

Insights on Inflation

Presented by RBC Wealth Management's Investment Committee

One of the greatest topics of interest among RBC Wealth Management's clients and financial consultants is the potential threat of inflation.

In the aftermath of the financial market dislocations and economic crisis, a number of uncertainties linger for investors. Considering the explosive expansion of the Federal Reserve's balance sheet, the significant increase of the federal deficit and debt, and the weakened U.S. dollar, it's understandable why inflation is being hotly discussed and debated on Main Street and on Wall Street.

So RBC Wealth Management's Investment Committee engaged two of our colleagues at RBC Capital Markets, Ira Jersey and Tom Porcelli, in a wide-ranging discussion about the topic. This report provides their professional insights and opinions about inflation-related issues in a conversational "question and answer" format.

In addition to addressing near- and mid-term inflation risks, they also discuss long-term challenges. Their perspectives about the U.S. dollar's potential vulnerabilities and how the weight of entitlement programs could impact inflation and the economy (pages 6-9) are particularly noteworthy.



Ira Jersey

Ira is head of U.S. Interest Rate Strategy for RBC Capital Markets' Fixed Income and Currency Strategy group. He oversees a team that covers the U.S. Treasury, interest rate derivatives, agency debt, and mortgage markets. Before joining RBC in 2009, he was a Director in the U.S. Interest Rate Strategy group at Credit Suisse. Prior to that, he was employed by Morgan Stanley and the Vanguard Group. Ira is also a Professor of Professional Practice at the Graduate school at New School University.



Tom Porcelli

Tom is the U.S. Economist for RBC Capital Markets' Fixed Income and Currency Strategy Group. He worked in a similar capacity on the fixed income desk at Merrill Lynch. Tom began his career on the Open Market Desk at the Federal Reserve Bank of New York. He holds an MA from Columbia University.



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Q&A Session ...

Moderator: You've asserted that inflation is not a near- or a mid-term risk for the U.S. economy. Can you elaborate?

Ira Jersey: Primarily it's based on several factors.

One factor is that the U.S. consumer continues to be very over-levered. From our work looking back over the past several economic cycles, one of the unique aspects of the last ten years is that the consumer did not increase spending because of higher wages. They really only increased spending because they were able to lever themselves, or indebt themselves very significantly. That generated about \$3.5 trillion worth of excess debt above the trend the consumer had been on since 1952.

So, one of our core beliefs is that until a proportion of that debt is either worked off or paid down, we're unlikely to see a large uptick in consumer spending.

Secondly, manufacturing overcapacity, globally, continues to be a major concern of ours as far as the pace of economic growth. This makes it unlikely that core inflation, especially, will wind up being a problem in the near and intermediate terms.

So all taken, we don't see a significant uptick in inflation, even considering what the Federal Reserve has done over the past year and a half in increasing its balance sheet.

M: But is there a possibility that measures of global manufacturing capacity will be less useful as inflation indicators than they have been historically?

Ira: There is a risk they're not going to work in part because for some of the developing economies, particularly in Asia and South America, there is considerable overcapacity, but measuring that is more difficult.

We don't really know how much overcapacity they have, but the assumption is that given the investment they've made over the years, they could have significant overcapacity, especially since the United States isn't buying nearly as many goods from developing economies currently as it had previously.

So capacity utilization measures are incomplete as a guide. You need to look at global capacity as opposed to just U.S. capacity, but there's more uncertainty in measuring that.

M: What events would need to occur before you would become concerned about inflation?

Ira: The primary indicator we would look at, just from a pure data standpoint, would be the money multiplier (a measure of the velocity of money). And what would have to happen is that the money multiplier would have to start to increase, while the Federal Reserve keeps its balance sheet about where it is today.

