



Learning to Love Inflation



Justin Marlowe

Not long ago my 11-year-old politely demanded a raise in her weekly allowance. I asked which new chores she'd like to take on to earn those additional dollars. Her answer: none. Instead, she wanted more money for the same work. To bolster her case, she mentioned that her friend's parents increase her friend's allowance five percent each year for inflation. "I don't know what inflation is," she said, "but I deserve some." I admire her moxie, even if her economics are a bit off.

It's hard to blame her for misunderstanding inflation. From 1980 to 2000, average annual inflation was 4.24 percent. Those of us who came up in that era were told to carefully account for it when forecasting budgets and investing public money. But since 2001, inflation has hovered at just over two percent, and since 2015 it's been an

ultra-low 1.54 percent. For kids today, inflation is something of an abstract concept.

This is especially strange, given our recent economic experience. Basic macroeconomics tells us we can't simultaneously have the low interest rates, low unemployment, and low inflation that we've enjoyed for a decade. The traditional story is that low unemployment causes workers to demand higher wages, those higher wages drive up prices and inflation, and the Fed then stops that inflation by cooling off the economy with higher interest rates. It was only a matter of time until we stopped defying the laws of macroeconomic physics. Then came COVID-19.

Now we're about to enter a brave new world of post-COVID-19 Fed policy. On August 27, 2020, Federal Reserve Chair Jerome Powell made an historic

announcement. He said the Fed would soon shift its strategy to maintain price stability. Instead of its traditional two percent annual target for inflation, the Fed will now focus on “average inflation targeting.” In fact, he said, persistently low inflation can bring on a new set of unwanted economic dynamics.

Translation: The Fed is going to keep interest rates low for the foreseeable future, even if that means more inflation. The economy will eventually work its way out of the record high unemployment brought on by COVID-19. This decline, if it’s as fast as some hope, could spark a faster-than-average run of inflation. The Fed is willing to pay that price to bring employment back to normal levels as soon as possible. This is an extraordinary shift in Fed policy, but many experts agree that it’s a necessary shift, given the extraordinary effects of COVID-19.

What does this shift mean for state and local finance? A few practical considerations come to mind right away.

First, if you invest public money, consider reallocating some of the portfolio. Investors tend to guard their portfolios from inflation by shifting away from dividend stocks and bonds. Inflation makes the fixed stream of payments from those investments less valuable over time. However, companies that become more valuable—i.e., “growth stocks”—tend to grow faster when inflation is on the rise. Unfortunately, it’s difficult to allocate a portfolio toward growth stocks without taking on considerable new risk that some public-sector stakeholders might consider unacceptable. Moreover, investment vehicles that have delivered reliable returns in exchange for that risk have come under intense scrutiny for the fees they charge and the political connections they leverage. The State of Kentucky’s recent class-action lawsuit against Blackstone, KKR, and other hedge funds is a prime recent example. All this suggests the growth stock strategy has its limits.

Instead, state and local portfolio managers might look to commodities and, to a lesser degree, real estate. Prices of real assets tend to keep pace with inflation, so they become more valuable as investments if inflation rises. Portfolio managers might also look to buy securities with payments to investors that automatically adjust for inflation. The most common are Treasury Inflation Protected Securities (TIPS), with coupon payments that increase automatically at the rate of inflation. These types of assets tend to be small portions of a typical pension or pooled investment fund portfolio. They could easily be ramped up as a hedge against higher inflation.

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Jurisdictions in the market to borrow money might also take heed. Higher inflation means the debt service on outstanding bonds takes a smaller relative bit out of annual budgets. This means now might be the time to accelerate the capital improvement plan and borrow a bit more.

Of course, it’s more difficult to sell bonds when inflation is on the rise. To deal with this problem, issuers might look to shorter call provisions. Recall that a call feature allows a bond issuer to pay back the bond ahead of schedule without penalty. Ten-year calls coupled with a five percent coupon have been the norm

for general obligation municipal bonds. This structure is attractive to both issuers and investors. Fixed-income investors like it because a tax-exempt five percent coupon is one of the best available in any asset class. Issuers like it because it gives them the flexibility to refinance at lower rates later, and with low rates across the market it all but guarantees the bonds will sell at a healthy premium. This means more money available upfront to deliver the project, and no problems with tax arbitrage later on.

But lately, more and more issuers have sold bonds with lower coupons and call features as short as seven or eight. Some investors have been willing to play along because they have anticipated higher inflation. Shorter maturity coupled with an attractive coupon is a terrific way to shorten a portfolio’s duration and insulate it from inflation. After last week’s announcement, many investors might look to shorter-call munis. For issuers, shorter calls mean greater flexibility to deal with whatever comes next.

The Fed’s new inflation target policy will create some new challenges and uncertainties. But it will also create new opportunities for issuers who are prepared to take advantage. Consider these and other strategies going forward. ■

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