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Global CIO Outlook
A Contrarian's View on Inflation Fears

By Scott Minerd
Global Chief Investment Officer and Chairman of Investments

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As the United States economy braces itself for the incoming presidency of Donald J. Trump, many observers have been quick to point out that the policies of the incoming administration may have the unintended consequence of fueling inflation.

They argue that the prospect of a large fiscal stimulus at a time when the economy is approaching full employment may create shortages in the labor market. Additionally, substantial infrastructure spending could spark a rally in commodity prices, lifting the cost of producing manufactured goods.

The Federal Reserve's Federal Open Market Committee meeting on Dec. 14 reinforced the inflation fear, and cited the strengthening labor market and inflation as it increased the federal funds target rate by a quarter percentage point, to between 0.50 percent and 0.75 percent. Of course the Fed should be alert to threats to price stability. But the current concerns could very well be overdone.

Already, markets around the world have reacted to the prospect of these policies. But the sharp rise in the exchange value of the dollar along with a marked increase in bond yields is hardly the backdrop associated with rising inflation in the United States. While many market participants point to the sharp increase in interest rates as evidence of rising inflationary expectations, that does not square with a stronger dollar and lower prices in precious metals and energy markets. The Fed announcement of three expected rate increases in 2017 is a more aggressive stance from the central bank, which should only serve to further strengthen the dollar.

Contrast that with Britain, where the pound's sharp depreciation following June's Brexit vote has revived inflation, which hit a two-year high in November.

An examination of a similar period in American history when United States policy resulted in large fiscal stimulus through military spending and tax cuts, along with lighter regulation, show that supply side shocks are not necessarily inflationary. The Reagan revolution of the early 1980s resulted in a stronger dollar and a meaningful, if not painful, decline in precious metals and energy prices. Inflationary pressures waned in the years subsequent to the election even as monetary policy became increasingly accommodative.

While it would be foolhardy to say history will repeat itself, I am reminded of the quip that it often rhymes.

Experience plainly shows that fiscal stimulus, especially when monetary policy is on a more restrictive path, results in higher real rates of interest and a stronger currency. Higher real rates help to tamp down inflation while a stronger dollar reduces import prices.

No one should be surprised that markets are already adjusting to reflect a stronger domestic economy, but this does not necessarily lead to higher core or headline inflation. As a matter of fact, the recent market moves have already primed the pipeline with disinflationary forces which will greet the new administration.

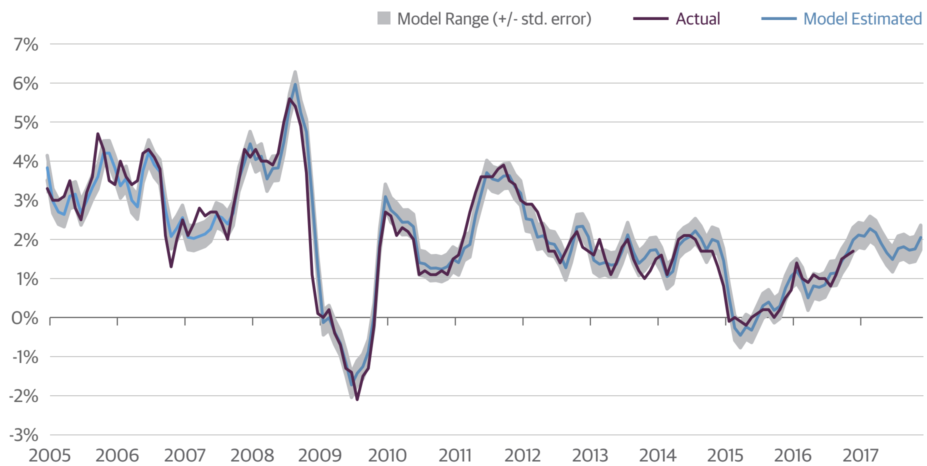
The incoming administration's focus on deregulation and support for domestic energy production only strengthens the argument against a sudden surge in prices.

Wages will probably be a different story. As the economy approaches full employment, wage pressures are expected to mount. Tax cuts, infrastructure spending, deregulation and support for domestic energy production all point to a powerful fiscal elixir which will increase demand for labor and encourage increased consumption.

Concerns over the inflationary effects of the Trump administration's fiscal policies will prove to be unfounded. Nonetheless, Fed policymakers will likely be spurred to raise rates at a faster pace due to higher growth.

Inflation Will Likely Move Toward Fed Target But Remain Contained

U.S. CPI, YoY% Change



Source: Haver, Guggenheim Investments. Data as of 12.15.2016.

Americans and the world should welcome a surge in wage growth. Income inequality in the United States has become as stretched as any time since the Gilded Age. Political and social instability is challenging policy makers as populist uprisings spread from one region to another.

As wages rise, consumer prices are likely to remain restrained. The resulting increase in real earnings along with increased job availability should foster an environment which encourages public confidence in political institutions by reducing economic inequality across classes and creating more opportunities for all.

There are many who would have preferred a different path. Some of their concerns are well founded. Policies that result in trade wars or mass deportations would undermine the success of a Trump economic revolution. These policies would not only create severe headwinds to growth but could result in recession or worse. These pitfalls must be avoided.

If the Trump economic plan is successfully carried out, the Fed is likely to find itself raising rates more rapidly than the market is currently expecting, not because inflation is rising but because the natural rate of interest is rising in line with higher potential output.

As the Fed moves to adjust for faster growth, shorter-maturity Treasurys will be more vulnerable to further price declines while the risk of a sudden spike in inflation will diminish. Bond yields are not rising because of increasing inflationary expectations; they are rising because of an increase in anticipation of real growth. Given that inflationary fears are overblown, longer-term bond yields are probably close to their highs for this cycle, and the environment will remain positive for riskier assets like high-yield bonds, bank loans and stocks.

[1] Monetary Policy in a Low R-star World by John C. Williams, August 15, 2016. [2] "Helicopter money"—a metaphor for an increase in public spending or a tax cut that is financed by a permanent increase in the money stock.