



Market Perspectives

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Return of the Phillips Curve



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When Ben Bernanke, chairman of the Federal Reserve, emerges from his meetings with the Federal Open Market Committee (FOMC), he addresses the media in that most

Delphic of dialects—"Fedspeak." Like any good central banker, he is careful to preach the piety of price stability. Even if he believed that more inflation could help the U.S. economy, he would be hard-pressed to admit it.

His allies on the FOMC, however, have more leeway. Charles Evans, president of the Chicago Fed, for instance, has openly declared his desire for more inflation. "Given how badly we are doing on our employment mandate, we need to be willing to take a risk on inflation," he said on October 17. For Evans, this would entail keeping rates near zero until unemployment dips below 7.5 percent or inflation rises above 3 percent. Evans was the sole dissenting vote against the FOMC's decision in November to maintain current policy. The reason: he preferred more monetary stimulus.

Although 3 percent inflation would run well above the Fed's implicit target of just under 2 percent, Evans is not alone in his appetite for risk. Even Fed Governor Daniel Tarullo, who seldom addresses the public, recently encouraged additional monetary easing.

This rhetoric about the trade-off between inflation risk and growth reminds me of the 1960s, a time when economists believed in the Phillips Curve: the idea that higher levels of inflation can reduce unemployment.

If the Fed is thinking about the Phillips Curve, that tells me that QE3 is on the way. One can't rule out QE4 or QE5, either. Though additional stimulus may arrive in a myriad of forms and labels, one thing is clear: the era of unconventional monetary policy is far from over. In fact, we may have only seen the opening act.

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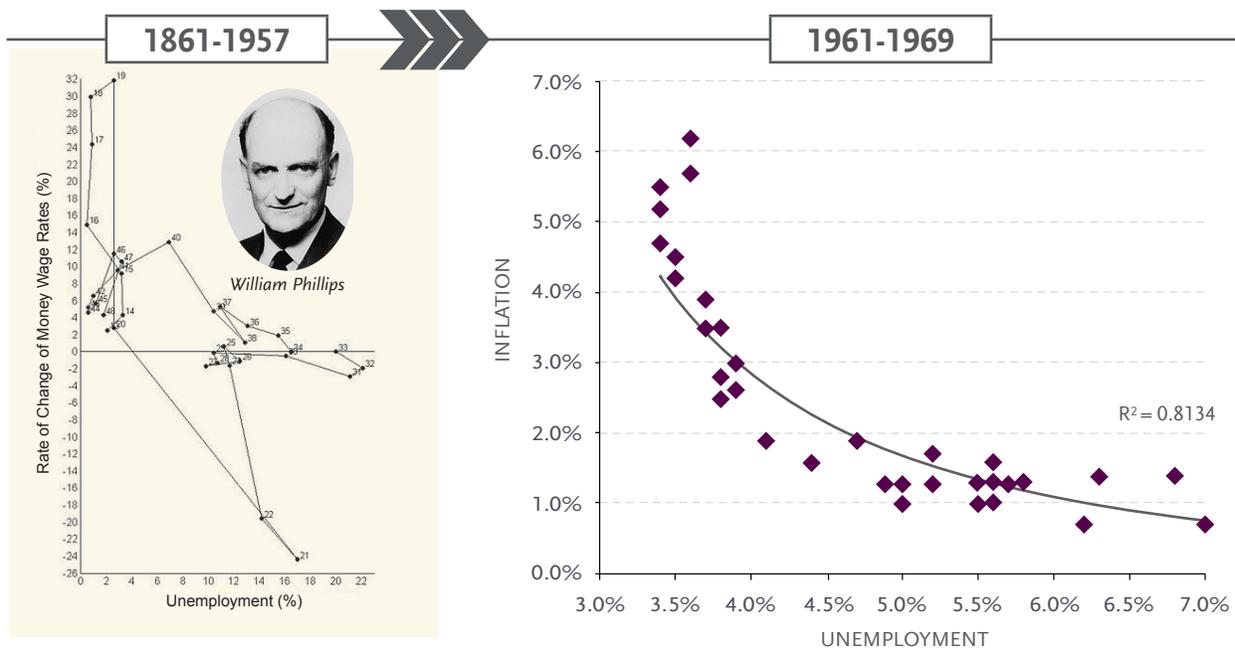
Unlike the European Central Bank, which has a single mandate—price stability—the Federal Reserve seeks price stability and full employment. It’s not inflation, per se, the Fed wants—it’s jobs. In one of his more candid moments, Chairman Bernanke recently described today’s job market as “a national crisis.” The notion that inflation isn’t always pernicious, that it can be a positive force to reduce unemployment, is rooted in the Phillips Curve. Here’s how:

In 1958, a New Zealand-born economist named William Phillips published research on the relationship between unemployment and the rate of change of wages. By studying British economic data between 1861 and 1957, he found that a burst of inflation brought higher nominal wages.

Why? Because when nominal wages rose faster than producers increased prices, consumers felt wealthier. The wealth effect spurred near-term consumption and higher nominal gross domestic product, leading to a decline in unemployment.

THE PHILLIPS CURVE ACROSS THE DECADES

When William Phillips analyzed economic conditions in the U.K. between 1861 and 1957, he found a clear pattern: higher inflation was correlated with lower unemployment. That insight guided policy in the 1960s, when inflation nearly doubled and unemployment fell to record lows.



Sources: Wikipedia, Bloomberg, Guggenheim Partners.

Intuitive and empowering, Phillips's theory quickly spread from academia to execution. When John F. Kennedy took office in 1961, unemployment was 6.9 percent and inflation 1.4 percent. So Kennedy cut corporate taxes, and the Fed eased. By 1967, inflation and unemployment had converged at 3.8 percent.

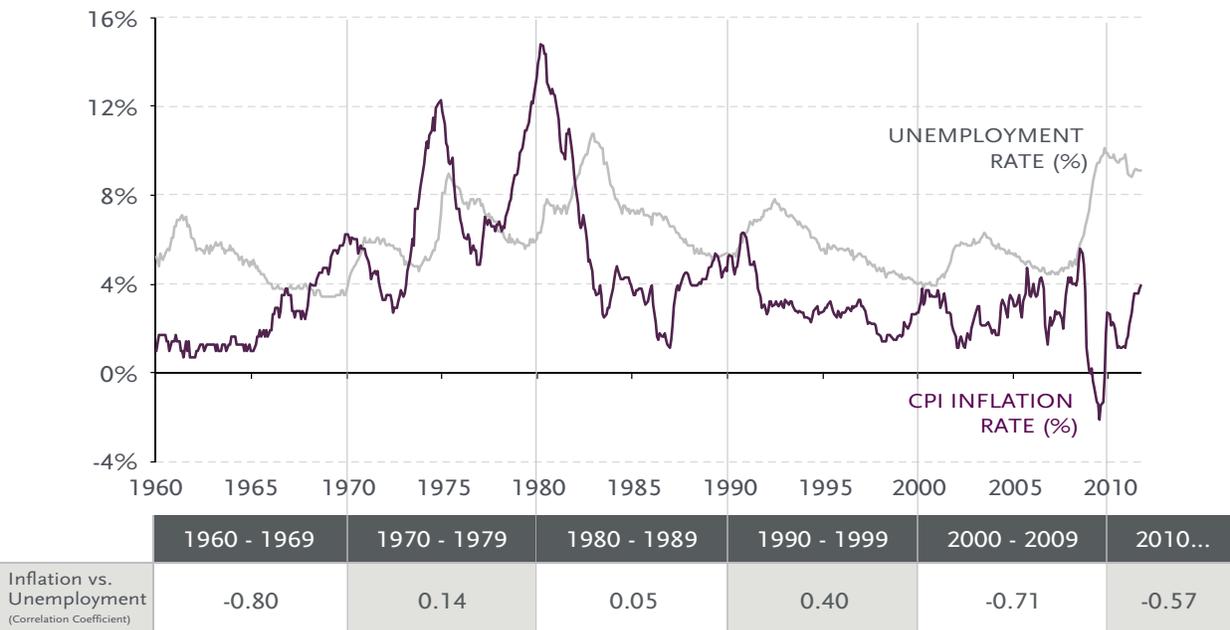
It was a halcyon day for economists. Some started to think that the natural rate of unemployment might be even less than 3.5 percent. Many thought that there might never be recessions or depressions again. The business cycle was officially declared dead.

