John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday September 2, 2020

Last week members of the board of the Federal Reserve met and unanimously approved strategic changes that will allow interest rates to remain low for years, even if inflation runs above the 2% long standing target. This might not seem to be a big deal, but it is. Stocks surged on the news.

For decades, the Phillips Curve has been accepted as inviolate. The Phillips Curve holds that inflation and unemployment are locked together in an inverse relationship. In other words, as more and more Americans find a good job inflation will rise. Last week Fed Chair Powell had this to say: "Our revised statement reflects our appreciation for the benefits of a strong labor market, particularly for many in low- and moderate-income communities, and that a robust job market can be sustained without causing an unwelcome increase in inflation."

For decades, the Federal Reserve raised interest rates when unemployment declined, to preemptively stamp out a rise in inflation. The new strategy means that will no longer be the case. Millions of Americans can find a good job, the unemployment rate can fall sharply, and the Federal Reserve will not automatically raise interest rates.

This does not mean that the Fed will never raise interest rates again. It means that the 2% inflation target is no longer a ceiling. The 2% target is now viewed as an average. Inflation can rise above 2% and the Fed will watch and wait to see if inflation keeps rising or falls back as it has been doing recently.

These changes in Federal Reserve policy are the result of experience since the 2008-2009 financial crisis. Quantitative easing boosted the supply of available money.

Since 2008 the U.S. monetary base has increased 460%. That is a lot of money. Milton Friedman, the legendary economist, said that inflation is always and everywhere a monetary phenomenon. That is hard to square with the post 2008 crisis reality. Not only has the monetary base grown explosively; until the pandemic the unemployment rate had collapsed, reaching lows not seen for a very long time. According to the Phillips Curve and prevailing monetary theory, that combination should have resulted in a sharp upward burst of inflation. The exact opposite has been the case. Our Federal Reserve and other central banks around the world have tried and failed to get inflation up to a 2% rate.

This isn't the first-time inflation has misbehaved. In the 1980s Fed Chair Paul Volcker raised interest rates in a preemptive strike against inflation that wasn't there. The dollar soared. I was in London at that time. The super strong dollar made everything in London seem cheap. The dollar's rise threatened the U.S. economy, forcing Volcker to reverse course and bring interest rates back down.

This time the Fed has been dealing with misbehaving inflation for much longer - over ten years. Why have the old rules stopped working? Why didn't inflation rise when the Fed flooded the economy with money? Why did inflation stay low when unemployment declined? Some economists say that the idea that inflation is the result of prices moving to align supply with demand, rooted in Economics 101 textbooks, is out of date and no longer helpful. They point out how prices have decoupled. The cost of education and medical care have doubled over the last 20 years. At the same time, the cost of furnishings, apparel and technology have declined.

In my view, oil has played a very important inflation role since the 1970s. In that decade, a spike in the oil price resulted in runaway overall inflation. By then the post-war world had become highly dependent on an ample supply of oil. The list of products derived from oil or dependent on oil for lubricating the wheels of production had grown very long. All of a sudden, the U.S. and global economies were shocked that OPEC emerged as the world's oil baron. From then on inflation rose or fell based on the oil price, as well as the level of economic activity. By the time of the 2008-2009 financial crisis the supply of oil had changed, rising dramatically. The recession that followed was caused not by rising oil and inflation, but by excesses in bank mortgage lending. The global oil supply remained plentiful leading up to the pandemic and current recession. The United States increased oil production so much that OPEC was finally threatened. Now the recession has pushed down demand for oil and the price has fallen further. I submit that the decades long decline in the oil price has been a major factor in keeping inflation low. The oil price is likely to stay low well into a recovery from the pandemic because supplies are so much greater than demand.

If I am right, we will enjoy low interest rates even as the U.S. and global economies recover from the pandemic-induced recession. In addition, there will be pandemic-induced changes in how we work, and they will increase productivity. That will also keep inflation in check.

This does not mean inflation has been permanently defeated. Inflation can and eventually will rise again. Meanwhile, the bigger threat to the economy will be financial excesses. The Fed didn't do a very good job preventing the 2008-2009 financial crisis. The new approach in dealing with inflation, hopefully means the Fed will now be watching for financial excesses. When the next one approaches the Fed will likely apply the same tools as it has used to fight inflation, namely reduce the available liquidity in the economy. That can be done by reducing the Fed's balance sheet, selling bonds or by raising interest rates. It is interesting to realize that the Fed will be able to sell a lot of bonds and reduce the monetary base without necessarily raising interest rates because of quantitative easing and the huge expansion of the Fed's balance sheet since 2008. Thanks to that our Fed may actually be better prepared for the next financial crisis than it otherwise would have been.

I will have the next market review and update one week from today on Wednesday September 9, 2020.

All the best,

John Dessauer