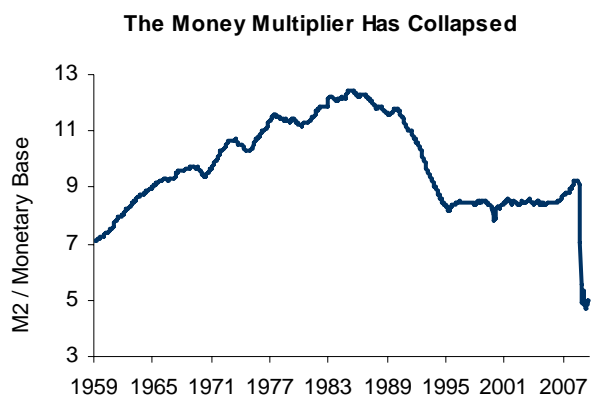
M: Can you explain, in layman's terms, what you mean by money multiplier?

Ira: Well what happens when the Federal Reserve actually prints money? We've all heard about that. But, there are two ways it prints money.

First, it does print bills. If you look at the dollars in your pocket, they say Federal Reserve Note at the top. So it can print physical money.

Or it can do the electronic form of printing money by increasing bank reserves. Banks can then lend those reserves a multiple amount of times. This is known as the money multiplier. No matter what form of the multiplier you look at, it has dropped very significantly.

One of the forms of the money multiplier we look at is M2, a reasonably broad measure of money, compared to the monetary base, which is the physical money and bank reserves the Fed creates. This represents the money the Federal Reserve literally creates. And that has fallen from about eight times to about five times.



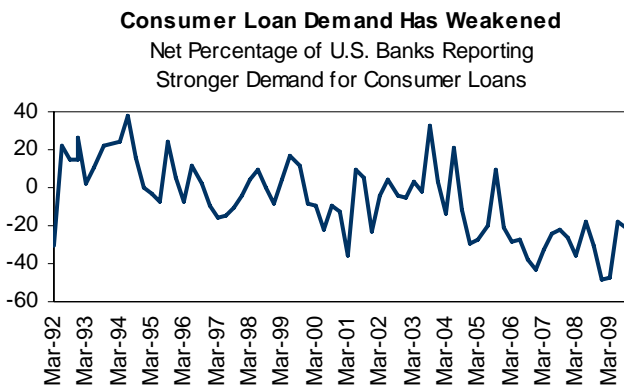
Source: RBC Capital Markets Fixed Income & Currency Strategy, Haver

Now the reason the money multiplier has fallen is that the monetary base has increased dramatically, but the money supply has not. One of the reasons is that banks continue to be capital constrained. There's been about half a trillion dollars of bank regulatory capital destroyed over the past several years, and as that has

occurred, banks have been unable to lend against the reserves created by the Fed.

M: So as long as banks aren't lending to a significant degree—partially because they're not in a position to do so and partially because there's not much demand for loans—is that why the money multiplier hasn't increased lately?

Ira: That's one of the big reasons why, yes. Bank capital remains challenged and, with new regulations coming online—as Treasury Secretary Geithner has suggested—banks will need more capital than before to start lending significantly more of their excess reserves. Until they do, the Fed's accommodation can remain in the system.



Source: Federal Reserve Senior Loan Survey, July 2009

The banking system may pick up some of the slack over time, but it will take several years to repair regulatory capital.

Also, while lending growth should stabilize along with bank capital, lending standards are not likely to ease over time. During the last credit cycle, bank lending standards increased, but while banks were increasing standards, new “shadow” banking products did not demand the same requirements (subprime loans, etc). As the regulatory environment changes, we believe banks will remain unwilling to commit significant capital to risky lending.

With a collapsed money multiplier and the reserves created during asset purchases remaining at the Fed, inflation is not likely to be a concern. We believe tightening (rate hikes from the Fed) will be necessary if we see signs that bank lending to riskier borrowers is picking up and if a rising money multiplier is combined with a stable monetary base.

M: If the initial phase of the U.S. and global economic recovery turns out to be stronger than Wall Street economists are currently forecasting, how would that impact inflation?

Ira: Well, it would increase inflation risk somewhat, but we have to keep in mind that a large reason why we're coming out of recovery right now is because businesses are rebuilding their inventories.

Tom Porcelli: Over the very near term, we actually expect economic activity will be boosted by inventories. We've gotten to the point where there's been a massive inventory drawdown—in other words, companies sold much of the remaining inventory they had on hand. And what that is allowing at this point is manufacturing activity to come back online. In fact, we're seeing that in the data.

