that it has grown during the first 2 months of 2009, we believe the year-over-year growth rate should turn negative this summer. In other words, we believe it is possible that the U.S. will enter a period of deflation sometime in 2009.

The less volatile core-CPI measure doesn’t include food and energy prices, and this index is running at a 1.8% year-over-year rate. This is significantly lower than the 2.5% September 2008 rate and the 2.4% June 2008 rate. ♡



Where are inflation expectations?

Based on actual measures, **inflation expectations are quite low.** The University of Michigan Consumer Sentiment survey includes questions about future inflation expectations. Looking out one year, consumers expect inflation to be 2.0%, down significantly from the 5.2% reading in May 2008. Looking out 5 years, consumers expect inflation to be 2.6%, also down from last summer’s reading of 3.4%.

As for market expectations, the difference between the yields offered on standard U.S. Treasury securities and the yields offered on U.S. Treasury Inflation Protected Securities (TIPS) is the “expected inflation” rate. The 5-year differential represents the *average* expected inflation rate over the next 5 years, while the 10-year differential represents the *average* rate over the next 10 years. Based on this measure, inflation expectations over the next five and ten years are both less than 2%, which is widely considered an optimal inflation rate. Therefore, it is tough to argue that the U.S. Treasury markets are currently worried about inflation. ♡

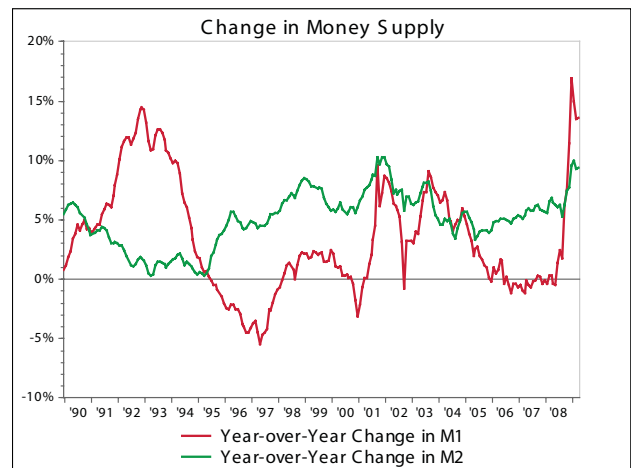
3/31/09 Yields			
	Nominal U.S. Treasury Yields	U.S. TIPS Yields	Difference
5-year	1.66%	0.84%	0.82%
10-year	2.67%	1.36%	1.31%

Source: Bloomberg

Given the actions of the Federal Reserve, why isn't the U.S. Treasury market worried about inflation?

Last fall, the U.S. Federal Reserve (the “Fed”) responded to a seizing of the credit markets and significant economic contraction by driving the Federal Funds target rate essentially to zero. This spring, the Fed embarked on a “quantitative easing” policy track that has significantly increased the size of the Fed’s balance sheet. As expected, the Fed’s balance sheet growth has led to an increase in the money supply:

- The total monetary base has risen, with currency and bank reserves up more than 100% on a year-over-year basis.
- M1, the narrowest measure of money (currency and demand deposits), has increased by 15% year-over-year. In comparison, M1 experienced almost no growth from 2005 through mid-2008.
- M2, the broader measure of money (M1 plus savings accounts, small time deposits, and retail money market funds), has also experienced a meaningful increase, up 10% on a year-over-year basis. M2 posted an annual growth rate of 5% over the prior 2-plus years.



Source: FactSet

All else being equal, increases in the growth rate of money supply tend to be inflationary.

However, all else is hardly “equal.” Bank lending has substantially decreased as the banking system has been compromised. Problems in the real estate markets have reduced banks’ capital bases and caused banks to become much more conservative. Banks are lending only to the cleanest of credits, fitting the old cliché that banks will lend only to those who don’t need it. Not only have banks reined in their lending, but consumers have also ratcheted up their savings, thereby lowering their demand for credit. So **while the Fed has materially increased the size of its balance sheet, flooding the financial markets with liquidity, the actual measures of money supply have not grown anywhere near as fast.**

While the money multipliers have compressed, the accelerating growth rates of M1 and M2 are nonetheless disconcerting. Fortunately, these rising money measures have been mitigated by a corresponding drop in the velocity of money – the rate at which money is exchanged. If money supply is growing, but the rate at which money is being “turned over” is falling as fast, or faster, then the two offset, limiting and/or eliminating any inflation pressures. ♡

Sounds like a lot of economic mumbo-jumbo (monetary base, multipliers, velocity, etc.) The reality is that the rate of money supply growth is accelerating and that will ultimately trigger inflation, right?

