Ameriprise Financial

Economic Views Brief

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ECONOMIC Q&A: INFLATION, THE FED, AND GOVERNMENT DEBT

- Inflation is likely to be volatile over the next several quarters but there's likely to be greater downward pressure on aggregate prices with a few notable exceptions. Year-over-year inflation numbers should rise in 2021, but we are not forecasting problematic changes in core consumer price levels in either direction.
- Recent actions taken by the Federal Reserve and federal government in support of consumers and businesses are unlikely to foster excessive inflationary pressures, in our view. Though massive sums, the moneys are not likely to generate "excess demand" in the economy under the current circumstances.
- Government debt levels were already high coming into 2020. Recent moves by the federal government to provide support for the economy through this difficult, yet temporary, period will incrementally boost government debt materially. Though certainly problematic, we believe the government debt situation is likely to remain manageable over the intermediate-term at least (i.e. several years).

Inflation:

Q: Has the coronavirus situation and the resulting changes to the economic outlook altered inflation expectations in a meaningful way?

A: Over the intermediate-term, we believe aggregate consumer prices in the U.S. are likely to see greater downside pressure (deflation) than upside (inflation). Some items such as beef, pork and poultry, are expected to see sharp price increases over the near-term due to virus-related supply chain disruptions. But these isolated, yet prominent, increases are unlikely to overcome broader downward pressures brought-about by lower aggregate demand.

Consumers are likely to enjoy lower energy prices over the next several months (relative to 2019 levels) due to the situation as well. In April, nationwide average gasoline prices were 35% lower than their year-ago levels as demand volumes plunged by nearly 50%, according to the Energy Information Administration (EIA). Here too, energy costs should slowly rebound as oil pumping is reduced and demand recovers; a process likely to take several quarters.

Headline inflation rates are quite susceptible to fluctuating energy prices, thus the Consumer Price Index (CPI) is likely to weaken considerably over the next several months. Meanwhile, core inflation (consumer prices excluding food and energy costs), should ease, but remain within its recent historical ranges. We focus on core rates (as does the Federal Reserve) because food and energy prices are often influenced by non-economic factors such as droughts, temporary production outages or geopolitical turmoil in the case of crude oil.

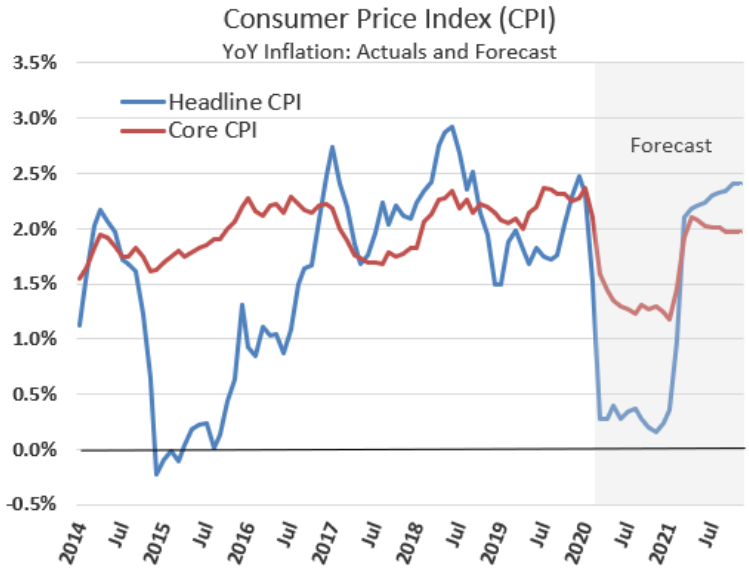

Chart Source: Actuals via Labor Department, estimates via American Enterprise Investment Services, Inc.

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Over time, we believe inflation should slowly reemerge as demand recovers. Some businesses could see stronger pricing power if competitors are unable to survive the downturn. Other businesses may need to raise prices to cover new operating realities. Restaurants, movie theaters, air travel, etc. may need to raise prices to make-up for lower seating capacities under new personal distancing standards until virus related risks diminish.

Q: What about the huge amount of new government spending, won't that lead to inflation?

A: That's a very reasonable question. But no, we do not believe the massive spending response recently enacted at the federal level will be inflationary. Through April 30th, the federal government has passed $2.9 trillion in new spending during this period, according to Bloomberg, equal to about 15% of U.S. GDP. Under ordinary conditions, whereby consumer and business spending were steady, a significant surge in government outlays would very likely be inflationary. But these are far from ordinary times, as we all know.

