

Inflation Explained By Fairy Tales

by [Steve Brown](#)

We were pondering a recent article in The Economist about inflation and we thought - this really is the same story as the Beauty and the Beast. You see, inflation is just an awful terrifying monster, but it can be transformed with just a little love and training into something necessary and useful. Lately though, inflation is more on the path of the Three Bears - going directly from scalding porridge that burns the mouth to congealed, cold and unappetizing sludge. Global Central Banks' search for a level of inflation that is "just right" is turning out to be elusive. Recall that inflation is characterized by a rise in prices from too much money chasing too few goods. In an inflationary environment, people want to buy products and services now, because the price is likely to be higher tomorrow.

The opposite of inflation is deflation. In that environment no one buys because things bought at today's prices will likely be cheaper tomorrow. Investments in productivity-improvement projects are also put off as they will be cheaper to do in the future. You know what we are saying if you have shopped for a TV lately. Consider that in 1986, a color Toshiba table top TV with a 19" screen cost \$490 (and that is not inflation adjusted). Compare that to a 42" flat screen TV today at Best Buy available for \$300. For those willing to wait a year, a comparable device will probably cost even less. Gasoline prices are in a deflationary cycle too, although admittedly they don't count over the longer term as they are generally supply driven. But declining demand due to cooling economies worldwide is currently driving the price of gas down too. All of this seems pretty deflationary.

For their part, Central Banks worldwide have spent decades fighting inflation that was too hot. As long as populations were growing, worker productivity kept improving and other engines kept economies mostly humming along. As a result the decline of inflation was generally seen as a positive. Too little inflation is a bad thing though. Goods are seemingly ever less expensive, so consumers simply wait to buy for a lower price and this slows productivity and the economic growth engine. Given stagnant wages in the US for most people, declining prices of consumer goods have been an important element in maintaining the lifestyle of the general population. The problem here is that there is a limit to the benefit, as prices going ever lower also drive wages and benefits lower for workers. That is because lower prices ultimately drive producers to find cheaper production markets in order to keep up profitability.

The Fed has recently ended its major stimulus effort of buying large quantities of Treasuries and mortgage-backed securities. This effort to drive longer term interest rates down has been successful, but now some are worried because rates have failed to move upwards even as Fed asset purchases have waned. In fact, Treasury yields are significantly lower than they were at the beginning of 2014. The Fed has stated that its longer term inflation goal is 2%, but inflation has been running below that level in the US and abroad for years. In Europe and most of Asia, central banks are beginning new stimulus efforts to fight deflationary pressures.

The tepid rate of growth in Europe and slowing growth in China are exerting downward pressure on prices. Despite this, the US economy continues to chug along and is performing better than most other global economies.

At this point, some fear inflation is simply snoozing like Rip Van Winkle, while others worry about deflation and say let the poor tired man sleep. Overall, a bit more inflation at this point would drive more consumption and improve wages. Given the bad news deflation can bring, for the sake of everyone we hope the world moves closer to a Goldilocks level of inflation.

ECONOMY & RATES

Yesterday

The rise in Treasury prices over the last 6 days sparked a sell-off, causing yields to climb 4bps.

Today

Yields are unchanged as there are no major releases scheduled.

Rates As Of: 12/02/2014 07:50AM (PST)

Treasury	Yields	MTD Chg	YTD Chg
3M	0.02	0.00	0.00
6M	0.08	0.00	0.00
1Y	0.12	0.00	0.00
2Y	0.53	0.00	0.00
5Y	1.58	0.00	0.00
10Y	2.28	0.00	0.00
30Y	3.00	0.00	0.00
FF Market	FF Target	Fed Disc	
0.00	0.25	0.00	
Prime	Unemployment	Oil	
3.25	0.00	\$0	

[More Market Rates](#)

BANK NEWS

M&A

First Foundation Bank (\$1.3B, CA) will acquire Pacific Rim Bank (\$121mm, HI) for about \$12mm in stock.

Dodd Frank

Davis Polk reports that as of Dec 1 about 58% of total rulemaking requirements had been completed with rules finalized. Meanwhile, about 18% have been proposed and are in process, so bankers will have that to look forward to in coming months, while 24% still have yet to be proposed.

ROE Analysis

Deloitte reports the average quarterly ROE for financial institutions in the US was 12.9% during the pre-crisis period from Q1 2004 to Q4 2006. That is about 32% higher than the average of 8.8% for the post-crisis period which is from Q1 2011 to Q2 2014.

Big Shift

The FDIC reports the banking industry closed 1,614 branches from 2Q 2013 to 2Q 2014, marking the largest decline in more than 20Ys.

Structural Change

Community bankers should be aware that the largest bank competitors in the country will have to comply with new liquidity rules starting Jan 1. This new rule requires large banks to hold enough liquid assets to handle 30 days of major market stress. That will pressure margins for the big banks, so they may move more aggressively downstream trying to capture loans. Be aware and be sure to closely monitor your largest accounts so you have time to react in the event they are approached by competitors.

Funding Opportunity

As Basel III kicks in starting next year, community banks should note it requires the largest banks to hold a lot more low yielding, highly liquid investments on the books. As such, once the Fed starts raising rates don't

expect those large banks to be quick in raising deposit rates. That could really help widen margins, but of course the offset is that depositors may also begin to move their money to other channels once this difference becomes too great. Something for community banks to monitor closely during 2015.

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