So a lot of this is being driven by one area that most people can really relate to—the inventory build that recently took place in the auto sector. That is what's basically going to boost economic activity, at least in the near term.

Our worry is that this will be more of a sugar-high. In other words, inventory has been drawn down to such extreme levels that manufacturing activity will have to come back. But, if that is not met with an increase in aggregate demand, then ultimately what we'll see is economic activity pull back.

If consumer spending does begin to pick up—which we'll actually see some of that happening during the third quarter—but is not sustained, then ultimately what's going to happen is a lot of this activity in manufacturing is actually just pulling economic growth forward. In other words, we could see a blowout quarter in Q3, but in subsequent quarters we could actually see economic activity pull back.

Our main thesis behind our projection that consumer spending could remain pretty soft is a jobless recovery. At this point there are a number of metrics pointing to a jobless recovery, and this is something that occurred after the last two recessions of 2001 and 1990.

During the 2001 recession, the fact that we went through a jobless recovery tended not to matter because economic growth, particularly in the consumer space, was largely unscathed.

However, of course, this time with consumer spending falling pretty significantly, if we do go through a jobless recovery—which tends to see consumer spending rise anywhere between zero and one percentage point in terms of its relation to economic growth—that'll be pretty painful.

So again, we can certainly expect some manufacturing activity to give a boost to top-line growth, but without any jobs going back online, it could be short-lived.

In general, we see economic growth being muted over the next several years as balance sheet adjustments continue.

Even with economic growth, we continue to believe inflation is likely to remain well below average, and core inflation, and therefore wages, continue to be lower than what can be considered problematic from a monetary policy perspective.

M: How does employment impact inflation risks? For example, if job growth and wage growth are weak—as you are forecasting—then are inflation risks lessened?

Tom: Yes, I think that's exactly right. Just think of it in simple terms. It's difficult to generate any kind of consumer inflation if you don't have wage or consumer spending growth. I think that is the simplest way to think about it.



Source: Bloomberg, Bureau of Labor Statistics

As Ira wrote recently, even if you do have economic growth, it doesn't necessarily mean we have to have significant inflation.

Observers of financial markets have been trained to think that is the case, but that doesn't necessarily have to be the case. And in fact, even if we do see economic activity pick up here, we're not looking for any kind of significant inflation.

M: How confident are you that the Fed will be able to withdraw its stimulus in an orderly and effective manner? In other words, are financial markets and investors dependent on whether or not the Fed gets it right?

Ira: To some degree that's always the case. I think in this situation we have to look at how the accommodation (the liquidity the Fed added to the financial system) could be reduced.

Everyone is concerned about the fact that the Federal Reserve's balance sheet has gone from about \$900 billion to over \$2 trillion.

So you have about \$1.2 trillion added to the Fed's balance sheet. How does it get rid of that? Half of that goes away in the next three years, just if the Federal Reserve stops buying any additional securities.

Between the roll off of treasuries it has purchased, the repayment of mortgages, and the roll off of agency bonds that it has purchased, a significant part of its current accommodation will go away without the Federal Reserve doing anything. Not to mention the fact that if it starts to do that in a significant manner, then some of the other programs, like the term auction facility and several of the other liquidity facilities that it has created, will be used significantly less.

That addresses the asset side of the balance sheet. Just like any other financial institution, the Federal Reserve has a balance sheet. It has assets and it has liabilities.

On the liabilities side of its balance sheet, it can manage that very easily by conducting reverse repurchase agreements, which basically would put treasuries back into the system without having to sell them. That would also have the effect of reducing the monetary base.

Then if it really needs to make sure that banks are keeping their reserves at the Fed, the Federal Reserve could just raise the Fed Funds Rate and pay banks more for the reserves they are keeping at the Fed.

So in general, I think they could reduce a significant amount of accommodation very easily, without creating a lot of havoc in the market. And they would be able to do so in a reasonably orderly fashion. Alternatively, the Fed could also auction "term deposits," which would basically be like longer-term Certificates of Deposit that banks would take from the Fed.

One of the worries we have in our broad outlook on inflation itself, is that the Federal Reserve would start to increase its balance sheet significantly further than it has so far.

