Why all the fuss over inflation?

Three reasons why fears are overblown

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Inflation fears have been weighing heavily on investment markets. At first glance, these concerns seem well founded. After all, prices for gasoline at the pump and food at the grocery store have skyrocketed. The chronically weak U.S. dollar is also adding fuel to the fire, as it makes the cost of imported goods more expensive. And the Federal Reserve has pitched in too by lowering interest rates aggressively over the last year from 5.25 percent to a mere 2 percent in response to the weakening economy and the global credit crisis. Despite these influences, a closer examination of the situation reveals that the inflation threat to the U.S. economy is actually fairly limited at present, which should eventually be welcome news for both equity and fixed income investors.

The inflation problem is more concentrated than it appears at first glance. Beyond food and energy, the rate of price increases across the broader economy is actually rather subdued. In addition, many segments are enduring an extended bout of deflation. For example, many furniture and clothing retailers have been offering fairly aggressive discounts in order to move merchandise from their stores. And one can purchase a new car for less today than what they paid for a comparable new model back in 2003. So, while some items we are buying today are significantly more expensive, other items are actually becoming meaningfully less expensive. However, it is still reasonable to question whether isolated inflationary pressures in food and energy might soon spread across other pricing segments. Several factors suggest that these pricing risks should not accelerate but instead should soon subside.

Wage growth is virtually nonexistent

Wage growth is a critical element to support an inflation outbreak, as consumers need to make more money in order to keep spending and subsequently push prices higher. However, workers in the U.S. are not seeing much of an increase in their paychecks and are actually taking a pay cut once inflation is included into the mix. In addition, since many companies are currently in the process laying people off, those employees that remain are probably less inclined to ask their boss for a raise and are likely more content to simply hang onto their job for now. This should help keep wage growth in check in the months ahead.

Without wage growth, higher energy and food prices have a deflationary effect

Most people are not getting pay increases at their jobs. However, they still have to spend more money on gasoline and food. As a result, once they have filled their cars with gas and their cupboards with food, they end up having less money left over than before to spend on other goods such as clothing, computers, washing machines and cars. This means that consumers will likely cut back spending on these less essential items, which would increase the discounting activity by retailers for these products. Thus, higher oil and food prices end up serving as a deflationary tax on consumers instead of an inflationary spark.

Increased globalization and declining economic growth are limiting pricing power

The global economy has become increasingly competitive as trade barriers continue to fall, international markets become more integrated and emerging markets become more developed. Because of this evolution, U.S. companies in many industries have far less flexibility to raise prices, as they run the risk of losing market share to global competitors. This is particularly true in the currently weak economic environment, as belt-tightening businesses and consumers are far more price-conscious. As a result, many companies have instead focused on lowering costs and increasing operational efficiencies to maintain margins.

Stock and bond markets should benefit, assuming that recent inflation concerns subside. After reaching a short-term peak in mid-May, the recent inflation threat has caused stocks to retrace their way back toward March lows and bond yields to spike higher, as investors are concerned that the Federal Reserve may be forced to raise rates sooner rather than later. If the inflation threat fades along with the decelerating global economy as expected in the months ahead, this would mute expectations for higher Fed interest rates and turn a headwind into a tailwind for both stocks and bonds.

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