

Monetary and Fiscal Stimulus: *Is Inflation on the Horizon? Will the United States Drive Global Inflation?*



Living Through the Pandemic

As we live through the pandemic, we are looking to gauge the health of both the population and the economy. Daily case counts, positivity rates, and hospitalizations provide data on how society is managing the spread of COVID-19. While virus containment efforts can distort our view of the economy, employment data, housing market indicators, consumer spending, and financial markets help gauge its overall health. We anticipate an economic recovery once the health crisis is contained, but do recognize additional stimulus is required to support economies worldwide. COVID-19 constrains economic growth, regardless of any government-imposed shutdowns. Airlines, restaurants, hotels, cruise ships, etc. are all feeling the brunt of consumer concerns related to the virus.

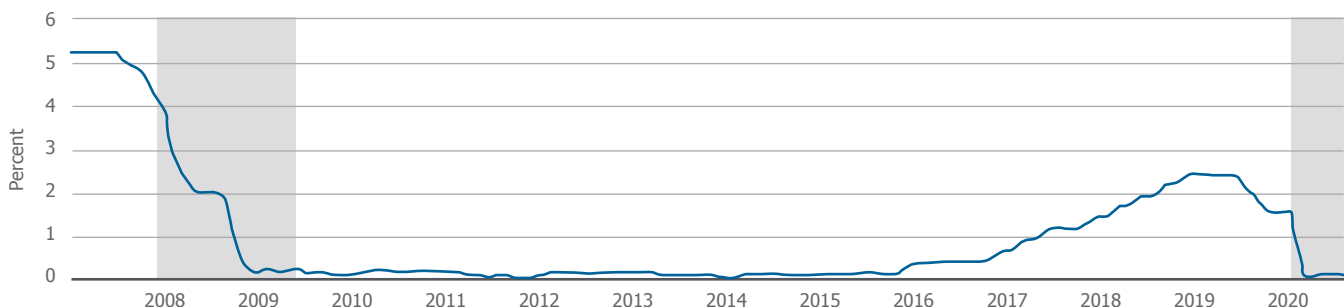
We recognize and agree with Federal Reserve Chairman Powell that future stimulus from monetary policy is limited, and fiscal policy is required to provide the needed support and boost to economic recovery. One can't help but worry about unexpected inflation from additional stimulus measures on top of the amount already pumped into the system.

Monetary and Fiscal Policies to Boost the Economy

Given the political independence of central banks, monetary policy can be implemented quickly and aggressively across the globe. For example, **Chart 1** illustrates how dramatically and quickly the Federal Reserve (Fed) lowered interest rates during the 2008-09 global financial crisis and this past spring.

The Fed lowers interest rates by purchasing Treasury bills and other debt instruments from member banks. This increased demand for government securities increases prices, putting downward pressure on yields. The real driver of stimulus, however, is the increase in bank reserves from the proceeds of sales. Banks are then incited to increase their loan portfolio, as the interest rate received on those loans will be higher than the interest rate received on excess reserves. Increased borrowing leads to increased economic activity.

CHART 1
Effective Federal Funds Rate



Source: Board of Governors of the Federal Reserve System (US)

Shaded areas indicate: U.S. recessions; the most recent one is ongoing.

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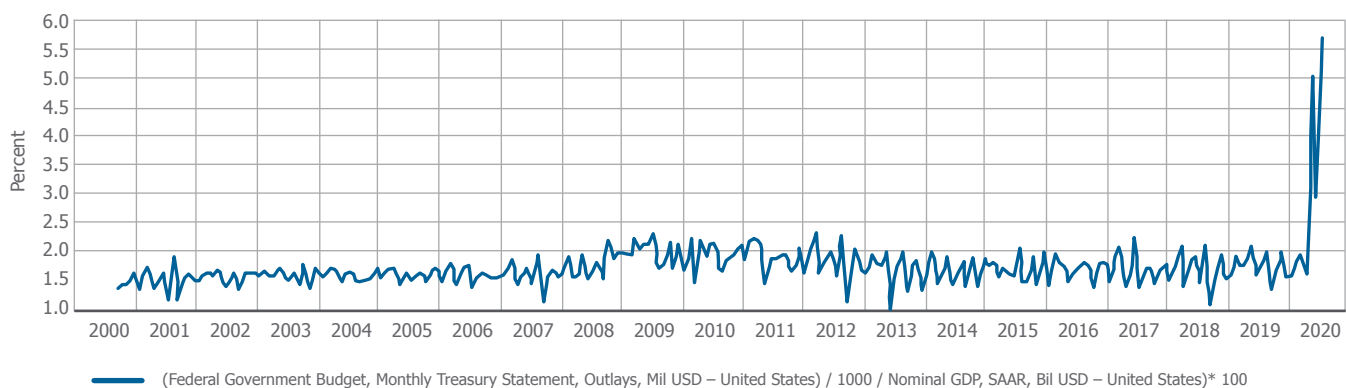
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What if Banks Don't Lend?

