INFLATION HOPES, DEFLATION FEARS, MARKETPLACE SIGNS

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"What's it all about, anyone in doubt,
I don't want to go until I've found it all out." Cream's song, "N.S.U."

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MARKETPLACE VISIONS AND VALUES

Assorted authorities offer diverse opinions regarding financial history as well as current and future economic scenes. What economic variables are important and what are their implications and why? Gurus unveil an array of viewpoints about the definition and importance of an individual economic phenomenon. Clairvoyants also reveal insights regarding apparent relationships between constellations of economic factors. In stock, interest rate, currency, and commodity universes, soothsayers proclaim or act upon their personal viewpoint regarding economic information; past, current, and future price trends especially fascinate observers.

In this ongoing cultural process, amid debates regarding marketplace facts, uncertainties, probabilities, and unknowns, the perspectives of various wizards and players reflect and promote their own (and very often widely-held) values of good and bad. Marketplace (economic) right and wrong and neutral (good, bad, and indifferent) is a complex subject. The same is true of concepts of merit within the political and social spheres. Moreover, often people take financial (and political) values for granted, or they do not clearly underline or emphasize them. Nevertheless, some values within a culture generally are rather clear, even though they may differ to some extent between audiences, and even though the values may change over time. For example, most Americans and many others nowadays believe that the American Dream, capitalism, free markets, and democracy are good (desirable). High and rising prices for the S+P 500 are excellent, with sharply falling or depressed equity prices bad (undesirable).

We hear language of goodness and badness regarding economic doctrines and phenomena all the time. Wall Street, Main Street, and media mavens declare that the level of a particular indicator, such as GDP growth, inflation, or unemployment, is good, bad, or neutral for one or more countries or a given marketplace. Why, when, and to what extent is supposedly substantial United States deficit spending ever a praiseworthy thing? People quarrel whether Federal Reserve Board policies are good (bad) for the United States, the world, the economy, stocks, US Treasury bonds, the dollar, gold, inflation, and so on, whether for the short term, medium term, or the mystical long run.

MARKETPLACE OUTLOOKS (MORE OPINIONS)

"I went down to the mountain, I was drinking some wine,
Looked up into heaven, Lord I saw a mighty sign.
Writ in fire across the heaven, plain as black and white;
Get prepared, there's gonna be a party tonight". Grateful Dead, "One More Saturday Night"

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At the dawn of calendar 2014, many commentators believe the future for the next few years for the overall international economy for the next few years looks good (or at least pretty good), or will be so eventually. The current and anticipated situation seems especially bright in comparison with the dreadful depths of the recent worldwide economic crisis. Despite some notable ongoing

problems, difficulties, and headwinds, and despite some differences in regional and national performance, global growth has picked up, inflation has remained relatively low, and unemployment (though troubling in much of the European Union) is less severe.

Thus the International Monetary Fund's Managing Director, Christine Lagarde, happily proclaims in her (1/15/14) recent speech, "The Global Economy in 2014" (1/15/14) "optimism is in the air: the deep freeze is behind, and the horizon is brighter."

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See what some widely-watched forecasts such as that by the World Bank and the US Federal Reserve Board reveal for key indicators.

In its "Global Economic Prospects" (1/14/14; "Executive Summary", Table 1.1), the World Bank claims world GDP growth will rise from 2.4pc in 2013 to 2014's 3.2 percent, edging up 3.4pc in 2015. Though GDP for high income countries rose merely 1.3pc in 2013 (with the Euro Area in recession at -.4pc), it allegedly will increase 2.2pc in 2014 (Euro growth 1.1pc) and 2.4pc in 2015. United States GDP, after a meager 1.8pc advance in 2013, expands 2.8pc in 2014 and 2.9pc in 2015.

Developing countries as a whole grew a rather healthy 4.8pc in 2013. Their GDP advances more quickly in 2014, at 5.3pc, and 2015's climbs 5.5pc. Even though some worry regarding China, the World Bank remains upbeat. It proclaims that China's 7.7pc real GDP increase of 2012 and 2013 will recur in 2014 as well, with 2015 a still-robust 7.5pc.