Under the current circumstances, the added government funds are predominantly meant to replace lost wages and /or revenues. As such, they'll replace some of the significantly reduced consumer and business demand, rather than be incremental to it. So, despite this massive amount of new government spending, aggregate demand across the economy will still be lower, thus limiting the ability of most businesses to raise prices. *Please see page 4 of this report for more on government spending and debt.*

Federal Reserve actions:

Q: The Federal Reserve has announced a huge amount of policy support over the last few months, AND they've been buying a record amount of U.S. Treasury debt, thus increasing the size of their balance sheet. Isn't this "printing money" and doesn't that lead to inflation or even hyper-inflation?

A: Although your description of the normal sequence of economic influences is correct, under our current, non-normal circumstances, the Fed's actions are unlikely to produce meaningful inflation pressure.

There are several technical reasons why, but they boil down to three basic ideas:

1. Only a portion of the money being created by the Fed is likely to find its way into the economy. Much of it is simply liquidity support for the financial system, while other significant sums have simply been "pledges" of support should the need arise (i.e., making loans available).
2. What funds DO enter the economy will mostly be translated via federal government spending and are unlikely to cause excess, incremental demand for the reasons previously discussed.
3. Inflation risk stemming from a weaker currency (the U.S. dollar) is also unlikely under the circumstances given that other major economies are following the same policies, and currencies are valued against each other.

Much of the Fed's support over this period will come via the purchase of U.S. Treasury securities, thus helping to finance recent government stimulus plans. As previously described, this funding is unlikely to cause excessive demand in the economy because aggregate demand will still be lower even with the added government outlays.

Also, one of the primary translation mechanisms for "printed money" to generate inflation is via a decline in the value of the currency (in our case, the U.S. dollar). But the value of any currency is measured against that of other currencies. For one currency to go down in value, one or more others must be rising in value. As such, we believe prospects for a material decline in the value of the U.S. dollar remain low, primarily because central banks around the world are basically following the same script as that of the Fed: purchasing government debt to help fund government support measures. As is often the case in crisis periods, the U.S. dollar has strengthened moderately over the last few months versus a basket of other major currencies. Through May 8th, the U.S. dollar was 3.5% higher year-to-date, as measured by the Bloomberg U.S. Dollar Index.

Q: What are the consequences of this much intervention from the Federal Reserve?

A: The sums the Fed has pledged in support of the economy have truly been massive. According to Bloomberg, the Fed has announced programs totaling about $6 trillion through the end of April. Most of this capital, however, is not meant to feed into the economy as we noted above. Additionally, a significant amount of the money being pumped into the financial system is coming right back to the Fed in the form of "excess reserves held at the Federal Reserve."

Under legislation passed after the Financial Crisis of 2008, banks have been required to hold greater reserves against potential losses. At the same time, the Fed has materially increased the size of its balance sheet by purchasing fixed

income securities in the market – mostly Treasury securities but also Mortgage Backed Securities, in an effort to keep interest rates low. This puts more cash into the banking system - the bank hands the securities to the Fed and the Fed gives them cash in return.

But despite the very low interest rates of the last decade, demand for borrowing has been modest, leaving banks with "excess reserves." These sums are usually held at the Fed because the Fed pays a small amount of interest on their value. At the end of 2019, excess reserves held at the Fed amounted to $1.50 trillion, according to the St. Louis Federal Reserve Bank. As of May 6th, the number had more than doubled to $3.16 trillion. The point is this: despite the Fed's massive pledges, not all of the pledged money is being employed. And that which is, much of it is coming right back to the Fed in the form of excess reserves rather than being lent out into the economy to potentially create inflation pressures.