It's clear that lowering the fed funds rate is meant to "monetize bank reserves" by initiating borrowing and lending activity to promote economic growth. Things don't always work out as planned. Lenders may face stringent regulations prohibiting them from lending to an individual or entity with anything but a superb borrower profile (this happened following the GFC). Borrowers may not take out loans for a number of reasons, including limited borrowing capacity, low demand for homes, and low demand for business expansion plans due to the economy. This lack of demand for financing the purchase of goods and the money needed to buy goods is referred to as a "demand gap". (Keynesian economics states that public spending is required to offset demand from the private sector to close the demand gap.)

With the fed funds rate close to zero, coupled with the Fed's reluctance to employ a negative overnight borrowing rate, the Fed is limited in its ability to provide further stimulus. It will have to come from the fiscal side—and that is in addition to the incredible amount of government spending so far this year (**Chart 2**). Tax receipts will not cover this increased spending, so the United States is looking at increased levels of debt issuance. Not only is this spending stimulative, but if the Fed continues its debt purchase program (mindful of its desire to avoid a negative overnight rate), monetary policy will remain stimulative as well.

CHART 2
Expenditures as % of GDP



Source: FactSet

What is the End Game?

If there is a large amount of currency in the system chasing the same or fewer number of goods and services, won't that lead to higher prices? It's impossible to predict with certainty the aftereffects of aggressive stimulus, but we can look at Japan to gain some insight.

To stimulate growth, Japan has used monetary and fiscal policies in a meaningful way for the past 20+ years. Japan's

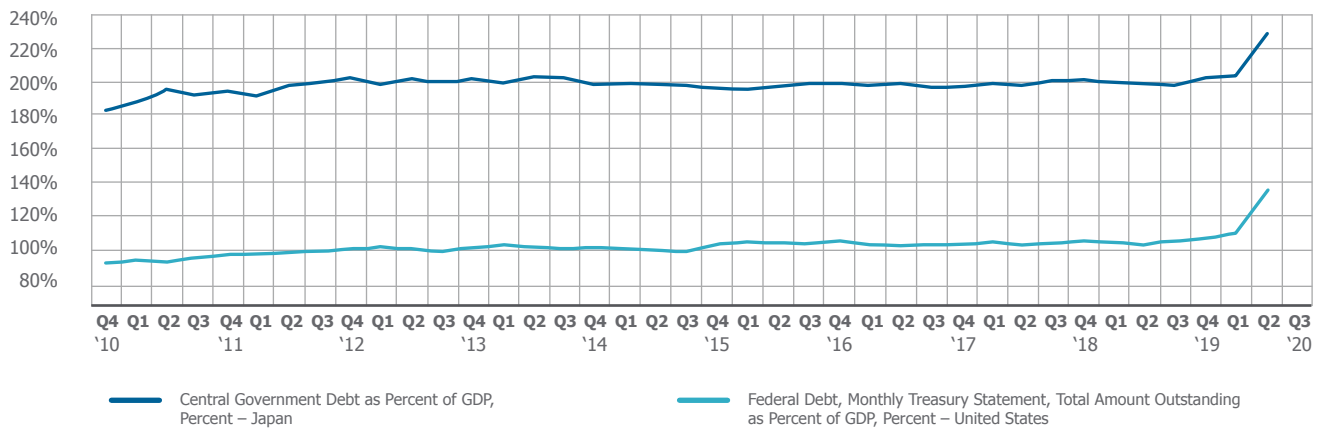
debt to GDP is over 200%, and it has a short-term interest rate target of -0.1% and a 0.0% target yield on 10-year government bonds. Despite aggressive stimulus measures, Japan has not experienced inflation. An important reason for the lack of inflation is due to a demand gap (described above) explained by the aging population and high savings rates. Older consumers have less need for goods and services, and Japan's culture supports strong saving habits for both individuals and businesses.