But we don't see it doing that. We actually see the first signs it is reducing accommodation and ending the quantitative easing program—in other words, ending the purchase of securities.

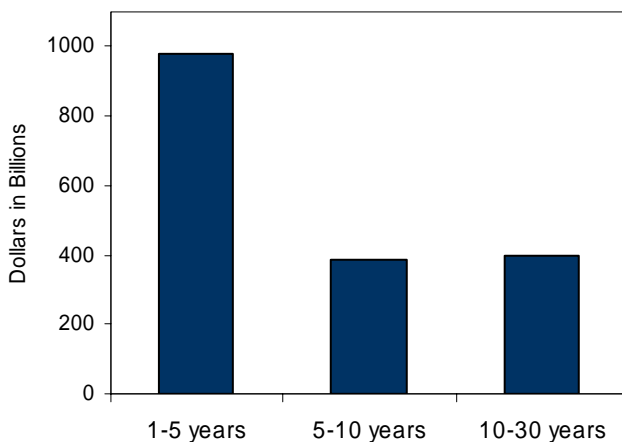
By reducing accommodation, we do think the Fed will actually keep inflation low and also keep the pace of economic growth lower than it would be otherwise.

M: It sounds like you believe the Fed has the sufficient tools to reduce its stimulus.

Ira: It's already done that, actually considering the approach the Federal Reserve has used to purchase treasuries and mortgages. It has bought throughout the yield curve—it just didn't buy, for example, 10-year bonds that it will have to wait 10 years to roll off. It purchased a significant amount of 1-year, 2-year, and 3-year securities.

Much of the Liquidity the Fed Injected will Automatically Mature within 1-5 Years

Fed Assets Purchased in Open Market Operations by Maturity



Source: RBC Capital Markets Fixed Income & Currency Strategy, Haver; data reflects the Fed's purchases of T-bills, Notes and Bonds, TIPS, Agencies, and Mortgage-Backed Securities

We estimate that over \$300 billion of the Fed's balance sheet will roll off by the end of 2010, reducing the Fed's balance sheet by over 10% in one year (excluding the liquidity programs).

This means that non-borrowed reserves would likely be reduced from about \$600 billion to \$300 billion next year. Ending the asset-purchase programs, in effect, is a removal of accommodation.

There has never really been an issue of whether or not the Fed has the tools. However, it is a good question whether or not it could unwind it in an orderly manner.

If it had to do it faster, for example, then it might have to ultimately sell treasuries or mortgages into the open market. That could certainly cause rates to spike up very quickly and probably cause the curve to steepen a little bit if it were to be selling 5-year and 10-year securities.

We don't think it will have to do that, but if it were to sell securities, there will be a question of whether or not it could do so in an orderly way.

Ultimately I think the Federal Reserve is aiming for modest inflation. Having deflation doesn't help. Having 1-3% inflation—especially if it's driven by higher wages—is beneficial for the economy, whereas having inflation significantly faster than that is not.

As for the Treasury market, as long as inflation expectations remain anchored and supply does not spike, it should remain supported.

M: Have the Fed's aggressive actions during the financial crisis created uncertainty about the long-term inflation outlook?

Ira: We really don't think so. In fact, it ultimately winds up being the underlying economic fundamentals of the United States and indeed the globe that matter a lot more. And there is significant overcapacity in global manufacturing infrastructure.

Now that being said, the bigger risk to our view on inflation, especially on U.S. domestic inflation, is that the global economy outside of the United States could pick up significantly—such as in emerging market countries and developed countries with cyclical characteristics.

So if the more cyclical countries wind up having significantly faster growth and are able to help drive commodity prices higher, we could get significant headline inflation in the United States, similar to what happened in the first half of 2008 when headline inflation was quite high, but core inflation (which excludes food and energy) was very low.

From all indications we have seen, the increases in corporate profit margins will remain reasonably low and will continue to be dependent on cost cutting. That means less jobs, and it means companies are going to be very conscious about their revenue.

We don't anticipate that revenue in the United States is going to grow very quickly, even if there is a significant increase in headline inflation, which is just a tax on the consumer. So actually that would hamper the government's efforts to increase growth domestically in the United States even more.