This dreamy state, however, was short-lived. The notion that inflation and unemployment were inversely correlated collapsed during the 1970s, when both went up. In studying why things went awry, economists learned that the Phillips Curve works during periods of stable inflation expectations. In order to get a wealth effect, incremental price increases must exceed upward adjustments to inflation expectations. Once both producers and consumers expect prices to rise, the wealth effect vanishes, along with its ability to spur nominal growth. In essence, using inflation to induce a wealth effect is like taking drugs—tolerances can build up that necessitate ever-larger quantities to achieve the same effect.

In due course, the effect stops altogether.

LOW INFLATION HOLDS THE KEY TO THE PHILLIPS TRADE-OFF

The Phillips curve — the inverse correlation between the rate of inflation and the rate of unemployment — holds when expectations of inflation are well anchored. In the 1960s, and between 2000 and 2009, unemployment fell as inflation rose. But the trade-off vanishes when individuals anticipate inflation.



Sources: Bloomberg, Federal Reserve, Department of Treasury. Data as of 12/31/2010.

Once inflation expectations come unglued, actual inflation loses its punch, and the inverse relationship with unemployment breaks down. This is what happened in the U.S. during the stagflation of the 1970s. By the end of the decade, inflation was 13.3 percent and rising. Unemployment was back up to 6.0 percent and heading in the wrong direction as well. That's the dynamic that forced Fed Chairman Paul Volcker to slam on the brakes in 1982, choking inflation with a 20 percent Fed funds rate and sparking a severe economic downturn that resulted in record unemployment in the postwar period. By the mid-1980s, the theory that inflation could permanently boost employment had been debunked.

Although it may not hold over long periods of time, the Phillips trade-off can work in the short run, especially when inflationary expectations are well anchored. In fact, with unemployment high and inflationary expectations low and declining, the current economic climate might be perfect for a Phillipian experiment. Expectations for U.S. inflation over the next five years have fallen to 1.76 percent from 2.47 percent in April.

This is why I believe some of Bernanke's cohorts are suggesting that a bit more inflation, now at 1.6 percent in the U.S., would help to ease the nation's 9.1 percent jobless rate.

Easy Money, No Recession

Whether the U.S. Federal Reserve actually wants to generate or just tolerate inflation is irrelevant. In my opinion, the obvious take-away from the recent rhetoric is that the Fed is exploring every avenue in its efforts to ease further.

Continued aggressive monetary accommodation by the Fed reinforces my view that, despite the cries of economic Armageddon, there will not be a recession in the U.S. this year. Even now, there is no broadly followed set of data that indicates that the U.S. is about to drop into a recession.

The U.S. economy, which expanded at a 2.5 percent annualized rate in the third quarter, is clearly gaining momentum and slowly adding jobs. Auto production is ramping up further, and bonuses linked to new UAW contracts could exceed \$1 billion in incremental wage gains. Retail sales, the best proxy for consumption, which represents about 70 percent of GDP, rose at an annualized rate of 4.6 percent in the third quarter.

In addition, lower prices for commodities and gasoline—the latter down by almost 14 percent since May—amount to a tax cut that may free up real disposable income. Another factor is that with mortgage interest rates at record lows, creditworthy borrowers are refinancing their houses and reducing their monthly payments. Refinancing activity, however modest, generally increases discretionary income. All of these factors bode well for a strong Christmas season and economic growth in the neighborhood of 2.5 to 3.0 percent in the fourth quarter.

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INFLATION EXPECTATIONS ARE WELL ANCHORED

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Sources: Federal Reserve, Bloomberg USGGBE05 Index, Guggenheim Partners. Data as of 10/28/2011.

Around the World and Back

In Europe, historic events continue to unfold. The fate of the deal to increase the EFSF and haircut Greek debt, agreed to on October 27, was thrown into doubt four days later when Greek Prime Minister George Papandreou surprised everyone—including his own finance minister—by calling for a referendum on the bailout. Although politics are in play, I see only a remote chance that Greece will have a disorderly exit from the European monetary union.

