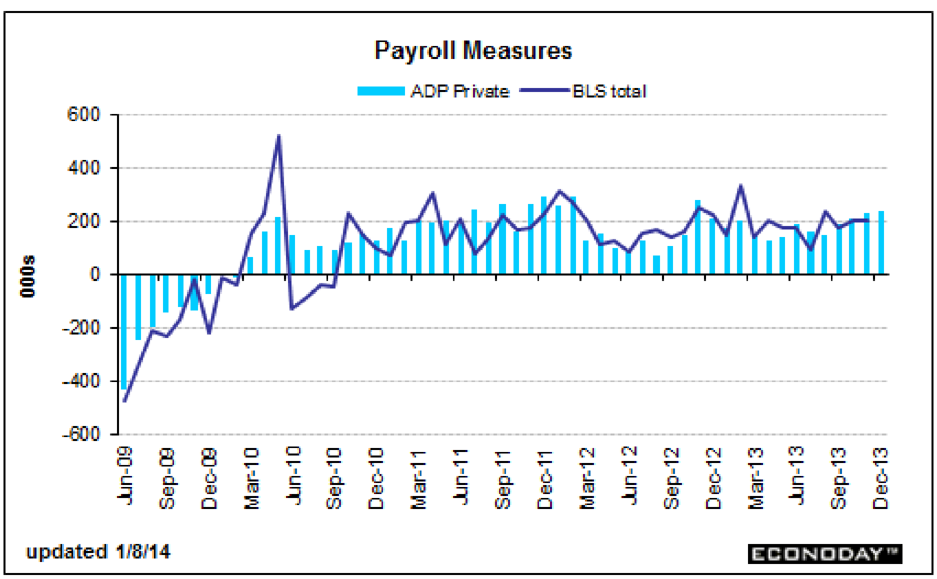
Did The Battle between Inflation and Deflation Just Take a Definitive Turn?

- Inflationary expectations, as measured by the spread between US 10-Year Notes and Treasury Inflation Protected Securities (TIPS), have recently increased to the highest level since August 2013
- Jobs numbers in the US as measured by the ADP survey and the non-farm payroll data are showing continued strength
- A plethora of additional data including consumer confidence ISM and PMI surveys seem to echo the theme of a strengthening US economy
- This is welcome news, but is it enough to overcome the strong disinflationary forces that we have written about?

Has the Tide Turned?

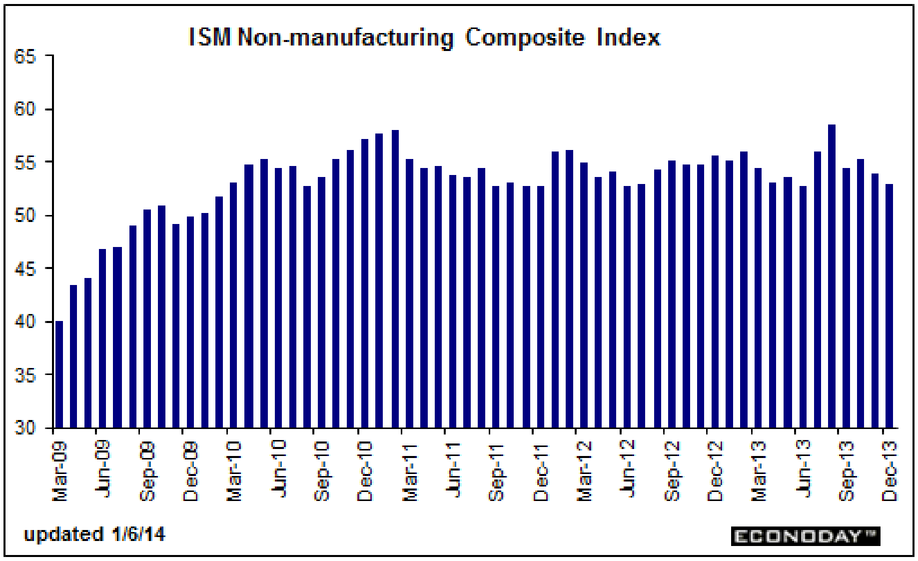
For the last six months, I have been writing and speaking on the tug of war between inflation and deflation. This is a battle with no clear winner - yet. Recent economic data from the United States has most wondering if we have finally “turned the corner” and are now on the path of sustainable economic growth.