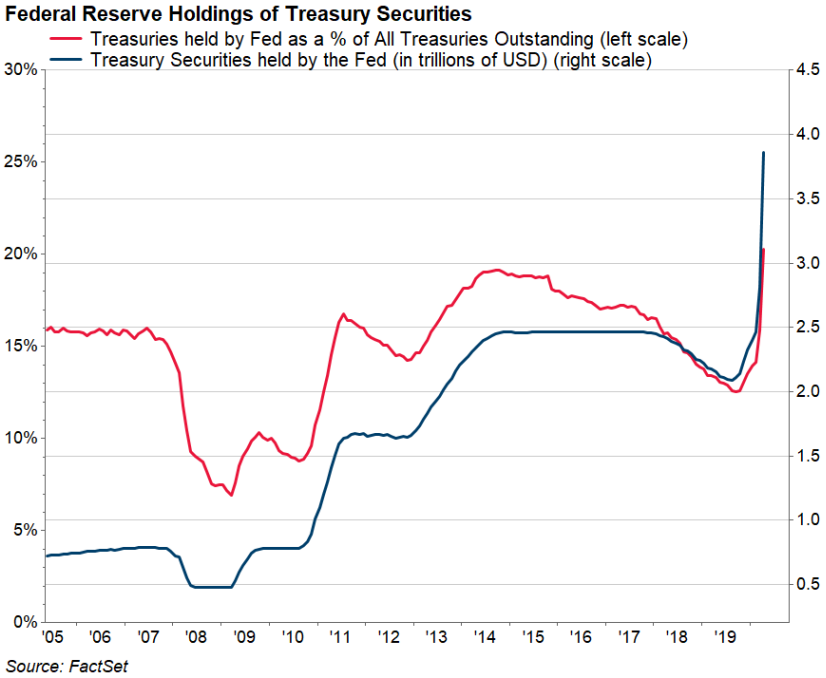
Overall, we believe the Fed has done a very good job in reacting to the current situation. Despite a few early hiccups, the financial system appears to be functioning well, which is quite unlike the 2008 Financial Crisis when the financial system was in serious turmoil, and peril, for months.

Q: How much government debt is TOO much debt for the Fed to own?

A: Central banks always own some domestic government debt as it is their primary avenue of regulating the money supply, interest rates, and the general financial system. What's important to monitor is the value of central bank holdings above and beyond this normal "operational" level.

Any economic textbook would tell us that a central bank buying too much government debt, a process termed "monetizing the debt" is indeed dangerous. When a central bank buys government debt it is generally putting more currency into circulation. Too much currency in circulation can reduce its value and cause inflation; at excessive levels the currency value can drop considerably with dire economic consequences.

But as we mentioned previously, we believe the current circumstances generally over-ride this theoretical path as portrayed in textbooks. Most central banks are utilizing similar policies with a similar low likelihood of inflation risk due to the drop in aggregate demand and other longer-term factors. This policy uniformity across major industrialized countries should limit the currency risk.



In the chart at right, the blue line represents the dollar value of the U.S. Treasury securities owned by the Federal Reserve, while the red line represents the percentage of all U.S. Treasuries that are held by the Fed.

As of April 30th, the Federal Reserve owned U.S. Treasury securities valued at $3.971 trillion, according to the St. Louis Federal Reserve Bank. At the time, it equaled about 20.8% of total Treasury debt outstanding.

In the years prior to the Great Recession (GR), the Fed typically held approximately 15% to 16% of Treasury debt outstanding. Thus, it might be fair to view this as a base-case, "operational" level.

In the year's following the GR, the Fed grew its holdings of Treasury securities under its quantitative easing programs to eventually hold 19% of Treasuries outstanding. From late 2017 on however, the Fed intentionally reduced its holdings and the percentage of its holdings eventually fell to 12.5% of Treasury debt outstanding in September 2019. The level appears to have been too low to properly supply market liquidity needs, as it was noted as contributing to the spike in overnight lending rates seen at the time.

Current levels, in a range of about 20% may be a "new normal," in our view. We note that the European Central Bank has a self-limitation on owning 33% of any one government's debt outstanding, a level that it is currently at for many of its member countries.

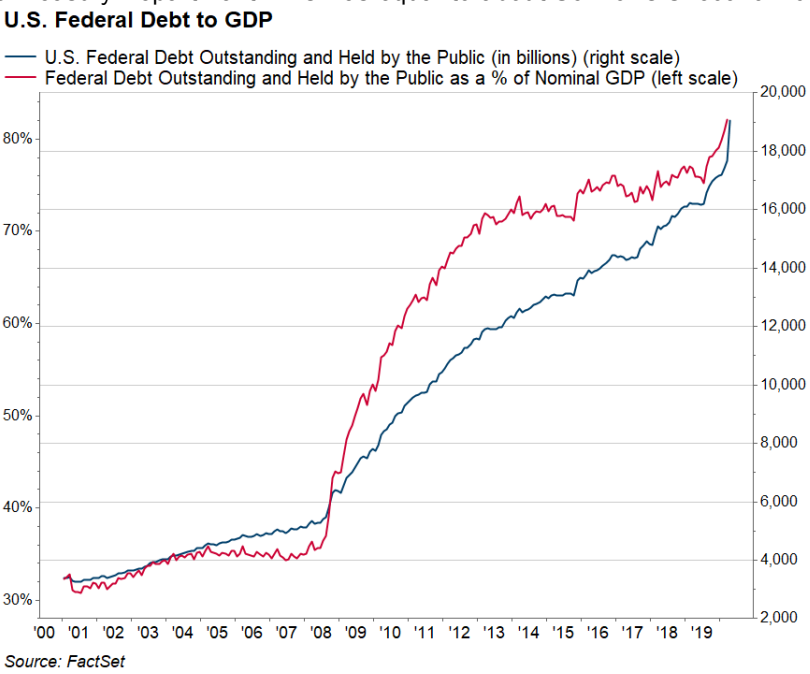
Government Debt:

Q: Government debt was already very high before the outbreak, and the CBO was forecasting a fiscal 2020 deficit of $1 trillion. Now the CBO forecasts a deficit of $3.7 trillion and a huge increase in total debt. What are the implications?

