Investment Update

BNY MELLON
WEALTH MANAGEMENT

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Inflation and the Dorothy Effect

In the movie classic *The Wizard of Oz*, Dorothy runs away from home and meets up with Professor Marvel, the fortune teller. "Take me with you to see the crowned heads of Europe," Dorothy says. Professor Marvel tells her he needs to gaze into his crystal ball first. While Dorothy's eyes are squeezed shut, he plucks a picture of her Auntie Em out of her basket, giving him the information he needs to read her fortune and send her home.

Many people would love to be able to predict the future, especially when it comes to investing. If I could pick one thing out of the proverbial basket to forecast the markets, it would be the specific path and timing for inflation's return. No other variable has more influence over how asset classes and the broader economy will perform over time.

As the Federal Reserve winds down its quantitative easing program, paving the way for the economy to continue strengthening and for interest rates to gradually normalize, inflation has been top of mind for many investors. A debate is now raging about the level of inflation going forward and how quickly, or slowly, it will manifest. Both sides—inflation is coming! Inflation is not coming!—have grown more heated. We believe inflation could remain low or moderate for perhaps years to come.

Inflation: Lower for Longer

While most investors look at inflation as a rise in prices, I also like to consider the other side of that same coin, namely, that inflation is the loss in purchasing power. When inflation is high, it can wreak havoc on portfolios.

The high-inflation camp argues that loose monetary policy, primarily through the Fed's asset purchases, has created a growing Fed balance sheet. Economists and strategists on this side of the argument say this high level of "money printing" has artificially propped up the markets and economy. As this money is unleashed into the economy it will inevitably lead to much higher levels of inflation.

On the other hand, the low-inflation camp argues that several factors will keep inflation low. First, the slow economic recovery has allowed slack to remain in the system, particularly in employment. While unemployment has fallen from its post-recession highs, it is still above 6%. This jobs slack has kept a lid on wage inflation, which has historically been a key driver for overall inflation.

The second factor is banking behavior, also known as the "velocity of money." Banks have been sitting on cash, rather than lending, which mutes the multiplying effect of money going into the system. Instead, banks have been purchasing securities and using them to boost their liquidity ratios. This trend has been good for bank balance sheets, but puts downward pressure on both economic growth and inflation. We expect this trend to continue.

Add to this mixture a slow growing Eurozone, a European Central Bank (ECB) that recently cut rates to protect against deflation, and a sputtering Chinese economy and you can see why the low-inflation camp feels pretty good about its analysis.

BNY Mellon's Inflation Forecast

At BNY Mellon Wealth Management, we are firmly in the low-inflation camp. While we see our economy at an inflection point toward higher growth, we believe that growth will not lead to higher inflation in the near term. This view is shared by many of our investment boutiques around the world as well. The constant theme stressed by all is that inflation will be moderate in the U.S. throughout 2014 and into 2015. While the threat of deflation remains in some areas of the world, including the Eurozone and Japan, we believe deflation is off the table for the U.S.

One of the driving forces of this lower inflation, at least in the near term, has been the decline in oil prices. Oil has returned to levels prior to unrest in Iraq and Syria and the resurgence of the terrorist group ISIS (Islamic State in Iraq and Syria). While the price decline is not good for the commodity's overall performance, it is excellent for both inflation and the U.S. consumer, resulting in some relief in gas prices. In fact, oil is now lower in price on a year-over-year basis.

If our lower inflation scenario plays out, the economy could be the real winner. Food and energy have shown recent signs of reversing their upward trends. These price declines will benefit the consumer, as they almost act as a tax cut, allowing the consumer to spend that money elsewhere.

Preparing for Inflation's Return

While we don't see inflation as a near-term threat, Curtis Arledge, chief executive officer at BNY Mellon Investment Management, recently made a very interesting comment when he said, "Never turn your back on inflation." We won't. We have already planned on how we will position portfolios once we see inflation becoming a threat.

Our positioning might include an overweight to Treasury Inflation-Protected Securities (TIPS), floating rate bonds, commodities, real estate and alternative investments such as managed futures. These asset classes have shown a history of performing well with a backdrop of (high) inflation. They also should serve to offset other asset classes, such as bonds, which generally struggle as inflation increases.

Investors should also be mindful of inflation's impact on cash investments. For example, money market funds have delivered a negative real return in today's low-interest rate environment. However, when inflation begins to rise, the impact will be even worse, as the returns fall increasingly short of the rise in prices. The "cost of comfort" of staying invested in such perceived safe investments ultimately will be of little comfort for investors.

Conclusion

Wouldn't we all like to have Professor Marvel's crystal ball (as well as his ability to pluck answers out of a basket) to determine inflation's path? Inflation is a critical variable for markets and the economy, and when it does make its appearance, the impact will be significant. While we do not see inflation in the near term, we continue to monitor economic conditions closely to prepare for its inevitable return. In the end, being prepared for inflation's return will be the best defense of all, and no crystal ball can be better than that.

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