The Federal Reserve Board's recent (12/18/13) "Economic Projections" for US real GDP look more optimistic than the World Bank's. The Fed weathervane (midpoint of central tendency) has America's GDP up 3.0pc in 2014 and 3.2pc in 2015. Skeptics may wonder why the Fed is relatively bullish on GDP for the next couple of years given that growth has not been high recently and as its longer run GDP forecast (December 2013 Economic Projections) forecasts longer run US GDP rises 2.3pc.

Many claim inflation is generally subdued. According to the World Bank, world inflation (Table A4.7; consumer price index) was 3.3 percent in 1Q13, sliding to 2.8pc in 2Q13. Though it jumped up 4.3pc in September 2013, it dipped back to 3.5pc in November 2013. However, this masks a difference between advanced and developing nations. Inflation in high income countries in November 2013 was only 1.2pc, with that in the European Union merely .2pc. As for OECD countries in general, November 2013's CPI rose up 1.1pc. However, that for non-OECD countries increased 4.5pc.

The OECD recently said (1/9/14) OECD real consumer prices (all items) rose 1.5pc year-on-year in November 2013. As for the OECD as a whole, consumer prices rose 2.9pc in 2011 and 2.2pc in 2012, with calendar 2013's high July's 2.0pc. Prices for the entire G20 set of countries rose 2.9pc in November 2013. G20 inflation was up 4.1pc in 2011 and 3.2pc in 2012, with the 2013 high 3.2pc in July. So from the G20 vantage point, inflation does not look terribly low. However, annual inflation in the closely-monitored Eurozone (HICP measure; Eurostat) was only .8pc in December 2013 (compare calendar 2011's 2.7pc in and 2012's 2.5pc). For November 2013, consumer prices marched up 1.5pc in Japan. That in the US increased 1.5pc in December 2013 (Bureau of Labor Statistics, 1/6/14). According to the Fed (Economic Projections, 12/18/13), US PCE inflation was only about one percent in 2013. Though it predicts a mild increase to 1.6pc in 2014 and 1.8pc in 2015, these levels remain beneath its two percent inflation target.

The World Bank indicates that unemployment (percentage of working age population; "Global Economic Prospects", Table A4.8) for high income countries was a relatively lofty 7.8pc in November 2013, with the OECD level 7.9pc. The late 2013 level unfortunately exceeds the 6.7pc average for the 2000-09 vista, although it erodes slightly from 2010's 8.4pc, 2011's 8.0pc, and 2012's 8.1pc. Eurozone unemployment was still sky-high at 12.1pc in November 2013 (European Commission). According to the World Bank, non-OECD unemployment is less, at 5.8pc in November 2013.

US unemployment was 7.0pc in November 2013 and 6.7pc in December 2013, way down from October 2010's 10.0pc though way up from May2007's 4.4pc depth during the glittering Goldilocks Era. According to the Fed's Economic Projections (central tendency midpoint), the US unemployment rate will tumble to about 6.5pc in 2014 and 6.0pc in 2015. However, these 2014-15 predictions remain above the Fed's longer run unemployment estimate of 5.5pc.

INFLATION GOOD, DEFLATION BAD!!!

The blues star Albert King sings that he was:
"Born under a bad sign
I been down since I begin to crawl
If it wasn't for bad luck, I wouldn't have no luck at all
Hard luck and trouble is my only friend…" "Born Under a Bad Sign" (songwriters W. Bell and B.T. Jones, Jr.)

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Despite some signs justifying economic optimism, the IMF's Managing Director's speech (1/15/14) informs us that "This crisis still lingers." In speaking of advanced economies, "the outlook is still subject to significant risks". Unfortunately, "global growth is till stuck in low gear. It remains below its potential, which we think is somewhere around 4 percent." This luminary thus believes that four percent growth is good. Almost certainly in her view, global real GDP expansion well under four pc (perhaps three pc or less) is bad.

