Is Inflation a Bigger Concern Than we Think?

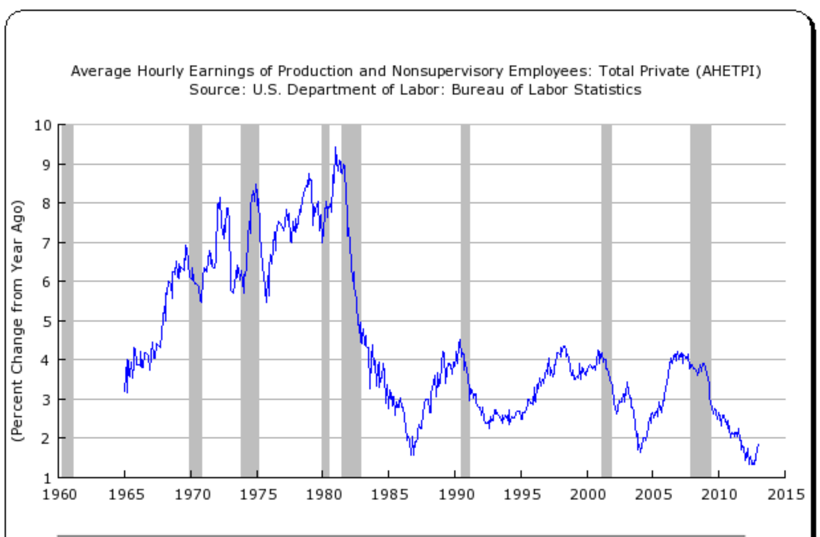
Cullen O. Roche
Founder
Orcam Financial Group, LLC
cullenroche@orcamgroup.com

Inflation on the Rise?

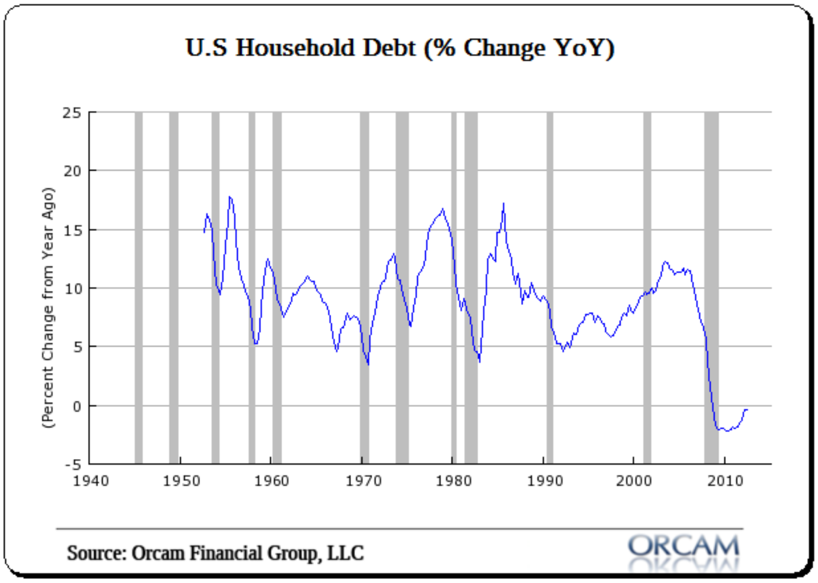
One thing has really been starting to creep into my mind that has the potential to dramatically shift my opinion of various asset classes—inflation. I have been rather vocal about my opinion that inflation wouldn't be a problem over the last 5 years. I warned of deflation in 2008 and then was basically a disinflationist (believing in a falling rate of inflation) for the next few years. And now, for the first time in a very long time we are finally starting to see the wheels move a little bit on the inflation front.

"If everyone is thinking alike, then someone isn't thinking."
-General George Patton

Here are a few items that really jump out at me. The first is average hourly earnings (to the right). We've seen a persistent decline in hourly earnings for a long time now as the labor class has taken a backseat to the capitalist class. But the tide is beginning to show some signs of changing here as the labor market improves and workers have more negotiating power. Government policy is also moving towards a position where workers rights are increasingly driving wages.

