Zacks
INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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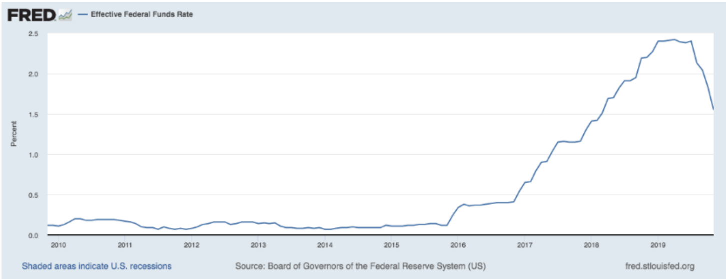
A Decade of Lost Inflation: What Happened?

In the wake of the 2008 Global Financial Crisis, the U.S. government was pulling all levers to try and stabilize the economy and get growth back on track. In addition to unprecedented bailout programs like TARP and liquidity-boosting schemes like QE1 and QE2, the Federal Reserve also effectively lowered interest rates to zero. In all, between 2008 and 2015, the Fed's balance sheet soared from $900 billion to $4.5 trillion.[1]

As the U.S. economy started to recover and grow, a new consensus formed about what was likely to happen next: runaway inflation. Even with the benefit of hindsight, calling for higher levels of inflation seemed at the time like a very logical conclusion to draw. With the Fed essentially eliminating the cost of borrowing and injecting trillions of dollars into U.S. companies and the financial system, surely we'd see a surge in inflation to be reckoned with down the road…right?

Yet here we are a decade later, with no signs of runaway inflation. There has been no inflation 'reckoning,' no systematic monetary policy tightening to try and stave off higher prices. In the months and years just after the financial crisis, consensus had largely been that the fed funds rate would be north of 4% by 2020. But with just a handful of days left in the year, the fed funds rate remains in a range of 1.5% to 1.75%, with the economy trudging along with below-target inflation and slower-than-average economic, wage, and productivity growth (but better-than-expected employment).[2]

Even as the Fed has Kept Interest Rates "Lower for Longer," Inflation Remains in Check



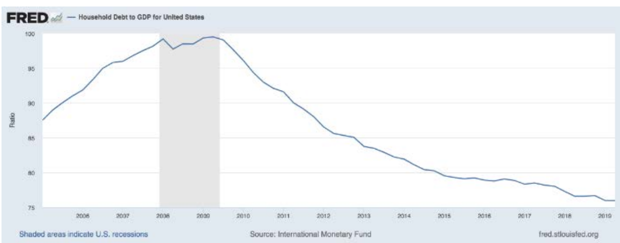
Source: Federal Reserve Bank of St. Louis[3]

So, What Happened? Why Did Inflation Never Really Take Hold?

I'm not sure we're at a point in history yet where it's possible to look back at this decade and understand exactly why inflation remained so subdued, for so long. But there are a few working theories I'll share with readers.

First - the return of the savers. In the wake of a financial crisis – particularly one that profoundly affected nearly every American – we tend to see households, businesses, and banks de-risk and take steps to improve balance sheets. Regulation forced banks to make such changes, and households followed suit and paid down debt in the ensuing years. These actions generally mean less borrowing, investing, and risk-taking, which keeps a lid on growth, inflation, and interest rates. As you can see from the chart below, household debt to GDP fell significantly in the years following the recession.

Household Debt-to-GDP Ratio in the U.S., 2005 – Current



***Source: Federal Reserve Bank of St. Louis*[4]**

A second possible cause for weak inflation is technology, which has actually been a deflationary force since the 1990's, in my view. I also believe in the possibility that technology's cost-reduction results in a multiplier effect, which results in various deflationary linkages throughout the economy.

There are myriad ways to think about how technology has reduced the cost of goods and the cost of doing business. Think about household goods and retail. The massive shift to buying goods via e-commerce (online shopping, Amazon) versus a trip to a brick-and-mortar store may increase the cost of physical delivery, but it reduces or eliminates cost of real estate, utilities, requires few workers, lowers inventory carrying costs, and uses data to target consumers with precision ads – which are far more effective than traditional marketing methods. In all, technology has driven efficiency, which has kept a lid on costs and prices.

Finally, a third possible explanation for subdued inflation over the last ten years is spare capacity in the U.S. economy. The 'Great Recession' led to such a dramatic decline in output, job losses, and wealth destruction that it created a substantial amount of spare capacity in the economy that we're only now starting to reach. It would make sense, then, that price pressures would remain tepid so long as that spare capacity existed.