The Federal Reserve Board's departing and widely-revered Chairman, Ben Bernanke, one of the brightest stars in the financial firmament, enlightened everyone in his 12/18/13 Press Conference: "the economy is continuing to make progress, but that it also has much farther to travel before conditions can be judged normal." The European Central Bank President recently stressed that it is too early to declare the crisis over (Financial Times, 1/10/14, p1; see the 1/9/14 ECB meeting remark that "it is still premature to declare victory").

Recall the World Bank's estimates of 2.4pc growth in 2013, with 2014 at 3.2pc and 2015 around 3.4pc. The IMF sentinel, to justify her opinion that growth potential is around four percent, perhaps partly relies on IMF data for 1995-2007. According to the International Monetary Fund's "World Economic Outlook" (October 2013, "Statistical Appendix", Table A1), world real GDP growth averaged 3.6 percent from 1995-2004, though during the Goldilocks Era it jumped to 4.7pc in 2005, 5.2pc in 2006, and 5.3pc in 2007.

Suppose the IMF head's stance on what represents suitable international GDP growth approximately represents the sentiment of many key central bankers, finance ministers, politicians, Wall Street, and Main Street. Then what should be done?

To escape the worldwide economic crisis that emerged in 2007 and accelerated in 2008, to spark and sustain appropriate domestic (and international) growth rates, not only has significant deficit spending been embraced. Leading central banks have engaged in long-running highly accommodative monetary policies such as interest rate repression and quantitative easing (money printing). The US Federal Reserve has played a key role in the lax money realm.

In the current environment, many central bankers in so-called advanced nations such as the US, Europe, Japan, and the United Kingdom (and in many other places around the globe) have adopted an inflation ideology. The IMF's leading light heralds in her speech: "With inflation running below many central banks' targets, we see rising risks of deflation, which could prove disastrous for the recovery. If inflation is the genie, then deflation is the ogre that must be fought decisively." For OECD-type (advanced) countries, one can summarize the current version of that beloved doctrine: "moderate inflation of around two percent is good, lower than that is not very good (or maybe even a little bit bad), and deflation is definitely bad." It is unclear how much inflation (in the opinion of marketplace generals these days) would be inappropriate (bad), but arguably over five percent on a sustained basis definitely would be bad (evil; monstrous).

Philosophy regarding a good (bad) real GDP gain entwines with that of beliefs good (desirable) inflation levels and trends. So to achieve and sustain good (adequate, appropriate, reasonable) global GDP growth, central bankers think sufficient inflation (of around two percent in key nations, perhaps higher in emerging nations) is a key policy measure.

Beliefs regarding good and bad growth and inflation levels interrelate with convictions regarding unemployment. European economic and political leaders (and Main Street) hate unemployment levels over ten percent. In the United States, the Fed has faith that US unemployment exceeding 6.5pc is bad; depending on circumstances, perhaps over the 5.2 to 5.8pc pc range over the longer run is not good or even bad (visit its December 2013 Economic Projections).

On 12/18/13, the Fed began to reduce its mammoth money printing project, cutting its debt purchases from $85bb per month to $75bb. Inflation has been running below the FOMC's longer-run two pc objective. Inflation expectations allegedly are well-anchored. Also, the Fed prophets believe the economy needs to grow more. And unemployment remains too high (above the present 6.5pc goal and beyond the allegedly normal long run rate around 5.2 to 5.8pc. Therefore the Fed believes a "highly accommodative monetary policy remains appropriate." Thus despite its recent modest tapering, the Fed continues its massive money printing enterprise and promises to maintain rock-bottom rates for a long time to come. The ECB likewise is married to its highly accommodative stance, as is the Bank of Japan and the Bank of England. China has not reined its easy money policies very much.

Many factors of course influence GDP growth, inflation, and unemployment levels and policies regarding them. But these days, rhetoric and actions of leading central banks play important parts in this process.