M: Is that your greatest concern about the economic environment?

Ira: My big fear—what keeps me up at night—is if the U.S. economy were to continue to slog along as it is currently, and for the rest of the world to have significantly faster growth.

Therefore, you would wind up with a situation where U.S. headline inflation would rise significantly but core inflation would remain very low.

A situation like that is really the worst-case scenario for the United States because the Fed can't raise interest rates because growth is so slow and you don't have wage growth.

But at the same time the back-end of the Treasury yield curve (long rates) winds up steepening and selling off. So you have a pretty big bear steepener. That's one of the dangerous scenarios in this environment. That's my biggest worry about the next couple of years.

M: Should individual investors monitor commodity prices for hints about whether or not inflation could occur? Or, can commodity prices provide false hints?

Tom: Yes, they can definitely be false signals. And in fact, if we consider the CRB Index—an index that tracks a broad range of energy, agriculture, and metals commodities—which has generally been on the rise over the course of this year, you could see is that in fact it could rise rather significantly.

Although that being said, even when some commodity prices have risen rather significantly recently, we haven't seen those higher prices being passed through into consumer spending. That's largely because there's just not enough aggregate demand for firms to feel comfortable passing along those higher commodity costs.

So again, just to use a data point we received recently, in a regional manufacturing index, we see that prices companies are paying for commodity inputs are actually on the rise, but the prices they are receiving for their final products are actually holding steady. That translates into a profit margin squeeze for manufacturers.

Ultimately, it comes down to aggregate demand. Only when we see a return of aggregate demand will manufacturers have the ability to pass on higher costs.

M: Are there any outside events that could cause inflation to rise to a relatively high level—for example, if consumer prices were to rise 5% or more over a sustained period?

Ira: I think one of the issues could be if there were to be a currency crisis in the United States.

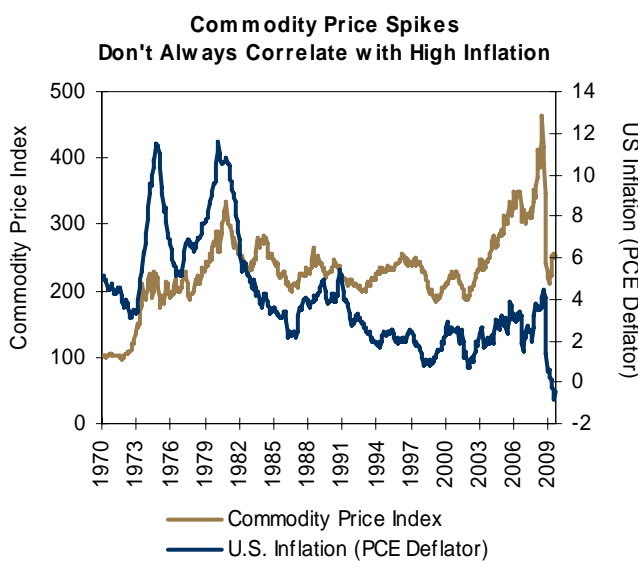
So for example, you can have a situation where the prices continue to go up significantly just because the value of the dollar gets significantly depreciated, and that could certainly make inflation rise somewhat.

Now can it go up more than 5%? That would be, I think, pretty unlikely.

Could you have headline CPI tick up towards there because gas and commodity prices wind up doubling in the span of a year? That's possible, and you saw that in the beginning of 2008, for example, even as most countries in the world were slipping into recession.

So there is certainly the possibility of headline inflation going too high. But the problem is that—as you saw, again, I'll go back to the beginning of 2008—even when you had 5% CPI growth, you still had very low core inflation growth. So excluding food and energy, inflation will wind up being reasonably low.

What that means is if you are worried about commodity prices moving significantly higher, then something like Treasury Inflation Protected Securities would hedge against that. Whereas, over time longer-term, nominal treasury securities tend to look more at core inflation because typically a spike in headline inflation does not persist, as you have seen happen over the past year and a half.



Source: Bloomberg, Bureau of Economic Analysis; Commodity Price Index reflects the Reuters/Jeffries CRB Index which includes energy, agriculture, and metals commodities

M: If the dollar continues to slide, what would that do to inflation risk?