Over the long-term, that is true. However, policy makers at the Fed are aware of this dynamic; they are not operating in a vacuum. With the U.S. economy under extreme duress, the Fed is not enacting potentially inflationary policies on a whim. Rather, it is reacting to the economic landscape. **The Fed has embarked on a quantitative easing track because it is worried about a deflationary spiral taking hold.** Remember, CPI will be down year-over-year as early as this summer. If left unchecked, the credit crisis, the subsequent credit contraction, and the necessary consumer retrenchment would likely trigger a deflationary spiral. **The Fed’s actions were implemented in hopes of preventing that.**

The Fed has the flexibility to react in an inflationary fashion because the U.S. economy is growing significantly below its “potential.” Economic potential is determined by labor force growth plus productivity gains. When the economy is growing below its potential, “slack” develops. Specifically, unemployment rises (which it has, moving to 8.5%), and utilization rates fall (which they have, hitting record lows for the data series dating back to 1949). **Inflation pressures rarely develop during periods of economic slack.** Furthermore, it will likely take quite some time for economic growth to return to its “potential,” suggesting that economic slack will continue to increase over the next 12 to 24 months. After that, existing “slack” needs to be absorbed before inflation pressures can really begin to take hold.

Regardless of the current situation, if money supply growth were to continue to grow unchecked, inflation would take hold. The Fed knows this and is not likely to stand idly by and allow that to happen. We believe that at some point the Fed will start draining liquidity out of the system by reining in the rate of money supply growth. Obviously, timing is an issue, and the Fed may not “stick the landing.” The Fed could wait too long, triggering inflation, but the Fed could just as easily remove excess liquidity from the system too soon, renewing the recession and/or a deflationary environment. Either way, **the situation needs to be monitored closely.** ♡

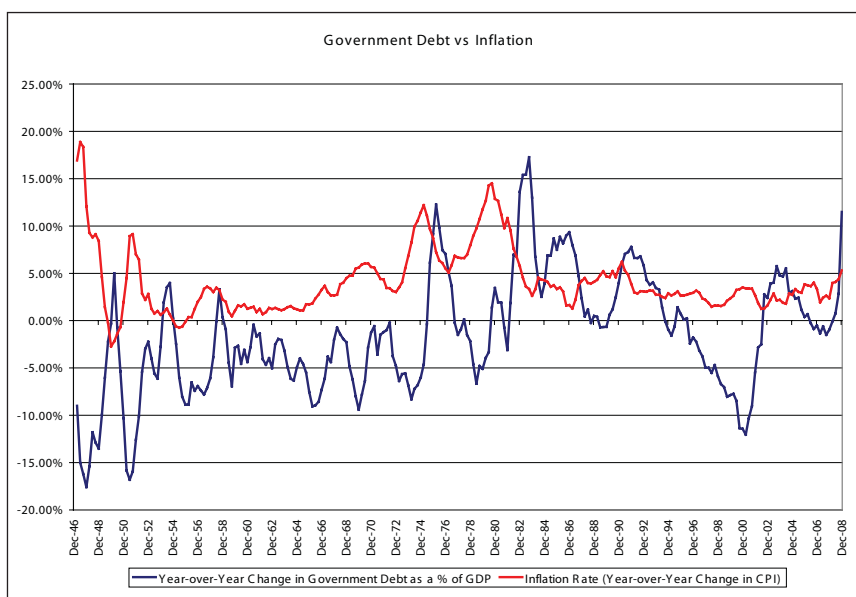
If inflation is not a near-term concern, then why have gold prices increased so much?

Gold prices did briefly top \$1,000, and they're currently about \$200 (or 25%) higher than where they were last fall. **While rising gold prices can indicate growing inflation pressures, they can also signal rising economic and political uncertainty.** Most would agree that uncertainties in both areas are much higher today than they were last year.

To a lesser extent, rising gold prices may also reflect imbalances in supply and demand dynamics. However, supply and demand imbalances relate more to other commodity prices than gold. For example, after years of under-investment, the supply of commodities could not keep up with rising demand, which culminated in last summer's severe spike in commodity prices. The situation reversed when demand dropped sharply, but the potential imbalances still exist. If anything, the recent drop in commodity prices has exacerbated the under-investment problem. When demand growth returns, commodity price pressures are likely to reappear.

Some might argue that a potential supply and demand imbalance in commodities would be cause for inflationary concern. While this is possible, it is worthwhile to note that from 2003-2008 the energy-heavy Goldman Sachs commodity index essentially tripled, while the CRB Raw Industrials index almost doubled. Over that same period, the year-over-year change in CPI averaged a mere 3.1%, with little or no volatility. ♡

But you haven't mentioned the effect of an exploding government deficit. Isn't that inflationary?



