When Will Inflation Really Hit Us?

By Terry Coxon, Editor, The Casey Report

Most of us are gathered at the station, watching for the Inflation Express to come rumbling in. But we've been waiting for a while now. Just when should we expect the big locomotive to arrive and start pushing the prices of most things uphill?

We'd all like to know the exact date, of course, but no one can know for sure. Not even a careful reading of the Mayan calendar will help. What we can do is estimate a time range for price inflation to show up, and that alone should have some important implications for investment decisions.

Why It's Expected

The reason for expecting price inflation is the recent, rapid growth in the money supply and the deficit-driven likelihood that more such growth is coming.

As of July, the M1 money supply (currency held by the public plus checking deposits) had grown 17.5% in a year's time. That's not just unusually rapid, it's extraordinarily rapid. Since 1959, M1 has grown more rapidly in only one other 12-month period – and that was the one ending last June, when the M1 money supply jumped 18.4%. Even in the inflation-plagued 1970s, growth in M1 never exceeded 10% in any 12 months.

Dropping large chunks of newly created money into the economy leads to price inflation, because the recipients are likely to find themselves overprovisioned with cash. As they try to unload the excess, they bid up the prices of the things they buy, whether it be stocks, shoes, gasoline, silver coins, or granola. The sellers of those things then find themselves cash rich and start doing some buying of their own, and so the wave of excess money and the bidding it inspires propagate through the economy.

The process isn't instantaneous. It takes time. Just as each player in the economy has a sense of how much of his wealth he wants to hold in the form of money, everyone will move at his own speed to make adjustments when his actual cash holdings seem to be off target.

And the process can seem to stall, especially when fear is growing. When people are worried or otherwise feel a heightened sense of uncertainty, they will gladly hold on to abnormally large amounts of cash – for a while. But when fear abates, as it will when the economy begins to recover from the recession, that temporary demand for extra cash will also fade, and the hot-potato process of trying to pare down cash balances will emerge to do its inflationary work.

But when?

The speed at which the public tries to unload excess cash and the timing of the effects have actually been measured, in the work of the late Milton Friedman and his monetarist colleagues.

The method was indirect and roundabout, and so the results, unsurprisingly, were nothing as precise as nailing down the value of a physical constant.

What the monetarists (or the first of them to be equipped with computers) found was that when the growth rate of the money supply rises:

- The initial effect is on the prices of bonds and stocks, an effect that comes within a few months.

- The peak effect on the growth rate of economic activity comes about 18 to 30 months after the pick-up in the growth rate of the money supply.

- The peak effect on the rate of consumer price inflation comes about 12 to 18 months after that, which is to say it comes 30 to 48 months after the peak growth rate in the money supply.

As Friedman famously put it, the lags in the effects of changes in monetary policy are "long and variable." He might have said, "It's a big, wide blur, but we're sure we've seen it."

And even that picture exaggerates the precision that's available to us. The emergence of money substitutes, such as NOW accounts and money market funds, has added its own muddiness to the picture of how growth in the money supply translates into growth in the level of consumer prices. It is only because the recent episode of monetary expansion has been so extreme that we can look to the results just listed for an indication of what's to come.

If you apply the findings of the monetarists to the present situation, here's what you get. The peak growth rate in the money supply occurred last December, so based on the general monetarist schedule:

- Some of the effect on stocks and bonds should already have been felt.

- The peak effect on economic activity should come between the middle of 2010 and the middle of 2011.

- The peak effect on consumer price inflation should come between the middle of 2011 and the end of 2012.

A More Particular Schedule

This time around, should we expect things to move more rapidly or more slowly than average? My bet is on slow, which would push the peak inflation rate out toward the end of 2012. One reason for slow is that the government's rescue packages are delaying the process. Rescuing banks that are choking on bad loans postpones the day of reckoning for both the banks and the loan customers. It retards the pace of foreclosure sales (whether of real estate or other collateral) and puts the deleveraging that has been going on since last fall into slow motion. A wilting of the recent stock market rally would confirm this.

Investment Implications

The big plus about the Mayan calendar is that, right or wrong, it is very definite about things. Human civilization will come to an end, I'm told, on Dec. 21, 2012 – not on the 20th and not on the 22nd. There was no room for monetarists in those step-sided pyramids, but there still are few what-to-do implications from the monetarist findings.

1. When you hear would-be opinion leaders cite the current absence of rising prices at the supermarket as proof that all the new money isn't a source of inflation, don't believe them. It is much too early for the inflation bomb to be going off, even though the powder has been packed and the fuse has been lit.

2. If the large and growing federal deficits and the Federal Reserve's unprecedentedly easy policies tempt you to leverage up on inflation-sensitive assets, such as gold, give the idea a second thought. It likely will be a year or more until price inflation becomes obvious and undeniable (which is what it would take to bring the general public into the gold market). In the meantime, your inflation-sensitive assets could get paddled rudely as the deleveraging that began last year continues.

For at least the next year, the simple, fire-and-forget strategy is 50-50 gold and cash – gold for what looks to be inevitable but on its own schedule, cash to be ready for the bargains that may show up while we're waiting for the inevitable to arrive.