

THE INFLATION DEBATE HEATS UP *By Evan Swanson, CMPS*

IT WAS IRVING FISHER WHO contributed the equation of exchange to the world of macroeconomics. This equation states that $MV=PT$, where M= money supply, V= velocity of money, P=price level, and T= quantity of goods and services transacted (real Gross Domestic Product [GDP]).

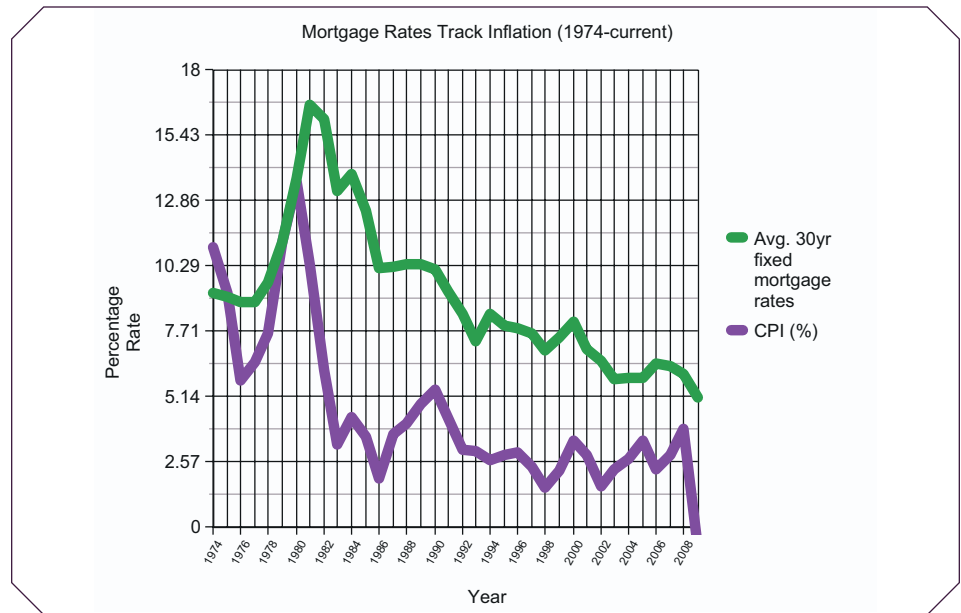
This relatively obscure equation is the cornerstone of a hotly debated topic in the world of finance these days—namely, whether or not the government's efforts to stimulate the economy will ultimately lead to acute inflation or not.

Why should you care? Inflation has profound effects on managing one's personal finances, especially when it comes to managing one's mortgage. Inflation is the main driver in mortgage rates; when inflation increases, mortgage rates follow suit.

The last time acute inflation struck our economy was in the late 1970s—early 1980s. In 1980, the Consumer Price Index, which is the most widely used measurement of inflation, increased by 13.5% from 1979. At that time, fixed mortgage rates averaged 16.63%. So why are analysts currently concerned about the future prospect of inflation? Let's return to Fisher's equation of exchange. By using simple algebra and solving for price level we get $P=MV/T$.

According to Fisher's equation, inflation rears its ugly head when money supply (M) and/or velocity of money (V) increase faster than GDP. In other words, when there are more dollars in the economy chasing fewer goods, we can expect prices to rise.

Through various programs, the government has flooded our economy with money over the past 12 months with the objective of stabilizing the housing and financial markets. As a result, money supply has increased by



9.0%, according to money stock measures from the Federal Reserve.

There are currently more dollars chasing fewer goods. However, because banks and households have been sitting on their stimulus money instead of lending or spending, inflation has yet to appear, and mortgage rates have remained low.

One side of the inflation debate contends that when the economy cycles back around for the better (pushing V and T higher in the equation), the Fed will not be able to unwind the money supply fast enough to curb inflation.

Arthur B. Laffer is one such alarmist who wrote an opinion piece in the June 11, 2009 Wall Street Journal entitled "Get Ready for Inflation and Higher Interest Rates," in which he stated, "We can expect rapidly rising prices and much, much higher interest rates over the next four or five years, and a concomitant deleterious impact on output and employment not unlike the late 1970s."

Others, such as Gus Sauter, managing director and chief investment officer for The Vanguard Group, are not concerned. In a recent letter to investors, he stated, "I don't think inflation is a foregone conclusion at this point ... If the Fed is nimble enough, they may be able to stave off inflation."

The reality is that we are in uncharted territory. The Fed's balance sheet has swelled in the past year, and U.S. budget deficits are widening at an alarming rate.

When the economy does recover, these factors suggest we can expect higher inflation and interest rates. Theoretically, the Fed does have the tools to unwind the money supply without major inflationary implications, but I wouldn't bet my house on it.

If you know you'll need to manage your mortgage at some point in the next few years, please call us today so we can evaluate your situation and proactively discuss your options with you.

SPEAK NOW OR FOREVER HOLD YOUR MORTGAGE *By Evan Swanson, CMPS*

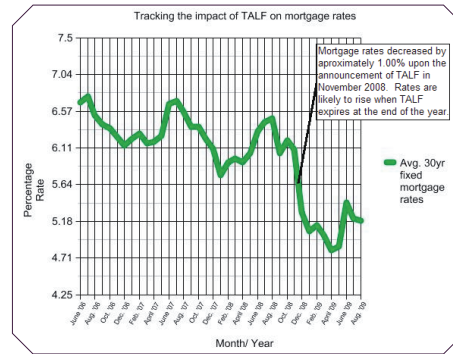
ON NOVEMBER 25, 2008, THE Federal Reserve surprised the financial markets by announcing that it would include agency-issued mortgage-backed bonds (MBSs) in what has since become a \$1.25 trillion open market operation known as Term Asset-Backed Securities Loan Facility or TALF. The goal is to improve conditions in the housing and financial markets.

Mortgage rates are inversely related to the price of MBSs. As the price of MBSs rises, mortgage rates decrease and vice-versa. The Fed's objective in its commitment to purchase \$1.25 trillion of MBSs was to create substantial demand; raising MBS prices and essentially subsidizing mortgage rates.

The results of the Fed's plan are substantial when you evaluate mortgage rates over the past three years. From August 2006 through November 2008, average 30-year fixed mortgage rates ranged from 5.875% to 6.625%. Since the announcement and active participation in the open market for MBSs, 30-year fixed mortgage rates have averaged between 4.625% and 5.50%. Millions of homeowners have managed

to take advantage of the Fed's subsidy by refinancing their existing mortgages. Furthermore, thousands of homebuyers have been able to buy real estate at depressed prices with historically low mortgage rates.

But all good things must come to an end. As of August 2009, the Fed had used \$766 billion of the \$1.25 trillion slated for the



program and announced that it would wind down this special program by the end of the year.

Even before the Fed officially discontinues its open market operations for MBSs we expect mortgage rates to rise in anticipation

of their departure from the open market. It's difficult to know exactly how much this will affect mortgage rates, but many analysts are predicting a 1% increase to fixed mortgage rates by the end of the year.

I realize that many homeowners refinanced in the first six months of 2009. Many others would like to refinance but can't because of lower property values and/or tighter underwriting guidelines. However, there are many homeowners who have yet to contact us regarding refinancing information.

If you've thought about it but haven't gotten around to calling, I would highly encourage you to do so soon. It costs you nothing to contact our office and at least discuss your situation. It costs you nothing to have us evaluate your situation and get back to you with options for your review. It costs you nothing to evaluate the information we provide.

However, once rates increase, as they are expected to do, it could cost you hundreds and even thousands of dollars over the life of your loan to not take advantage of the current level of mortgage rates.

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