Bottom Line for Investors

Even with weaker-than-expected inflation – or perhaps because of it – the U.S. economy has managed to deliver its longest economic expansion on record, with unemployment at a 50-year low and the stock market at all-time highs. In other words, this head-scratching bout of low inflation has not resulted in any material adverse impact for investors, businesses, or consumers.

As we move forward from here, my cautionary advice to investors would be that just as everyone starts to ignore or write-off inflation for good, that's when you should perk up and watch for rising inflation and rising interest rates. It could happen sooner than many think.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] The Wall Street Journal, December 14, 2019. https://www.wsj.com/articles/economists-got-the-decade-all-wrong-theyre-trying-to-figure-out-why-11576346400

[2] The Wall Street Journal, December 12, 2019. https://www.wsj.com/articles/economists-got-the-

decade-all-wrong-theyre-trying-to-figure-out-why-11576346400

[3] Board of Governors of the Federal Reserve System (US), Effective Federal Funds Rate [FEDFUNDS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FEDFUNDS, December 19, 2019.

[4] International Monetary Fund, Household Debt to GDP for United States [HDTGPDUSQ163N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/HDTGPDUSQ163N, December 20, 2019.

Our 4 Reminders for Year-End Investment Planning

IN FOCUS THIS WEEK

1. Contribute to Retirement Plans
2. Work with Your Advisor and Tax Advisor on Potential Tax Loss Harvesting
3. Don't Forget Your Required Minimum Distribution (RMD)!
4. Remember Lessons from 2019, and Stay Focused on the Long-Term

There are only a few days left in the year, which means the clock is winding down for some key 2019 investment planning. Here are our four tips and reminders for investors as we enter the New Year!

1. Contribute to Retirement Plans

Whether you have an employer-sponsored retirement plan like a 401(k) or 403(b), or are a small business owner with your own retirement plan, you may still have one paycheck left to make an additional contribution to your plan if you haven't maxed it out already. If you don't have a job where a retirement plan is offered, then consider making a contribution to an IRA or a Roth IRA (your income and tax filing status may affect how much, or if, you can contribute). Truth be told, you actually have until April 15, 2020 to make IRA contributions, but why not end the year on a savings note if you can!

2. Work with Your Advisor and Tax Advisor on Potential Tax Loss Harvesting

At Zacks Investment Management, we are not tax advisors and our core focus is on managing wealth. But one of our advisors can work with you and your tax advisor to determine if you have gains in your taxable portfolios that you may be able to strategically offset with losses. You are also allowed to offset up to $3,000 in income from capital losses in your portfolio, if you don't have any gains to offset from 2019. You'll need to place trades before market close on December 31, and don't forget about the wash-sale rule, which states that you cannot repurchase the securities you sold until after a 30-day waiting period.[1]

3. Don't Forget Your Required Minimum Distribution (RMD)!

If you're over the age of 70.5 and have qualified retirement accounts, then you almost certainly have to take an RMD each year. If you don't make any withdrawals from your IRA in a year that you're 70 ½ or older – or if you withdraw less than the required amount – you may have to pay a 50% excise tax on the amount not distributed as required. In addition to paying a hefty tax, you likely have to do more paperwork the next year at tax time by filing Form 5329, "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts."[2] So don't forget to take it!

4. Remember Lessons from 2019, and Stay Focused on the Long-Term

We would qualify 2019 as a year where many investors entered the year skeptically, especially considering the dramatic sell-off experienced at the end of 2018. The trade war was growing, the stock market was wildly volatile, and recession chatter was growing by the day. At the outset of the year, there seemed to be more reasons to be negative than positive.

But as the year draws to a close, it will go down as one of the best performance years for U.S. equities for the entire decade. It serves as a reminder that stocks are often able to climb the "wall of worry," and that investing based on emotions or news headlines can often result in being on the sidelines when the market surprises us the most. As we enter 2020, no one can say for sure what the new year will bring in terms of stock market returns or economic growth. But what we do know is that over time, the stock market and the economy have overcome adversity – with speed bumps along the way, certainly – to reach new all-time highs.

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[1] Betterment, As of December 20, 2019. https://www.betterment.com/tax-loss-harvesting/

[2] IRS, October 25, 2019. https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-required-minimum-distributions-rmds

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