Focus again on the US Federal Reserve for a moment. As the Fed convinced itself that (based on its interpretation of its legislative mandate) its specific policy goals regarding sufficient growth, inflation, and unemployment are wise (good), it likewise generally believes that its means to achieve these targets such as interest rate repression and massive money printing are good (reasonable, intelligent).

By pinning the Federal Funds rate to about ground level for the past several years, the Fed has offered savers no or little real return (particularly over the first few years of the US government

yield curve) relative to inflation via the US Treasury marketplace. For any fixed debt amount, don't debtors prefer to pay back their obligations with cheaper (devalued) money? Thus the Fed wizard (and its central banking allies) long has favored debtors and borrowers relative to savers and creditors, even though they surely believe that their undoubtedly noble actions are best for everyone over the long run. And does little apparent inflation now guarantee there will be little inflation later, whether in America or elsewhere?

MARKETPLACE SIGNS AND PATTERNS: INTERPRETATIONS AND OUTLOOKS

Recall the Old Testament Book of Daniel (chapter 5, verse 5). "In the same hour came forth fingers of a man's hand, and wrote over against the candlestick upon the plaister of the wall of the king's palace: and the king saw the part of the hand that wrote." How should this handwriting on the wall be interpreted?

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Just because gigantic sustained money printing, yield repression, and other easing measures have not encouraged much inflation so far, that does not mean that these will not encourage it over some long run.

According to the recent FOMC survey, the "longer run" (apparently after 2016) Federal Funds target rate at year end is about four pc (12/18/13, see Figure 2 of FOMC participants' assessments of appropriate monetary policy). If this four pc eventuality comes to pass (and placing US dollar trends on the side for a moment), how eager should US debt marketplace participants be to own long-dated US securities nowadays. US Treasury rates established a major low in summer 2012, with the 10 year UST note bottoming at 1.38pc on 7/25/12. It edged over three pc recently (12/27/13 high 3.02pc).

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But inflation is not the only source for rising nominal (or real) interest rates, whether in the US or elsewhere. Besides, marketplaces in some circumstances can have rising interest rates alongside relatively flat (or even falling) consumer (and other) prices.

Think about severe fiscal problems and recall historic financial crises, whether on the European periphery, or in Latin America or Asia.

US regulators and politicians probably favor a relatively weak broad real trade-weighted dollar ("TWD"). The TWD made a major high in February 2002 at 112.8 (monthly average), as well as an important lower peak in March 2009 at 96.9 (recall the major low in the S+P 500 at 667 on 3/6/09). It established a record low (for the 1973-present period) around 80.5 in July 2011. Its December 2013 level is 84.7. Suppose the TWD challenges the 2011 bottom. What will happen to US Treasury yields? Probably foreign creditors of the United States (who own a huge share of UST and other dollar-denominated debt) would not enjoy substantial US dollar depreciation (and especially if UST rates were moving upward).

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Marketplace high priests concern themselves with diminished net capital inflows to developing countries. Will tapering by the Fed help to cause this? According to the World Bank (Table 1.3) net capital inflows collapsed to about $698bb in 2009. They then rebounded to about net $1.1 trillion in each year from 2010 through 2013. The Bank's tea leaves suggest the 2014 and 2015 sums will remain around the yearly levels of 2010 through 2013. However, developing nations as

a whole now run current account deficits, which totaled about $174bb in 2013. The World Bank predicts deficits of $181bb in 2014 and $178bb in 2015. Compare surpluses of $315bb in 2008 and $167bb in 2009.

Traders and the media these days gaze nervously at the so-called "fragile five" countries- India, Indonesia, South Africa, and Turkey. For example, see the Financial Times (1/16/14, p1). Might problems in these lands reflect (intertwine with) issues (such as deflationary pressures) in advanced nations?

Given China's role in the world economy, since that nation faces some significant challenges (problems) and displays rising government interest rates, it should be monitored as a notable source of international marketplace risk. See "Another Marketplace Tapering Tale: the China Story" (9/9/13) and "Chinese Rates: Opening the Gates" (12/2/13).