But what if the worst-case scenario happened? After thinking things through, I'd describe my reaction as "Ho hum." To be sure, it would be tougher on Spain and Italy. (In a sign of distress, the yield on Italian 10-year bonds reached 6.3 percent in intraday trading on November 1, its highest level since the creation of the euro.) But there is still the commitment by European leaders to recapitalize the banking system and backstop other peripheral nations—pledges that I believe have removed systemic risk from Europe's banking system. Absent a Greek bailout, policymakers also would have more firepower and would likely only strengthen their resolve. Mario Draghi, who became president of the ECB on November 1, will likely be more sympathetic to the plight of the periphery.

Given that Europe probably fell into a recession in the third quarter, the ECB may have to reduce interest rates and engage in additional quantitative easing over the coming months. So, I've concluded that even the worst case scenario for Greece wouldn't be that dire for Europe—a realization I think markets are headed to as well.

Outside of Europe, the Bank of Japan added 5 trillion yen (\$66 billion) to its asset-purchase program (a.k.a. the Vegas account) on October 27. Then, after the yen hit a post-World War II high of 75.35 to the dollar on October 28, the Ministry of Finance intervened once again, lowering the currency's value against the dollar. Still, the Japanese currency remains so overvalued that without meaningful and sustainable relief, the economy will eventually melt away. Deflation, exchange rates, and corporate profitability are so bad that manufacturers are shuttering factories in Japan in favor of Vietnam and South Korea. Tokyo has to do something to stimulate the economy, but with a 200 percent debt-to-GDP ratio, further deficit spending is not an option. None of this is a surprise, however, given how Japanese policymakers have managed to consistently falter over the past 20 years. In sum, Japan is simply a basket case.

With regard to emerging markets (EM), I've been mostly negative all year. I'm hesitant to say that we've reached a bottom, as structural issues in China have yet to be resolved. Nevertheless, given the depth of the sell-off in EM equities and the fact that many EM nations have begun to ease monetary policy, it's hard not to argue for adding to emerging-market positions at this time.

What This Means for Investments

What all this means is that the U.S. remains the least-dirty shirt in the bag. In fact, it's looking comparatively better all the time. In the stock market, I believe fundamental and seasonal factors could push the S&P 500 to new highs before the end of the year, despite the drama in Greece. Right now, a little certainty can go a long way. The market has discounted some pretty nasty events that I don't believe will come to fruition. When more certainty comes, especially regarding events in Europe, investors will likely look back and wish they had paid more attention to fundamentals rather than emotions. On a historical basis, stocks are attractively valued, dividend yields are robust, and balance sheets are strong. This is why I continue to echo the anthem "Keep Calm, and Carry On." By staying focused on fundamentals, investors tend to win in the end.

If my outlook on the U.S. economy and Europe is correct, then we've clearly hit a bottom in bond yields. I think 10-year Treasury yields will head higher. I wouldn't be surprised to see them reach the 3.0 percent range over the next few months.

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Elsewhere in the world of fixed income, high-yield debt had one of its worst quarters ever in the third period, with returns basically discounting a recessionary default. Because we now know that is highly unlikely, I believe the fourth quarter should see a price recovery in below-investment-grade debt. Value may also be had in structured credit securities and municipals, both of which have experienced undue price pressure as of late.

Parting Thoughts

Stepping back from the economic tea leaves, I'm surprised that some find certain central banker utterances about tolerating higher inflation so mysterious. They're just acknowledging what U.S. policymakers have done in the past. Inflation helped the U.S. discharge the debts of World War II, the wars in Korea and Vietnam, and the Great Society. You see, when you have a printing press, you can debase your way out of nearly any problem.

With renewed faith in the Phillips Curve trade-off, the Fed is likely to pursue a period of higher inflation in hopes of reducing unemployment. In the short run, it probably works, but a prolonged dependence will lead us to the same end: stagflation. No matter. The implicit return of the Phillips Curve to Fed rhetoric sends a strong message to investors: if the Fed secretly wants a little more inflation, it will get it one way or another.

That's not necessarily all bad for the U.S. In the near term, the moral of the story is what I've been preaching for some time now. The rising tide of liquidity will buoy asset prices, especially U.S. equities.

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