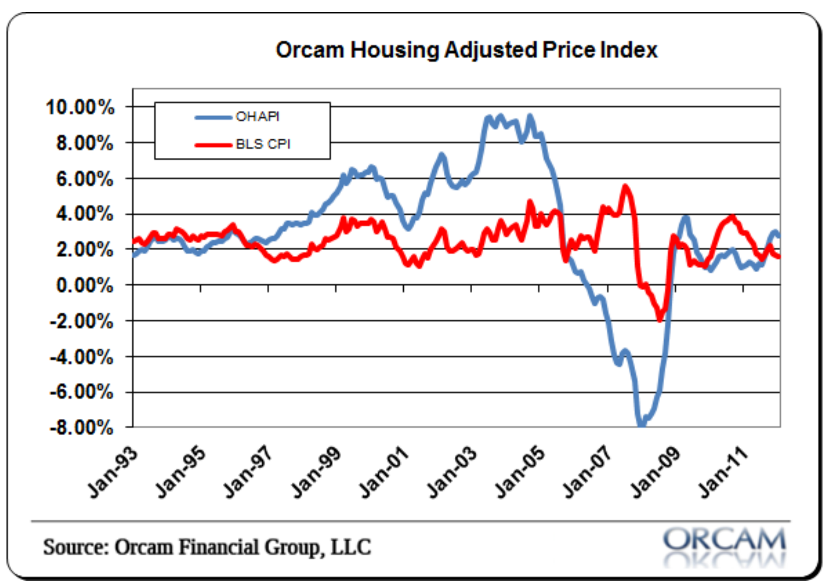


Source: Orcam Financial Group, LLC



The second chart is the change in household debt. If you're familiar with the operational realities of the monetary system you understand that debt is the primary form of money in the system since loans create deposits and the government is a mere redistributor of bank deposits. Contrary to popular opinion, the only money the government creates is a facilitating type in either the form of cash (which allows a bank account holder to draw down their account) and bank reserves which serve as a medium for interbank payment and are never held outside of the banking system (thereby having very little influence on actual economic transactions).

For the first time in almost 4 years, the credit markets are starting to move again. And that means the amount of money in the system is on the rise. More debt means more spending and higher inflation. I think we're unlikely to see high inflation until this indicator moves towards a more historical level, but it's certainly something to keep an eye on. The balance sheet recession is slowly coming to an end.



Lastly, I think the actual inflation in the economy is higher than the BLS is currently telling us. Don't be alarmed—I haven't been drinking from the hyperinflationist punchbowl, but I do think the rationale for at least moderately suppressed government data is fair. The data point that most jumps out is the change in housing. The BLS uses Owners Equivalent Rent in their CPI calculation. They do this because they classify housing as investment and not consumption. But this misconstrues the fact that housing actually contains both components of investment AND consumption. And while OER might smooth the data, it doesn't properly account for shorter-term disequilibrium in the economy. For instance, I calculate the Orcam Housing Adjusted Price Index to account for actual house price declines AND rental prices. In other words, it considers housing to be both consumption and investment. Had the BLS been using this formula during the housing bubble we likely would have had much tighter Fed policy in the early part of the decade when the CPI was showing modest 3% inflation and the OHAPI was at 7%. In retrospect, it's obvious that the OHAPI better represented the actual disequilibrium in the economy and would have triggered alarms about prices much sooner than the Fed actually grew worried.

The current readings of 3% inflation are nearly double the BLS reading and likely to continue moving higher as home prices continue their rise. That means inflation is probably higher than the BLS is currently reporting and the Fed should probably begin thinking about what an exit strategy will be. But, that's highly unlikely given their recent communications. Of course, this is the same entity that saw no worry of a housing bubble as late as 2007 so we shouldn't expect too much on the forecasting front….

Of course, when it comes to the markets we have to continue to look at not only what we think is happening, but what we think others think is happening in the economy. As Keynes once said, the market is a beauty contest. It doesn't matter if you think a certain market is the most beautiful one in the world if you can't find anyone else to agree with you. That said, we have to continue to view the markets through the prism of the Fed. I wouldn't become overly concerned about inflation at this juncture, but I do think it's something we need to start putting on the radar in the coming year or so as it could have a huge impact on policy in 2014. I would put the odds of a Fed move at 0% in 2013 so we're still "good to go" regarding their recent communications.

What does it all mean? Well, first of all, this is all consistent with my bullish macro view of the economy at present. BUT, it's also consistent with a reasoning to own both government bonds and gold as compliments to the equity piece. Tactically, I would not be adding to equity positions at present as I remain risk averse, in the short-term but the bullish macro view has been confirmed by many recent data points. If you don't own a little gold or t-bonds in your portfolio 2013 should continue to display many of the characteristics that we saw in recent years where all three major asset classes generate a positive return. If real rates move even further negative this will help both bonds and gold.

Remember, proper portfolio construction is always about achieving positive risk adjusted returns while protecting our savings against permanent loss and purchasing power loss. The risk of purchasing power loss is on the rise, but a portfolio constructed around an equity component with gold and t-bonds serving as smaller hedging pieces should continue to perform fine.

From the tactical equity view, we've been on the wrong side of the market for little bit now and that certainly eats into the core strategic equity holdings that have performed well during our strategic bullishness here. Of course, the tactical piece is designed to keep us out of the market when risks are high (as it did in October/November) and even at times when the risks are high and we end up foregoing some of the gains.   I still see the equity markets as being a higher risk endeavor in the near-term than most others presume, but I guess only time will tell if this turns out to be a sizable opportunity cost.