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Look back again at the United States. America, even some observers still viewed it as a good "flight to quality" haven, has not solved its severe long run fiscal troubles. And the Fed's slow tapering represents reduced demand for US government securities.

What about net foreign acquisition of American securities? US Treasury TIC statistics reveal net foreign buying (selling) of long term American debt securities and stocks. For 2013 to date (data through November 2013), net foreign buying of US Treasury notes and bonds averaged about two billion dollars per month, a precipitous fall from 2012's $34.7bb monthly average (as well as 2011's $36.0bb and 2010's $58.6bb). Total net foreign buying of all US longer term securities (including stocks) averaged $41.1bb per month in 2011, rising to $52.8bb in 2012; however, in 2013 to date, net buying was a paltry $8.8bb. Incidentally, foreigners have been net sellers of US stocks in 2013, liquidating an average of $2.3bb per month.

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Though many marketplace watchers believe heroic central banks can rescue the world, or play a crucial part in doing so, central banks (and politicians) obviously are not the only influences on GDP, inflation, or employment. Printing money and depressing interest rates may boost business and consumer confidence. These policies may push corporate earnings and nominal wages higher. Yet inflation (or allegedly sufficient inflation), even if wished for and promoted, is not necessarily destined.

Suppose worldwide deflationary forces remain very significant. Perhaps credit (and debt) and leverage problems developed during the Goldilocks Era (and probably during quite a few years before then) have not been solved. Suppose the worldwide economic crisis that emerged in 2007 and accelerated in 2008 did not create sufficient deflation to remedy the inflationary issues previously built up. Then lax monetary policy at best (even if accompanied by substantial deficit spending) may create mediocre real economic growth, generate less than desired (sufficient) inflation, and only modestly improve the dismal unemployment picture.

According to the IMF, the output gap as a percentage of potential GDP for advanced nations reached about -4.6pc in 2009. It was a positive 1.8pc (no gap) in the wonderful year of 2007. Although the gap narrowed after 2009 to about -2.6pc in 2012, it stretched slightly wider to about -2.9pc in 2013. The IMF forecasts it will narrow very little in 2014, to -2.5pc (World Economic Outlook database, October 2013). Perhaps the output gap, due to structural changes in recent years, is no longer a gap or hole that will be closed except over some indefinite long run. If that is the case, then related unemployment problems probably will not be solved much more than they

have been to date, despite hopeful actions and claims by central bankers and others. Then extravagant money printing, even if it helps to push yields higher (perhaps even in the face of deflationary challenges) may not ease the unemployment challenge.

Why else may the health (real GDP expansion) of the global economy faltered recently? The Conference Board speaks of a decline in global productivity growth (and see the Financial Times articles of 1/15/14, p4 and 1/16/14, p3). The Conference Board says it is not clear whether or not the international slump in productivity growth results from weak demand (reducing the output of economies). Or, perhaps the remarkable consumer innovations have not improved the efficiency of economic activity. Possibly the long history of falling productivity growth in advanced nations is no longer more than offset by big gains in the efficiency of emerging economies.

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Consumer price inflation (including "core" CPI notions) and its cousins such as personal consumption expenditures (PCE) inflation (a Fed favorite) and the GDP deflator (the IMF likes this one too; see the World Economic Outlook's "Statistical Appendix", Table A5) of course are not the only important measures of "inflation".

Think of wage inflation and commodity price inflation. Take US real wage levels and trends as one sign for (a key component of) international earning trends. Use the S+P broad GSCI Commodity Index as a guideline for commodity prices "in general" (although it is heavily weighted toward petroleum). A great number of variables influence US wages. The same is true in regard to commodity trends; think of US dollar trends, interest rate patterns, world economic growth, and so on. And as commodities vary in their supply/demand situations, not all commodities move in the same direction or to the same fashion.