Ira: Well a significant fall in the dollar would feed into the imported goods. So import prices would tick up, and that would be where inflation would come from, firstly.

And then secondly, if it was considered to be a long-term phenomenon, it's possible that large foreign investors in U.S. Treasury securities might not be buyers of those securities.

This would have a detrimental effect on the demand for the significant supply of treasuries that are still likely to come over the next couple of years. The supply won't be as egregious as in 2009, but certainly the net supply of treasuries is going to be reasonably high in 2010 and 2011.

So a situation like that would certainly be worrisome. Now would that create inflation per se? Ultimately, what happens is that you get a significant tick-up in inflation and you wind up getting a decreased value of the dollar. But, then as interest rates go up so high, at some point you'd see somewhat of a reversal of that.

It's hard to envision a situation where you get a true currency crisis in the United States, given a number of factors, including the fact that all of the debt the government has issued is denominated in dollars. Unlike a lot of other countries that have had currency crises in the past, most of them, in fact, all of them that I can think of, have had significant non-local currency liabilities.

In the case of the United States, realistically, we're not a credit concern. So the question is, will increased treasury issuance and will the Federal Reserve's balance sheet being higher be a precursor to inflation? And that is everyone's concern, but that is not our concern, just because of the reasons that I've highlighted over the course of this discussion.

Is it possible if we had a currency crisis for inflation to tick up to double digits? Perhaps, but to get a currency crisis, you'd really have to have a lot of policy mistakes, and I'm not sure the current Federal Reserve and the current administration are going to make those mistakes.

In fact, if they're going to make any mistakes, it is probably to the other side, the disinflationary side, where increased taxes and some other policies similar to that can actually create an environment where we have disinflation and perhaps deflation as opposed to faster inflation.

M: What are your thoughts about the long-term risks for the dollar?

Ira: Shifts tend to be generational as opposed to near term. So your time horizon ends up being important. We recognize the fears and some of the rhetoric coming out of countries that want a global reserve currency that's not necessarily the dollar. That may ultimately occur 30 or 40 years from now. But it would be a generational and evolutionary change.

Secondly, it would mean countries would need to agree on some type of new paradigm. And basically it would mean countries would have to be more open to each other.

Think about how long it took for Europe to create the euro. There were 20 years of the European Monetary Union and other initiatives ultimately before the euro was created. So a shift away from the dollar isn't a change that could happen in the next 5-10 years, but longer term it's possible.

What impact would this have on the United States? It depends. It depends how the economy is at the time. It depends on the demographic shifts that are occurring over that period of time. The United States probably won't be the demand driver of the global economy in one generation's period of time, just because of our demographic challenges.

So longer term, there is the possibility that some major shifts could occur. Does that mean the United States is going to default on its debt or that Treasury yields are going to rise in the next five years? No. It does not mean that at all.

M: In terms of the soaring fiscal deficit and high federal debt level, is that a concern to you from a mid-term inflation perspective?

Ira: No, it's not. Realistically it would be if the deficit were a significant driver of consumer spending, but ultimately a lot of the federal spending programs are multiyear programs that are not going to be very stimulative over very short periods of time.

Although, with that being said, there could be some very successful programs like Cash for Clunkers, which are going to help third-quarter GDP quite dramatically.

The question is, could that \$3 billion or so that they have used for Cash for Clunkers, is that going to feed into a sustaining cycle of economic activity? We don't think it will.

M: Does a high level of government debt automatically cause inflation? For example, you've written previously about how Japan's debt-to-GDP ratio is much higher than ours is right now.

Ira: Japan's inflation rates have been either negative or near zero for the better part of a decade and a half. And its 10-year government bond yields, for example, have been roughly under 1.25% recently. So high deficits and high debt-to-GDP do not necessarily mean you're going to get higher yields.

And Japan is an interesting case because, like the United States, all of its debt is denominated in its own currency. So even though it has a non-AAA credit rating, it is still able to have very low rates and very low inflation.

It also has a demographic challenge, even greater than the United States does. And because of that, it has other demand factors the United States isn't necessarily beholden to. But, it's another interesting case-in-point that high deficits don't necessarily mean high yields, especially when the inflation situation remains very disinflationary.