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The U.S. has rising debt levels (**Chart 3**) and low interest rates, though to a lesser degree compared to Japan. Similar to Japan, there is a lack of demand for borrowing due to the current economic malaise. While the Japanese savings rate is higher than in the U.S., we expect the shock from COVID-19 to lead to higher

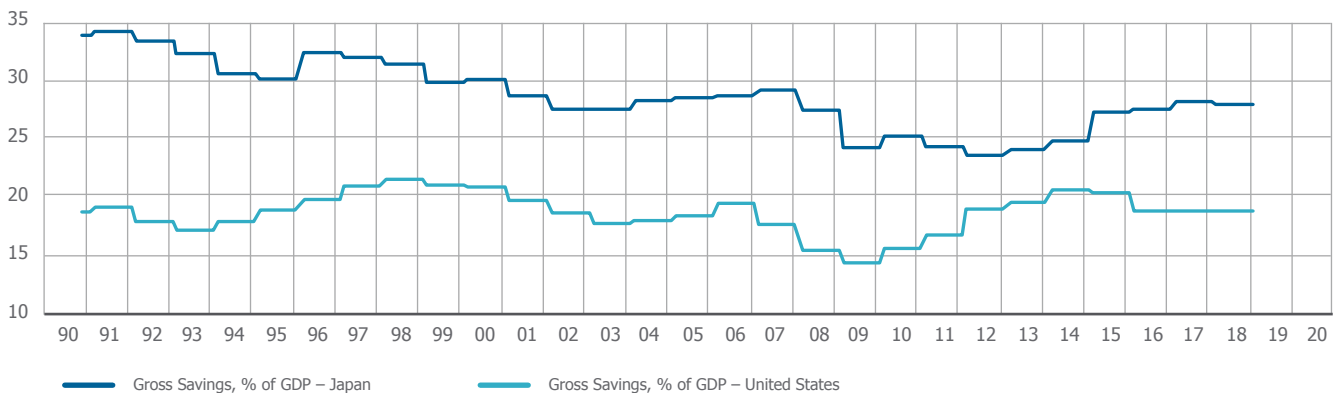
U.S. savings (**Chart 4**). In the near and intermediate term, we do not expect the U.S.' stimulative fiscal and monetary policies to lead to inflation in the U.S. or globally.

CHART 3
Debt to GDP



Source: FactSet

CHART 4
Savings Rates



Source: FactSet

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Uneven Recovery

COVID-19 has impacted sectors in different ways. While overall inflation levels should remain suppressed, there may be certain sectors of the economy that experience higher-than-expected inflation. Service, entertainment, and travel sectors have been negatively impacted, while information technology and manufacturing have fared better.

The implication for our funds is a continued focus on securities with strong financials positioned to weather the inevitable economic volatility. Within corporate bond holdings and across equity portfolios, there is a focus on strong balance sheets (i.e. companies that will remain relevant in this environment and maintain a strong competitive position). Although underweight mortgages are in most fixed income portfolios, holdings in the

funds emphasize securities with underlying borrowers that have significant equity in their homes and relatively low borrowing rates. Thus, refinancing is less likely. While stimulus can support a recovery, well-diversified portfolios manage the risk of continued economic malaise.

It's important to note that while the outlook for goods and services inflation is subdued, we have witnessed asset inflation due to monetary stimulus. By definition, bond prices have been inflated due to the purchase activity of global central banks. Low bond yields are also supporting equity price levels. This has led to strong returns over recent periods, but it does suggest future returns may be more muted, at least on a nominal basis.



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