First Trust
Monday Morning OUTLOOK

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Senior Economist*
Andrew Opdyke, CFA – *Senior Economist*
Bryce Gill – *Economist*

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# The Return of Inflation

Inflation is not dead. It is not gone. It has not been tamed. We know it seems like it, especially after the past few decades which generated in many an "inflation-complacency" that feels justified. After all, following the 2008 Financial Panic, many predicted Quantitative Easing would cause hyper-inflation.

When the Fed boosted the Monetary Base by more than $3 trillion dollars during Quantitative Easing 1, 2 & 3, and the federal budget moved to a huge deficit, gold and silver commercials proliferated. So did predictions of a collapsing dollar.

But inflation never came. Since the end of the 2008-09 financial panic, the Consumer Price Index has increased by an average of just 1.7% per year, falling short of the Fed's (conjectural) 2% target. So, what happened?

The answer: Boosting the monetary base is not the same as boosting the amount of money circulating in the economy. Milton Friedman taught us to watch the M2 measure of the money supply.

During the first period of QE, from 2008 to 2016, the Fed bought trillions of dollars of bonds, but also increased bank regulation and capital requirements. As a result, banks ended up holding excess reserves and the money supply remained calm, with M2 growing, on average, about 6% per year, similar to the growth rate in the 1990s.

During the 2020 COVID-induced round of Fed money printing, instead of using QE to put reserves in the banking system, the Fed financed government programs to fund loans to businesses and direct payments to individuals. As a result, M2 has grown 26.3% in the past year, the fastest annual growth we can find in US history, and roughly double the pace of M2 growth the US experienced during the 1970s.

According to those who believe in Modern Monetary Theory – which isn't modern, and is just vaguely a theory - the US can increase real output enough to absorb it. In other words, they say that while inflation is "too much money chasing too few goods" – they expect the output of goods to increase enough to keep inflation low.

We find this impossible to believe. In fact, we think many are living in denial. Inflation is already on the rise. In the past six months, the Consumer Price Index is up 3.6% at an annual rate and if it rises a modest 0.2% per month between January and May, it will be up 3.4% over 12 months. Part of this is because COVID shutdowns led to weak inflation in early 2020, but we expect inflation to move higher in 2021.

But, in addition to M2 growth, incomes and savings have increased, while production has not. Demand is exceeding supply. All personal income combined – wages & salaries, employee benefits, small business income, rents, interest, dividends, and transfer payments – was up 6.3% in 2020 versus 2019. Total after-tax income was up 7.2% in 2020, the most for any year since 2000.

Combined, Americans saved about $2.9 trillion in 2020, more than doubling the previous record high of $1.2 trillion in 2018. As of the third quarter of 2020, the amount Americans held in checking accounts, savings accounts, time deposits, and money market funds was up $2.8 trillion from the year prior. Add another $1.9 trillion in federal government stimulus spending (borrowing from the future, to spend today) and the US is awash in cash, much of which is funded by Washington's money printing.

Unfortunately, in spite of a strong recovery in output, industrial production is 3.3% below pre-COVID levels, while real GDP is 2.5% below. In other words, demand is OK, it's supply that's still hurting – a perfect recipe for inflation.

We can see the impact of this affecting markets. The 10-year Treasury yield has risen from roughly 0.6% in May 2020 to 1.2% today. The gap between the yield on the normal 10-year Treasury Note and the inflation-adjusted 10-year Treasury Note suggests investors expect an annual average increase of 2.2% in the consumer price index (CPI) in the next ten years, and those expectations are rising.

Bitcoin, while we doubt it will ever be real money, hit a record high today reflecting fears of lost dollar purchasing power. Commodity prices continue to surge.

All this money printing threatens to eventually create a sugar high in equities. We aren't there yet, but markets are floating on a sea of new money. In fact, its more like a tsunami! Inflation hedges (real estate, commodities, materials companies) will do well. Traditional fixed income (long-term bonds) is at risk. The return of inflation because of misguided policy choices is a very real threat to the long-term health of the US economy.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 2-10 / 7:30 am | CPI – Jan | +0.3% | **+0.3%** | | +0.4% |
| 7:30 am | "Core" CPI – Jan | +0.2% | **+0.2%** | | +0.1% |
| 2-11 / 7:30 am | Initial Claims – Feb 8 | 760K | **803K** | | 779K |
| 2-12 / 9:00 am | U. Mich Consumer Sentiment- Feb | 80.9 | **79.5** | | 79.0 |