Earlier this week, the ADP Private Employment Report surprised to the upside with 238,000 jobs created in December 2013. This was in excess of the initial estimate of 205,000 – a very strong number in and of itself. Further, the previous month’s jobs number was also revised higher (a final print of 229,000 new jobs).



Despite the strong job numbers dating back to late 2010, official inflation stats remain mysteriously subdued. To be clear, there *is* inflation in the economy, but the cost push inflation one would expect is not fully evident. We can also argue about the "quality" of these jobs that are being created, but this is perhaps another topic for another Note.

The positive economic news extends beyond job creation. A look at the trends in select ISM data also would confirm a scenario of generally positive economic growth. As a reminder, a reading above 50 indicates economic expansion.

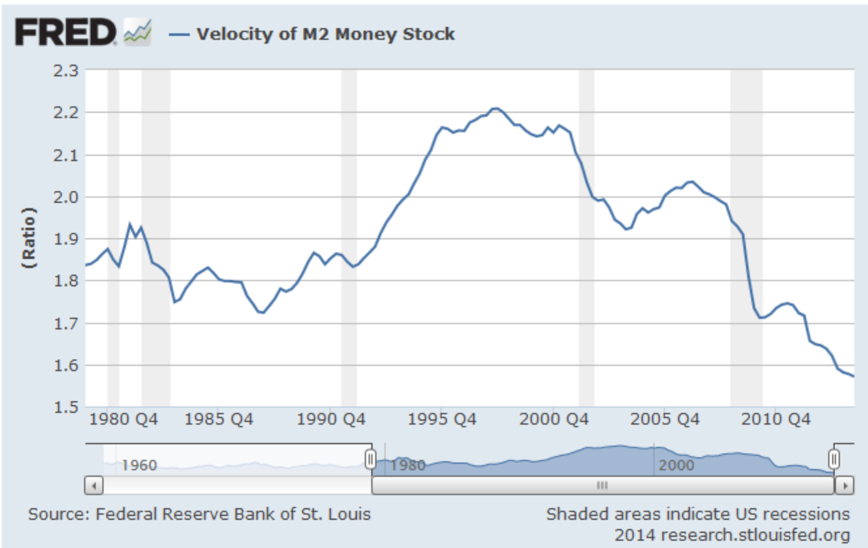


Other metrics, improving consumer sentiment, strong PMI readings, and upward revisions in GDP numbers reinforce the recovery thesis. Even the angriest bear would have to admit that while the economic recovery here is slow, we are at least "recovering".

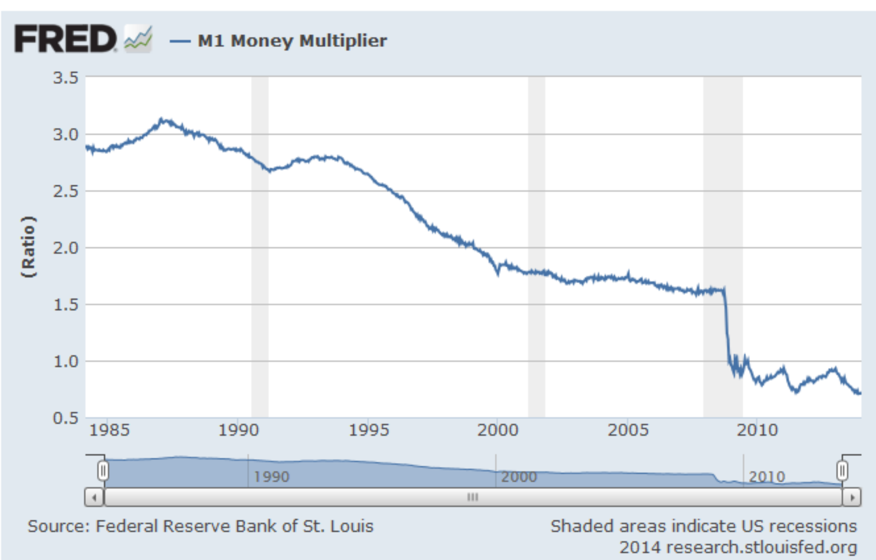
The Case for Rose-Colored Glasses May be Overstated

