



The Inflation the Fed Fears Most

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The term inflation is widely used but generally misunderstood. Economists, politicians and the general public understand it to mean one thing. Inflation, however, has a very different meaning to our central bank, as I will explain.

If you've studied economics, you may think inflation is a rise in the general level of prices of goods and services in an economy over a period of time, measured by the Consumer Price Index, the Producer Price Index, or the GDP price deflator – indices that adjust wages, taxes, retirement plans, and interest payments.

Inflation generally applies to tradable goods, services, and wages, on which the popular indices of inflation focus. Inflation is also personal. If the prices of the goods and services you purchase are going up (say, college tuition, for example) you are experiencing inflation. If you don't go to school, tuition inflation doesn't matter so much.

We generally don't apply the principle of inflation to the markets, on the other hand. If the general price level of the stock market goes up, we don't call it inflation; it is a bull market. Investors routinely attribute gains from rising prices to their superior investment skills. Homeowners who rode the boom in the housing market were similarly self-assured.

Point being: Inflation as we know it is a nuanced concept that touches on all facets of the economy. You might think we can all agree on that, first and foremost the Federal Reserve, whose policies have such wide-ranging implications for inflation.

Think again. As the Fed has been concerned about it recently, inflation is something completely different: a phenomenon affecting a single asset in a single segment of the economy – housing.

Let me explain. For more than 60 years before 2006, the general level of housing prices in the United States rose on average a little more than 3% a year. As this was the principal asset of most Americans, this steady rise was considered a good thing, maybe even an entitlement. Unfortunately, and for a multitude of reasons, the inflation of housing prices reversed in 2007. Because the asset class was so widely owned and so heavily leveraged, this abrupt deflation is having huge consequences. The Fed is still wrestling with the housing price debacle today, as it continues to threaten the solvency of the banking system.

Given that assuring the solvency of the banking system was the Fed's primary, founding mission, it follows that arresting the decline in housing prices and providing the banking system the time to earn its way back to financial health has become the one and only job



of the central bank. You should now understand that when the Fed's Governors state that we must avoid deflation, what they mean is that housing prices cannot be allowed to decline anew.

In the grand scheme of things, the Fed cares little about food, energy, healthcare, or other goods and services, because movement in their prices will not create the existential crisis for banks that declining housing prices will. Nor will a declining dollar against other currencies. In fact, a declining dollar is desirable in the Fed's view – it may help stimulate the domestic economy, and a better economy will support the housing market.

Despite their best efforts, the central bank is on the verge of failing in their primary mission. Housing prices are likely to decline more going forward, as Gary Shilling explains in a recent article, "[Housing prices may still have 20% to fall](#)." QE2 was a desperate attempt to forestall this decline in housing prices, which resumed in the fall. The Governors must be beside themselves watching the yield on mortgages rise over the last few months; they have gotten exactly the opposite of what they wanted and needed. The banking system can ill-afford another leg down in home prices and the central banks is running short of tools to deal with the problem.

So the next time a spokesman for the Federal Reserve Bank uses the word deflation, remember that it is really a code word. They are talking about housing prices and housing prices only.

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