Protect Yourself from the Fed's "Inflation Delusion" with This

Peter Krauth

November 24, 2015

The U.S. Federal Reserve has kept interest rates stuck near zero for the last seven years, so there's little wonder investors and savers feel like "perma-zero" is the new paradigm.

Despair and ennui have settled in. According to the Fed, some 31% of non-retired Americans have no savings or pension whatsoever.

Some have been frozen out, unable to save thanks to stagnating incomes and dismal job prospects. Others who might otherwise be able to save just don't see the point when they're not making any interest to speak of.

That negative outlook is understandable, given today's economic realities. But it doesn't have to be that way.

Not when a small investment in one easy-to-buy asset can make so much difference.

Anyone Can Fall Into the Trap

Recency bias in investing is basically the tendency to assume that recent trends and behavior are likely to repeat in the future.

That typically works fine to predict the very near term, but the farther out one's timeline, the less reliable it tends to be.

It's one of the biggest reasons why the investing crowd is usually wrong, and it's all too easy to fall for.

It's bad for investors, but when policymakers like the Fed's Federal Open Market Committee (FOMC) fall into this trap, there can be consequences for everyone.

For instance, St. Louis Fed President James Bullard thinks America may be, according to ***Reuters***, "entering an era of permanently low rates and inflation that will require a rethink of monetary policy."

He told attendees at a Cato Institute conference that "should we find ourselves in a persistent state of low nominal interest rates and low inflation, some of our fundamental assumptions about how U.S. monetary policy works may have to be altered."

According to Bullard, zero rates may become a *permanent fixture*, which could lead to higher market volatility, along with pressure to make quantitative easing (QE) a Fed policy norm. Fed Chairwoman Janet Yellen herself highlighted the need to assess the unconventional monetary policies employed by central banks worldwide as they reacted to the global financial crisis of 2008.

There is, however, the odd hawk…

Fed Vice Chairman Stanley Fischer told a conference of researchers and FOMC members that "some of the forces holding down inflation in 2015, particularly those due to a stronger dollar and lower energy prices, will begin to fade next year."

And Chicago Fed President Charles Evans recently told reporters after a presentation to the Manufactured Housing Institute in Chicago that he's been dumbfounded by the lack of change in the inflation outlook, despite a strengthening U.S. economy.

To his credit though, Bullard did say that the Fed's near-zero interest rate policy was subjecting the American economy to "considerable risk of future inflation."

And so from these remarks, we can see real signs that the Fed itself is falling victim to recency bias with respect to interest rates and inflation expectations.

The market itself is pointing to a real risk of deflation, with oil and commodities especially weak. But as you're about to see, real interest rates may actually be lower than you think.