Morgan Stanley

WEALTH MANAGEMENT

The Skyline Group

7175 N Pima Canyon Drive
Tucson, AZ, 85718

direct +520 878 2007
toll free +800 877 8417
fax +520 519 2358

advisor.morganstanley.com/the-skyline-group

James P Dretler
Senior Portfolio Management Director
Senior Vice President
Financial Advisor
NMLS #1279614

direct +520 878 2001

David Hum, CFP®
Portfolio Management Director
Vice President
Financial Advisor
NMLS #1262203

direct +520 878 2002

Christopher Graves, CFP®
Portfolio Management Director
Vice President
Financial Advisor
NMLS #1265113

direct +520 878 2003

Hugo Frausto
Portfolio Manager
Financial Advisor
NMLS #1923254

direct +520 745 7074

Anne Emmerich
Senior Registered Associate

direct +520 878 2007

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Inflation Versus Deflation

If a person anticipates inflation, he buys in advance of the expected higher prices in the future. If he expects deflation, he delays purchases to take advantage of lower future prices. As a result, he might conclude that inflation could be a potential positive for the economy, while deflation would not be.

In Keynesian economics, the government steps in to spend money or invest in the economy, replacing the consumer who might either not have money to spend through unemployment or be reticent to spend what capital he has out of fear of future uncertainties.

The Federal Reserve, after injecting massive Keynesian stimulus in hopes of preventing or at least counteracting a recession during the Covid Pandemic, is attempting to reverse the inflation it caused by raising interest rates.

Economic commentators have generally forecast a recession as a result of these interest rate increases, believing that increased unemployment as well as the thrift paradox will ensue.

In the past, notably during the Fed Chairmanship of Paul Volcker (1979-1987), higher inflation rates were countered by high federal funds interest rates (20% in June 1981). [1]

By raising the fed funds rate to this level, Chair Volcker and the FOMC in effect made the Fed a competing entity for all private investment dollars. In that it was considered risk-free and liquid, very few investment dollars went elsewhere.

When the government issues debt, investors buy that debt, converting their cash to static, long (or at least longer) maturing securities. This reduces money supply and can reduce the velocity of money in the economy.

Under Paul Volcker with support from Ronald Reagan, these actions caused a recession, contributed to the failure of many businesses, and some think caused a Schumpeterian boom in which the surviving businesses were renewed in the subsequent period of lower costs and fewer competitors.

Under Fed Chair Powell, so far, this has not happened.

After the financial crisis of 2008, now called 'The Great Recession', Interest rates were lowered to essentially 0%, here as well as around the world. Now rates are moving up to counter inflation in most of the developed world. By raising interest rates to the current 5.5% area, Chair Powell has, like Volcker, given investors a place to park money, lowering its velocity.

Employment remains robust, consumers continue to spend.

Even housing prices, although showing some weakness, have not collapsed. Builders have adjusted purchase terms and avoided over-building in order to match the supply of housing with buyer demand.

On the banking side, the Fed continues to require the banks to retain high levels of reserves and pays them high rates to deposit those reserves at the Fed, also reducing the velocity of the money they have created.

As a result of these factors, we might not have a recession any time soon.

This is, in my opinion, the situation we have today. An economy driven by the needs and wants of individual consumers and investors pursuing their own objectives.

Chair Powell and the FOMC are, I think, well-aware of the applicable historical precedents. If they can convince us that they will repeat an ever-tighter monetary policy ala Mr. Volcker until they have achieved their goal of a 2% rate of inflation, they may not have to raise much more than they already have.

This threat of future rate-hiking action may be enough to achieve their goal.

Once again, the concept of a 'managed economy' through central bank planning may not work.

To the extent that we have a free market, the economy is a result of individual investors making their own financial decisions, not of governmental manipulation.

We remain committed to investing in individual, liquid, growth-oriented, companies and markets.

Please call to discuss opportunities that might fit your individual investment objectives.

Sincerely,

James P. Dretler

James P Dretler
Senior Portfolio Management Director
Senior Vice President
Financial Advisor

1. https://en.wikipedia.org/wiki/Paul_Volcker#:~:text=The%20Federal%20Reserve%20board%20led,rate%20rose%20to%20over%2010%25

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