Source: FactSet

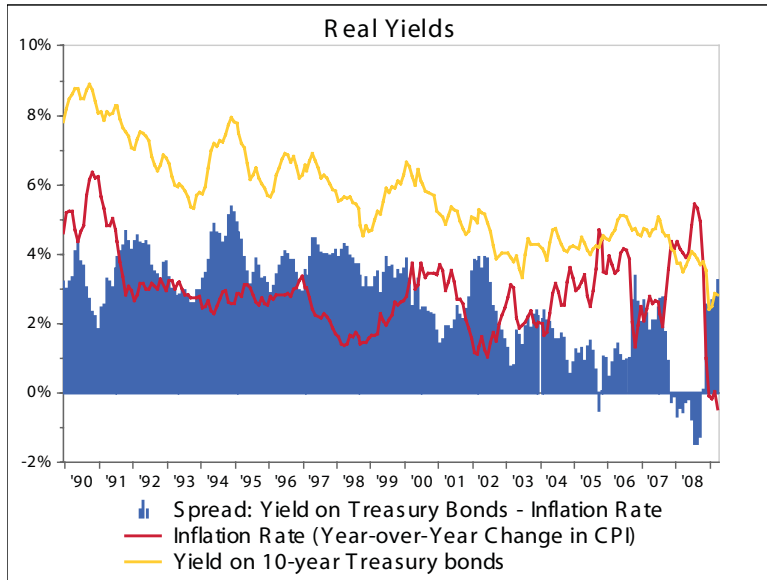
buys U.S. Treasury securities. This is exactly what the Fed's current "quantitative easing" policy entails. The point to remember, however, is that the **Fed enacted this policy to tackle a deflationary threat**, not simply to fund excessive borrowing needs. When concerned about deflation, a country's central bank should enact policies with an inflation bias, just as they should enact policies with a deflation bias when concerned about inflation. The success of the policies depends on when the monetary authorities reverse course.

A secondary risk exists if huge deficits and a growing debt burden create an incentive for the U.S. to attempt to "inflate" its way out from under that burden. Fortunately, the slightest indication of such an approach would face a harsh reaction from the currency markets. The value of the dollar would plummet, which would enforce proper monetary discipline. ♡

Deficits are not inherently "inflationary." The U.S. has run deficits for most of this decade, and inflation has remained relatively stable at about 3%. During the 1980's, deficits as a percentage of GDP were extremely high and growing, but inflation fell from a double-digit level in the early 1980s to below 5% by the end of the decade. As for extreme government debt burdens, those existed as the U.S. came out of World War II and then fought the Korean conflict. While CPI spiked to a double-digit level in 1946-47, when war induced price controls were unwound, and also rose at the start of the 1950's, from the end of 1951 through 1960, it averaged an extremely low 1.5%.

Indeed, deficits can be inflationary if the government simply "prints" money to finance deficits, such as when the Fed

Regardless of inflation, the supply of U.S. Treasury securities has exploded and is poised to go even higher. Are U.S. Treasuries simply the latest investment “bubble?”



Source: FactSet

There is no denying that the supply of U.S. Treasuries is growing and their yields are quite low. However, it is important to remember that **the economic attractiveness of U.S. Treasury securities is not based on absolute yield levels.** Consider that at the start of 1990, 10-year U.S. Treasury yields were 8.4%, while the year-over-year change in CPI was 5.2%. That generates a real yield of 3.2%. At the end of February 2009, 10-year yields were 3.0%, while year-over-year CPI was 0.2%, creating a real yield of 2.8%. On an absolute basis, the yields are quite different, but on a real basis, they are quite similar.

It is true that back in 1990 the supply of U.S. Treasuries was not set to explode as it is today. However, it is also true that private sector debt was not poised to contract as it is today. As a matter of fact, in 1990, consumer debt levels were just beginning a long-term climb that culminated in the current credit crisis. One can argue that current U.S. Treasury issuance is simply filling the

void created by the expected contraction in consumer debt, so total public and private borrowing within the U.S. might be essentially flat.

The bottom line is that comparing U.S. Treasury securities today to technology stocks in the late 1990s or real estate prices earlier this decade is challenging. When the internet bubble burst, investors lost roughly 80% of their investment. Those investors have still not recovered their losses. The real estate bubble is still “bursting,” with real estate prices down about 30% and projected to fall even further. For many, it will take years to recoup their losses. **As for U.S. Treasuries, regardless of what happens, investors will get 100% of their original investment back if they hold their securities until maturity.** In the interim, investors will earn a coupon. Most investors who fell victim to prior investment bubbles would probably be quite happy with an outcome like this. 🌱

So, what does this all mean?

When the Fed starts buying U.S. Treasury notes, inflation alarm bells should start going off. It would be troubling if they did not. However, the U.S. finds itself in the longest post-war recession on record. This recession is not your run-of-the-mill inventory correction, nor is it a Fed-induced recession designed to fight rising inflation. This recession was triggered by a credit crisis that has resulted in a credit contraction and, if left unchecked, would likely result in a deflationary spiral. **In the current environment, the Fed should be enacting inflationary policies.**

Aside from inflation concerns, it is reasonable to have doubts about holding U.S. Treasury securities. However, it is important to remember that the Fed is buying U.S. Treasuries in an effort to pull down short, intermediate, and longer-term yields. **Falling yields bode well for the prices of U.S. Treasury securities because prices and yields are inversely correlated.** If for some reason the yields do not fall, the Fed would likely re-assess its policies and look to implement an alternative method of establishing lower interest rates.

Extraordinary times require extraordinary policy responses. In the near-term, we do not see cause for inflation concerns and we believe that current policies are likely to bode well for U.S. Treasury prices. However, it is important to be mindful of potential long-term implications of today’s policies. **At Manning & Napier, the Fed’s policies and their long-term impacts on inflation and U.S. Treasury prices are being closely monitored.** 🌱

Sources: FactSet, Bloomberg, zFacts.com, Federal Reserve.

Analysis: Manning & Napier

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