That's one of the reasons why deflation is such a concern. The fiscal situation of the U.S. government cannot improve significantly without a pick up in wages and the subsequent pick up in tax receipts that comes along with it.

Japan is the perfect example. It's basically had zero inflation for ages and its fiscal situation continues to deteriorate partly because it has had no new revenues, no new tax receipts.

M: What are your thoughts about the long-term entitlement commitments that are stacked against the U.S. and taxpayers?

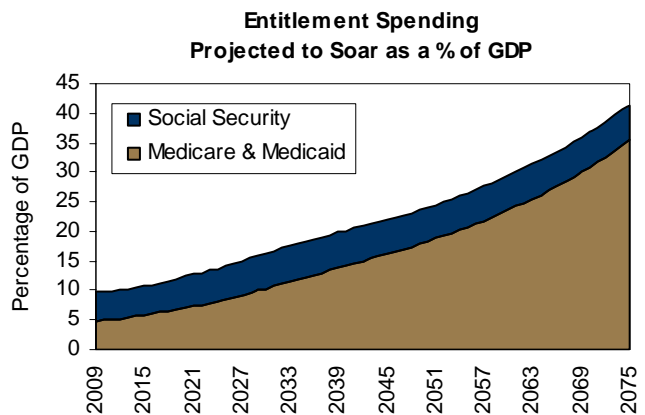
Ira: They need to be addressed—period. There are no ifs, ands, or buts about it.

The government needs to come up with a credible plan and actually implement the plan in order to ensure that funding of Social Security, Medicare, and the new public healthcare option being debated are actually dealt with because they will be a significant drag on the U.S. economy in general.

Whether or not such a plan would be for the Fed to monetize the debt and thereby create inflation—I think politically that's not likely.

For people on fixed incomes, inflation is an undesirable outcome. It's politically very difficult for a government with a two-year election cycle to allow for

significant inflation with much of the electorate on fixed incomes, in our view. Is it possible? Yes. Is it likely? No. That would be the only way I could characterize it because the political economics of doing so would mean the standard of living of retirees would go down more than most are anticipating.



Source: Congressional Budget Office

However, ultimately even the slowing down of the growth rate of entitlement spending over a period of time—such as slowing growth pace of Social Security payments—would diminish long-term demand growth in the United States. That's something else that will change the economic condition of the country. We would no longer be the consumer of last resort for the world.

With respect to the baby boomers retiring, that should result in less savings, probably greater government spending, and therefore the potential for higher taxes, which again ends up being disinflationary as opposed to inflationary.

M: So do you see the entitlement issue as a drag on the economy either way?

Ira: Yes, it's still a drag, but not as much of a drag if the government lowers entitlement payments instead of increasing taxes on those still in the workforce.

How we pay for these entitlements is important. The "pay as you go" federal budget process has challenges due to demographic changes. Eventually it creates an unsustainable system. But unfortunately the reality is we have built such a system.

It's interesting that five years ago everyone was talking about the transfer of wealth from the baby boomers to their kids, and now we're talking about the baby boomers basically needing to use almost all of that wealth in retirement.

M: You mentioned the possibility that the government could attempt to monetize the debt, or inflate its way out of debt. Can you elaborate on that?

Ira: I'm just not convinced there is really a way to engineer that in a very significant way.

It's clear to us that the Federal Reserve does not want that outcome. With a lot of the Fed speak you have heard over the past month or so, the fact that it has gotten rid of the quantitative easing program and purchases of treasuries, all of those actions are really disinflationary and less accommodative. It's not the other way around.

One of the beauties of being in a reasonably informed representative republic is that the representatives are ultimately going to do what the people want. If people see inflation as a serious problem, the government is going to respond to that.

We're already hearing Fed officials comment about that recently. Their message is, "We will put the kibosh on inflation if we think it's going to be a problem." Everyone is questioning whether or not Fed officials have the will to do it, but ultimately they probably do.

There is a risk that something like monetization might happen if the government were to regulate the Fed more than it does now.

But, I think central bank independence ultimately is something that will also continue. It's going to be very difficult for the government not to ensure that the Fed is independent.

