**Will the Government’s Huge Stimulus Programs Currently in Place Bring Inflation in its Wake?**

Economic controls implemented by the US Government during WWII created an enormous economic boom post-war. The economic controls in place today as a result of the pandemic raise the same possibility. The question is: will the US economy repeat the post-war boom via consumers spending pent-ups savings, or will inflation be the result of the gigantic amount of stimulus money being poured into the economy?

The *Economist* magazine reports US households have stashed away $3tn in excess savings (funds above and beyond that needed to pay for essential goods and services) during the first 9 months of 2020, and this amount does not include funds being injected in President Biden’s most recent stimulus plan. What will consumers do with all this excess cash?

If consumers spend their excess savings all at once, economists predict GDP growth would balloon upwards toward 10 percent, a very hot recovery. An abnormal rate of growth could cause bottlenecks in the supply chain of raw materials that would lead to inflation--too much money chasing too few goods. We are beginning to see potential problem with chips, which would be big trouble for automobile manufacturers.

The Phillips Curve, which is derived from empirical observations (it is not a theory), captures the tradeoff between high growth (low unemployment) and inflation. Strategists at the Fed use the Phillips Curve as a guide when constructing economic policy in pursuit of their dual mandate of stimulating economic growth while keeping a lid on inflation.

The graph below shows an inflation rate of 2% at an unemployment rate of 6% (point A). As the economy heats up and unemployment decreases to 3%, the rate of inflation increases to 5% (point B). Professional economists generally accept the Phillips Curve as an economic principal that guides public policy although it has not been supported by the data over the past several years.



Prior to the pandemic, the US economy enjoyed historically low unemployment with very little inflation, an anomaly by historical standards and contrary to the tradeoff depicted by the Phillips Curve. One possible reason for this occurrence was because consumers curtailed spending in order to stash away funds to pay perceived higher taxes down the road. That could happen again today as higher taxes loom on the horizon.

Another possible reason is that technology has mitigated the possibility of bottlenecks in the economy. Fracking, for example, is keeping the world awash with an abundant supply of energy necessary to produce goods and services. As long as energy prices remain muted, the rate of inflation will likely remain muted. In the pre-pandemic period, the economy was growing but it was not overheating. Proponents of large stimulus packages point to these and other reasons in claiming the same thing can happen again post-pandemic—high growth without high inflation.

Relative to the rest of the world, the US is far ahead in terms of the amount of money the Government is injecting into the economy. The prevailing thought is that the American people have been hurt so badly that helping them is the first priority; worrying about inflation an afterthought.

While the stock market has embraced this high growth/low inflation scenario, a scary scenario looms in the distance. The meteoric rise in the price of Bitcoin casts some doubt on whether the stimulus plans will jolt inflation to the point of seriously damaging the US dollar as the primary currency for conducting international financial transactions.

Bitcoin enthusiasts say the digital currency is a good hedge against inflation due to its limited supply relative to the US dollar. Jeromy Powell, Chairman of the Federal Reserve, recently stated that the central bank is taking a hard look at the possibility of introducing its own digital currently. He further stated that Bitcoin is too unstable to fit the role of a transactional currency. Chairman Powell seems to be saying what professional investors already know although his comments are contradictory. He has made similar comments in the past that got no traction with Congress who has ultimate authority on the choice of a national currency.

If, by chance, Bitcoin were to replace the US dollar, as some speculative investors hope, it would not only disrupt the US economy but would also hamper the entire global market. This fear is well-ingrained into the minds of central bakers across the world. Even then, the twin forces of democracy and capitalism combined with a highly efficient securities market would eventually right the global economic ship over time, although the short-term effect could be devastating. While I see the Bitcoin scenario as a possibility, I do not see it as a high probability. Still, we need to pay attention to what the market is telling us.

So how will the Government pay for this huge stimulus package? Raise taxes? Use tax revenue generated from the economic boom? Turn on the printing presses? Only time will tell although we have some indication from historical evidence. Prior Keynesian programs designed to stimulate the economy based on the idea of repaying debt with increased tax revenue from growth did not materialize. Politicians are good at diverting tax dollars from growth into other programs as opposed to paying down debt. What actually happens is just more debt, and here we are: levels of debt beyond any reasonable expectation of ever being repaid. One way to get out of this quandary is inflation, but that cure could be extremely painful. Remember what happened in Germany after WWI? That situation led to the follow-up: WWII!

I do not see a similar situation happening here in the US. I do not see runaway inflation, but I also do not see the American consumer doing anything other than what we all do best, which is to spend money. Behavioral economists say past behavior is the best predictor of future behavior. If that is true, an economic boom on the scale of the post-war boom or greater is quite possible especially as long as interest rates remain lower than growth, a very bullish situation for both the economy and the stock market as long as it lasts.

Like any other potential economic scenario, risk is ever-present. Given the current environment and because we cannot see the future, the implication for portfolio management is to maintain a disciplined investment strategy based on diversification across multiple asset classes and within each asset class. A sector rotating or a stock picking strategy is significantly riskier and should play only a minor role, if any, for the thoughtful investor.

Economic controls are about to be lifted and consumers are ready to live again. I see a massive global economic boom happening. My hope is that inflation will not get out of hand in the process. As powerful as it is, the Fed possesses limited control; it cannot defeat overwhelming market forces forever. I welcome your comments. REC