A: Government debt levels were already problematic, and the current situation of sharply higher spending and reduced tax revenue, resulting in sharply higher deficits, does indeed make the challenge of eventually fixing the debt problem much more difficult. However, even with the added debt, we believe the situation is likely manageable over the intermediate-term. The expanded holdings of the Federal Reserve (a near interest-free loan) eases the interest expense burden. While the fact that other major industrialized economies are following the same policies eases the potential negative influences via currency values, in our view.

Let's look at the situation… At the end of 2019, the U.S. had total government debt outstanding and held by the public of approximately $17.2 trillion, according to the Treasury Department. This was equal to about 80% of U.S. economic activity (referred to as "debt to GDP"). Alternatively, U.S. government debt could also have been quoted as $22.0 trillion at the same time (equal to 101% of GDP). The difference in the figures is "intergovernmental holdings," which are primarily the "IOU's" contained in the Social Security Trust Fund. However, there is no actual debt issued and outstanding relative to the intergovernmental holdings, so most analysts, including the Congressional Budget Office (CBO), focus on the first figure which is the actual amount of debt issued.

In January, the CBO projected U.S. government debt to GDP would reach 100% by 2031. In late April, however, the CBO released an update to its projections to account for recent spending bills. The CBO now forecasts government debt to GDP to reach 101% by the end of the current fiscal year (September 30, 2020).



The manageability of such levels lies primarily with how much is spent on interest expense. In 2019, net interest on the Federal debt amounted to 1.8% of GDP, according to the CBO, below its 50-year historical average of 2.0% due to the today's exceptionally low interest rates. Rising interest rates could thus sharply impede the government budget in the years ahead. We believe Federal Reserve policies are likely to keep rates relatively low for quite some time, but higher debt levels will also add to interest expenses. The longer elected officials take in getting the long-term budget on a more sustainable path, whereby debt to GDP projections eventually start to decline via a mix of faster economic growth, reduced spending or higher tax rates, the more difficult the aforementioned adjustments will need to be.

Q: How much is TOO much?

A: There's no specific level of government debt that is universally seen as too much. A broad number of country-specific circumstances, which are beyond the scope of this short report, inform investor opinions as to the interest rate they require to purchase each country's debt obligations. Regardless, it seems contradictory that as U.S. government debt approaches levels not seen since World War II, Treasury interest rates are close to their historical lows (the 10-year Treasury currently yields +0.7%).

A strong case could be made that current interest rates are artificially low due to the heavy buying by the Federal Reserve. However, a slowly rising personal savings rate, both here in the U.S. and in most developed nations around the world, also supports the demand side of the equation for government fixed income securities.

At all times, Treasury rates are also influenced by the rates offered by other, comparable securities. On this measure, we note that European sovereign debt yields, are considerably lower than U.S. rates in many cases. The rate for a 10-year government bond in Japan, meanwhile, is currently 0.0%, as maintained by Bank of Japan policy and a high national savings rate.

Summary:

Despite a jump government debt, over and above what had already been high levels, we currently believe U.S. government debt burden is manageable over the intermediate-term. There is no doubt however, that over the longer-term policies need to be enacted that get debt to GDP projections on a downward trajectory through a combination of simulative economic growth policies, higher government revenues (i.e., taxes) and lower spending.

Undoubtedly, the debt is concerning, but there are two factors that help ease the potential repercussions under current circumstances, in our view. First, most governments in the industrialized world are in a similar position. As such, the potential negative consequences that could otherwise befall U.S. government borrowing costs, or the value of the U.S. dollar, are somewhat held in-check, in our view.

Second, around the world, central bank ownership of domestic government debt has been rising, just as it is here. Under normal circumstances, this "monetization of debt" could be quite inflationary and potentially lead to deep currency devaluations depending on the magnitude and individual country circumstances. Under the current situation, however, these avenues are unlikely to transpire. The money supply boost via central banks is not incremental to normalized consumer and business spending levels (thus unlikely to cause demand-pull inflation), but in replacement of such.

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