The trends of recent years show declines in real US median (and mean) income. Commodities have been in a downtrend since their peaks in spring 2011. Of course commodities are only one part of consumer price indices. And wages and incomes are not the same as consumer prices. Yet these trends in US income and the broad GSCI indicate that "inflation in general" (including such measures as the consumer price index, PCE, and GDP deflator) is strongly entrenched at low levels. In addition, unless the Fed and other central banks embark on even more massive easing than they have done thus far, this income and commodity evidence (especially when interpreted alongside the low rates of CPI-type inflation) suggests that it probably will be very difficult for "inflation in general" to rise much if at all from current low levels. And "very low" inflation (or even deflation) eventually may appear outside of the real income and commodity territories (especially if US and related interest rates leap higher).

In any event, the US income statistics and broad GSCI bear trend indicate that despite all the Fed (and other central bank) easing, the creation of sustained "sufficient" consumer price (or PCE) inflation remains a huge challenge. Given the intertwining of inflation policies and phenomena (and forecasts) with those of real GDP and unemployment, these notable wage and commodity trends hint that real GDP increases probably will be less than regulators and politicians (not just in the US) aim for, and that unemployment probably will not fall as much as desired.

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Focus on the long run pattern revealed in "Income, Poverty, and Health Insurance Coverage in the United States: 2012" (US Census Bureau, Table A-1; September 2013). US median household income (in 2012 CPI-U-RS adjusted dollars) in 2012 was about nine percent less than its peak in 1999 and about 8.3pc less than it was in 2007. Mean household income tells a similar story. After reaching its 2000 high, it tumbled. Mean income in 2012 stands at 6.4pc beneath 2000's summit,

and roughly 6.0pc under the Goldilocks Era top (in 2006). Note that US consumer confidence (Conference Board) since its bottom around 25 in February 2009, and despite the economic recovery (and higher S+P 500 levels) has not come close to its January 2000 pinnacle (about 145) or its June 2007 top (near 112). It was about 78 in December 2013.

US real average weekly earnings for all employees on private nonfarm payrolls rose not at all (was flat) year-on-year in December 2013 (Bureau of Labor Statistics, Table A-1, 1982-84=100; 1/16/14). Wage growth in the prior two months, though stronger, was still not great. Average weekly earnings rose 1.6pc year on year in October and 1.1pc in November 2013.

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To what extent is some commodity inflation (higher real prices) good (or bad)? Perspectives vary between producers and consumers. In general, producers prefer higher prices, consumers lower ones. So on a global basis, arguably it is desirable to strike a balance over the long run between these two commodity camps and thus aim for roughly unchanged real commodity prices (except as necessary to generate supplies to meet a growing world population).

The S+P 500 continued to rally, assisted by the Fed's easy money policies, although commodities did not. Yet note the decline in emerging stock marketplaces (MXEF Index, Morgan Stanley) alongside that in commodities. Though well above its 10/28/08 bottom at 446 (and 3/3/09's 471), the MXEF has gradually declined since its 4/27/11 high at 1212.

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After a murderous fall during the worldwide economic disaster to its major bottom of 306 on 2/19/09 (compare the timing of the low in the S+P 500), the broad GSCI rallied to its peak around 762 on 4/11/11 and 5/2/11. Since spring 2011, the broad GSCI has drifted downward in a bear trend (or a sideways to bear venture). Note the lower tops of 3/1/12 (at 717), 9/14/12 (at 699), and 2/13/13 (at 682). Key bottoms since its spring 2011 pinnacle are 10/4/11's 573 and 6/22/12's 556 (compare the 5/3/10 high at 556).

The World Bank ("Executive Summary") forecasts that non-oil commodity prices in dollar terms, having fallen 8.6pc in 2012 and 7.2pc in 2013, will decline 2.6pc in 2014 and remain about unchanged (-.2pc) in 2015. The World Bank oil price benchmark (dollars per barrel) is a simple average of Brent, West Texas Intermediate, and Dubai crude oils. It was $105.0 in 2012 and $104.1 in 2013. The Bank predicts it will dip a bit further, sliding to $103.5 in 2014 and $99.8 in 2015.

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