As is the case with any argument, there is always another side to the story. Many of the metrics we have written about in recent months still look shaky, including:

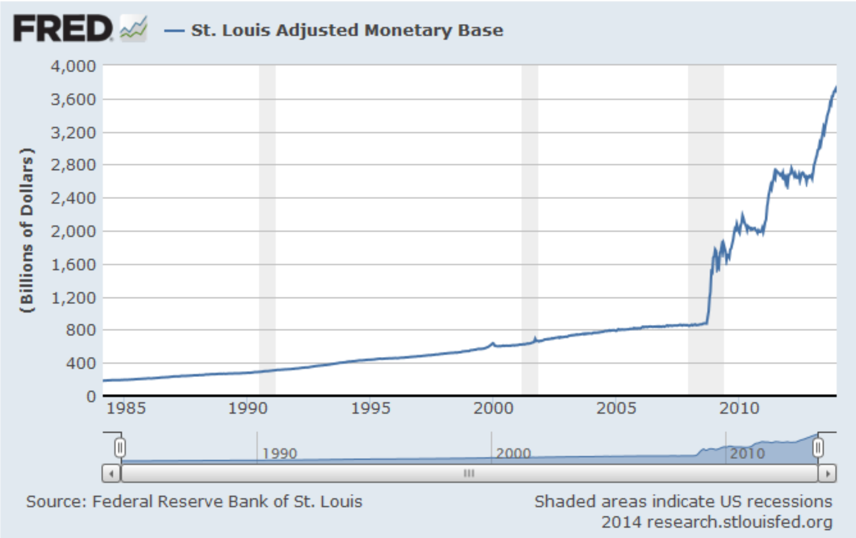
The Velocity of Money (M2):



The Money Multiplier:

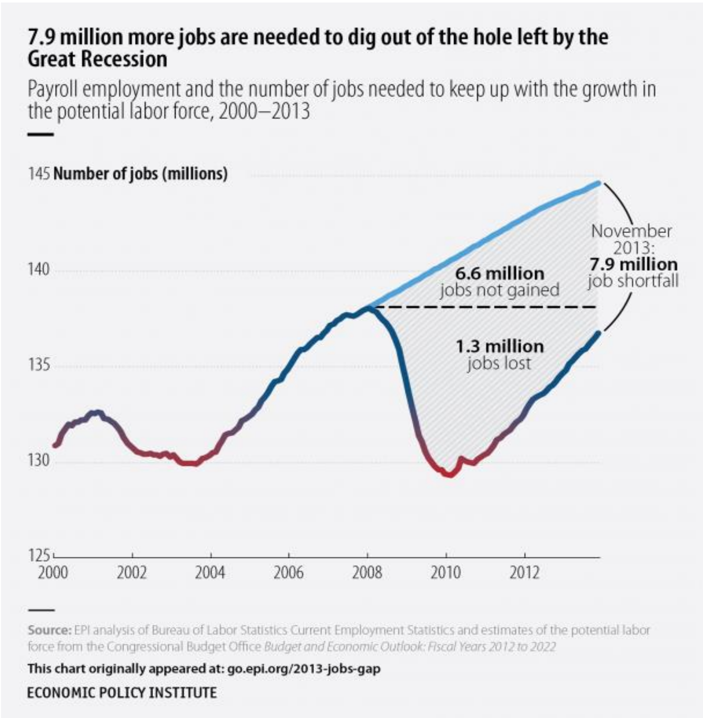


and the Adjusted Monetary Base:



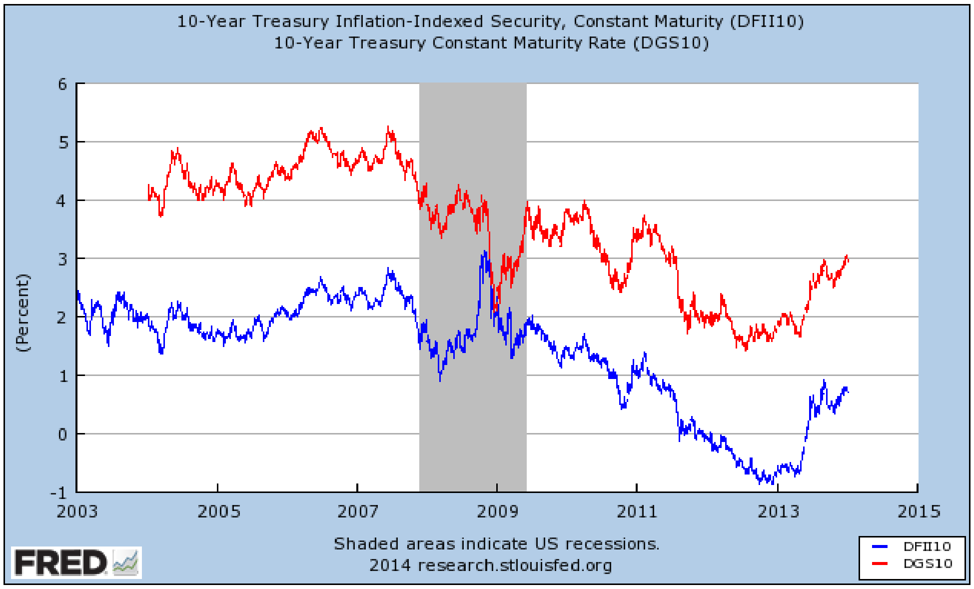
These metrics, along with a yawning output gap and historically low labor force participation rate are clearly still struggling to gain their footing and state the case for a stagnant economy and stoke fears of deflation.

In addition to the data above, the chart below shows just how far the U.S. economy must improve vis-à-vis job creation to stay even with the growth in the overall labor force. As you can see employment is not back to its pre-recession level in 2007. This is troubling for a consumer economy such as the U.S.



This yawning employment gap is a very real albatross around the neck of the U.S. economy.

In spite of these arguments, new data shows markets are now forecasting the first whiffs of inflation in the economy. Shown below is the spread between the U.S. 10 Year Treasury Note and the 10 year Treasury Inflation Protected Security (TIPS).



This spread is a measure of inflation expectations. As the spread widens, this tells us that market participants are anticipating increasing inflation as measured by the CPI. This is important, because it is a ***forward-looking*** indicator as opposed to so much else which is not. The benefit of owning TIPS is that since their value is indexed to the CPI, as the CPI rises, so does the value of the TIPS. The idea here is to protect the value of your investment against inflation which can, of course, erode your returns.

According to the Financial Times, inflation expectations in the US are at their highest level since August of 2013. The U.S. dollar would appear to be pricing in a higher interest rate environment, having shown sustained strength since late October 2013, despite the overall move lower since July.

The Takeaway

Despite the best intentions of Central Bankers in the U.S., the Euro Zone, and Japan, deflation/disinflation remains a much larger concern than inflation. I have said, in the past, and still believe, that QE, ZIRP, forward guidance, and other schemes put forth by Central Banks are actually deflationary in nature. The money they have created is not finding its way into the economy through expansion of credit.

Evidence of inflation in the economy should be a welcome sign – to policy makers and consumers alike. Policy makers want to see inflation as they believe it is a much simpler problem to control. Debt holders and the U.S. government should like inflation as it can push up wages and devalue outstanding debt.

Rising inflation should be a net positive for commodities, especially after the challenging environment we endured in 2013. This doesn't mean that the now devastated junior exploration sector will immediately benefit, but there are a number of ways to play this.

We'll be speaking about some investment strategies at the Cambridge House Resource Conference in Vancouver next week.

With the Federal Reserve in "taper mode" I will be paying close attention to these bond spreads as well as any sustained increase in commodity pricing to gauge whether or not we've broken free from the cold grip of disinflation. The risk, of course, is that higher interest rates choke off a nascent US economic recovery. This will be one of the key events to watch for in 2014.

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