

## Sentinel Perspectives

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“Over the past few years, we have watched the U.S. government pump more than \$3 trillion into the financial system. Is this the harbinger of rising inflation to come? We don't think so, based on the application of three commonly used principles of economics.”

## Deconstructing the Great Inflation Myth

Three reasons inflation will not be a concern in the near-term.

If you've taken courses in economics, you've probably come across concepts like the Quantity Theory of Money, Capacity Utilization and Labor Utilization.

As we apply these principles to the current economic environment, it's difficult to make the case that inflation is a serious risk, at least in the near term. Let's look at each concept individually, and deconstruct what can be called the “Great Inflation Myth:”

### 1. The Quantity Theory of Money

The notion that an increase in the money supply will directly lead to an increase in the price level of all goods (i.e., inflation) has historically been explained through an economic concept called the Quantity Theory of Money. To better understand this theory and ultimately the impact of money supply on inflation, we need to take a closer look at a formula within the theory known as the Equation of Exchange.

#### The Quantity Theory of Money and the Equation of Exchange

$$M * V = P * Q$$

Money supply (M) x Velocity of money (V) = Price level (P) x Quantity of goods (Q)

Let's take a moment to define each of these variables:

**M** — Money supply is the total amount of money available in an economy for a given period of time.

**V** — Velocity of money is the frequency at which a unit of currency is exchanged amongst different parties in a given period of time. If it changes hands once in a year, velocity = 1; if it changes hands twice in a year, then velocity = 2, and so on.

**P** — Price level is simply the overall level of prices for all goods. The Consumer Price Index (CPI) could be used as an observable index for P.

**Q** — Quantity of goods exchanged within an economy for a given period of time.

As you can see from the above equation, for money supply (M) to be the only driver of inflation, you need to assume that both V and Q are constant. In reality, the velocity of money is not constant and in fact is rapidly declining at the moment. When the velocity of money is declining there can be considerable increases in the money supply with little to no impact on the overall level of prices.

Today, many investors are concerned that the increase in money supply resulting from the unprecedented levels of recent fiscal and monetary stimulus will lead to runaway inflation. The fixed income team at Sentinel does not believe that inflation poses a significant risk to the US economy at this point in time. We believe that significant decreases in the velocity of money or V in the Equation of Exchange are offsetting the impact of any increase in the money supply.

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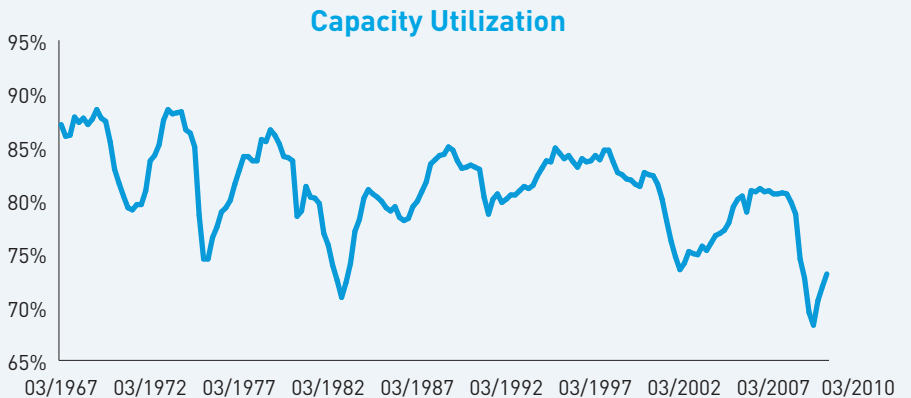
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“Even though the money supply is rising, we conclude that inflation is not a near-term risk in the U.S. economy given the decrease in the velocity of money and the tremendous slack in both the manufacturing and service sectors.”

## 2. Capacity Utilization

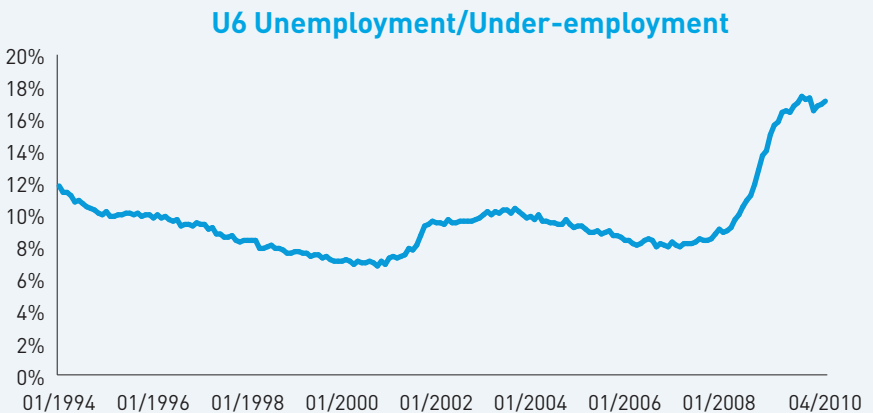
Capacity utilization measures the actual output relative to its potential output for a given machine, company, or country, etc. In the United States, we are currently utilizing approximately 74% of our potential output. That means that 26% of our potential output is not being utilized at this point in time. You can see by the chart below that 74% represents a very low level of capacity utilization relative to historical levels.



In the U.S. economy, there is tremendous amount of capacity that is currently not being utilized. This extra capacity or slack in the economy makes it very difficult for producers of goods to increase the prices of those goods. Historically speaking, we need to have capacity utilization well north of 80% to have material levels of inflation (i.e., CPI above 5%).

## 3. Labor Utilization

Our thoughts on labor utilization are very similar to our thoughts on capacity utilization. The May 2010 unemployment rate was reported at 9.7%. But this headline number did not account for people who are either under-employed or so discouraged with the job market that they are no longer looking. This additional segment of the population is captured in a metric published by the Bureau of Labor Statistics called “U6.”



The May 2010 U6 unemployment rate of nearly 17% represented about 25 million people who are now either unemployed or underemployed. This rate represents a spread of 7% over the headline unemployment rate. In our view, inflation is not a concern when there is this degree of slack in labor market.