Fed independence is one of the reasons why we are able to have a reasonably robust currency and one of the reasons why we are able to have interest rates that haven't ticked up and why interest-rate volatility and inflation volatility, for that matter, hasn't been more significant than it has been over the past 20 or 30 years.

M: There is a movement among some in Congress to regulate the Fed more. What are your thoughts?

Ira: It would not be constructive for individual decisions and for some of the programs the Fed institutes to be regulated.

Now given that this is taxpayer money we are talking about, ultimately I do think there are certain parts of it that make some sense to be questioned.

For example, the government has the right to ask what types of credit risk the Fed is taking. Also, it could ask about the haircuts or discounts on the securities and the

other collateral the Fed is accepting for some of the programs.

But, releasing some of the information to the public—in particular, individual names of financial institutions, for example, that utilize the programs and question whether or not a decision is correct—I think those type of audits are not very helpful and certainly not useful, given that the Fed chairman does go to Capitol Hill several times a year to talk about both monetary policy and the Fed's actions.

M: Do you anticipate the Fed will remain relatively independent after the new regulatory framework is imposed?

Ira: I do think that ultimately will be the outcome. Will there be somewhat more scrutiny on some of the credit issues and programs it has implemented over the past several years? Perhaps, but at least from the standpoint of monetary policy decision making, I think it will remain independent. And if not, the markets would likely react unfavorably.

M: Because we would then be in the hands of the politicians?

Ira: Correct.

M: Let's shift gears a bit ... The extreme historical example of a major global power experiencing hyperinflation is that of Germany in the 1920s—the so-called Weimar Republic. Under what circumstances, if any, do you think this could occur in the U.S.?

Ira: Germany wasn't a major economic power when its hyperinflation occurred in the 1920s, which was part of the post-war problem it had.

Think about the capital flows and money flows that occurred back then. Simply put, Germany ran out of money and couldn't pay reparations from World War I to the U.K. and France.

So Germany borrowed money from the United States to pay the reparations. Then the U.S. ran out of money. We exported our dollars to Germany so they could pay the U.K. and France the reparations.

Then the U.K. and France loaned money to the U.S. so the U.S. could in turn loan money to Germany to pay the reparations to the U.K. and France—on and on the cycle went.

Those capital flows ultimately led to Germany needing to inflate just to make their payments.

The Weimar treaty was a policy error. You can make the argument that every negative economic situation during the past century has a policy error somewhere. But I think the situation in 1920s Germany is a bad comparison because there were structural issues that occurred. They monetized the debt because of that structural change.

Could the United States do that and just print money to get out of this? Sure. But I think we won't have the appetite to do that politically.

M: How should investors protect themselves from the risks of inflation over the mid or long term?

Ira: Treasury Inflation Protected Securities are certainly the easiest means of expressing a view on inflation.

And if you look at right now, for example, at the 10-year breakeven inflation rate—basically what inflation would have to be for you to outperform buying a Treasury Inflation Protected Security over buying a 10-year nominal bond—it's about 1.94%.

So if you think inflation is going to be higher than 1.94%, you want to buy TIPS. If you think it's not, then you want to buy a nominal treasury.

M: Do you have any closing thoughts?

Ira: I would just close by noting that in looking at inflation, we have to consider that traditional thoughts on monetary policy—and “traditional” meaning the last 40 years of what we have learned from monetary policy—we kind of have to unlearn what we have learned and reconsider our reasoning of how monetary policy functions.

We have been taught that low rates or monetary base expansion will cause growth to increase and then inflation will pick up just because economic activity is higher. Again, that's not necessarily the case. So I think we need to rethink some of these ideas.

We need to rethink the concept that the monetary base going up is inflationary. It's not necessarily so. We need to rethink a lot of what we have learned, because this situation is significantly different than any situation we've seen in the last 60 years, certainly in almost every market participant's lifetime.

So we need to go back to other periods and look at, for example, the 1800s, when you had significant volatility in the economy and actually had deflation and disinflation for most of that century. Now granted, it occurred for different reasons—because of innovation and other factors—but at the same time there are lessons to be learned from periods outside of the post war period.

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