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Hello and welcome to the Dividend Cafe. I am your host, David Bahnsen. What a beautiful weekend it is going to be here in New York City, and what a topic we have for you today in the Dividend Cafe.

The subject of inflation is not exactly a new topic in the news cycle, in the Dividend Cafe, in my investment writing, or in my economic study. It is a conversation that you can hear in a lot of different places. But we're not really just talking about inflation this week. Questions like: Are oil prices going higher or lower? Are grocery prices going higher or lower? Is the cost of living going to hurt the president or not hurt the president? All of those things are fine. They're legitimate topics to a certain degree. I'm not sure everyone always approaches them in good faith, but they are certainly subjects that are relevant to regular people, to those studying the economy, and to those trying to make investment decisions.

At a deeper level, the broad secular—and by secular, I mean non-cyclical—a long-term structural dynamic wherein there is a sort of equilibrium range around prices is the question I think we need to address. Are we looking at a change in what the structural equilibrium has been for something as important as inflation? When you factor in the AI conversation and expectations for what this artificial intelligence transformation means to the economy, to productivity, to economic growth, and therefore how that trickles down to its impact on the price level, this becomes very important for the next iteration of macroeconomic development, economic growth, and quality of life. It is also important for investors trying to determine whether paradigm shifts are coming in things as important as interest rates, which largely take their cues from expectations about inflation, deflation, and so forth.

I want to set this up around the historical reality of a prolonged period of declining inflation that the United States experienced. For the sake of argument, let's refer to this as roughly the 1990 to 2020 period. You could argue it started a little earlier or ended a little later, perhaps in 2022. But I don't think it is unreasonable to suggest that around the fall of the Soviet Empire, the end of the Cold War, China's economic reforms and entrance into the WTO, and the liberalization of global trade, we entered a different economic era. Alongside those globalization dynamics, we also experienced extraordinary technological advancement through the digital revolution, the internet, the cloud, and numerous innovations that dramatically enhanced productivity. This was inherently disinflationary, and I don't deny that for a second.

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One of the great influences on my thinking in this area is Dr. Lacy Hunt. I've had him on my Capital Record podcast multiple times. I've quoted him in The Dividend Cafe for years. I've read virtually everything he's written, both academically and for broader audiences, and I've enjoyed many private conversations with him over the years. Lacy is one of the few living economists who has profoundly influenced my thinking. Many of my influences are no longer with us, but thankfully Lacy is. Lacy has done remarkable work, often far outside the consensus, on fiscal and monetary policy, debt, the velocity of money, and the forces that influence both economic growth and the price level. He has firmly convinced me that excessive government borrowing crowds out productive private investment and ultimately detracts from long-term economic growth. In my opinion, his work here is unparalleled.

Lacy has recently proposed that the long-term inflation equilibrium of roughly 1.5% to 2.5% has now broken and that inflation will instead settle into a 3.5% to 5% range. That would be significantly higher than bond markets or many economists currently expect. When Lacy proposes something outside the consensus, I pay attention because his out-of-consensus views have proven remarkably accurate over several decades. I want to examine his thesis. The argument is that globalization was the primary driver of the long disinflationary period and that globalization is now ending. Therefore, if globalization produced disinflation, the end of globalization should produce structurally higher inflation.

I do not accept the premise that globalization was the sole cause of disinflation. I think it was unquestionably one factor, particularly during the first half of that thirty-year period. Productivity improved. Supply chains became more efficient. Labor costs fell. Capital costs declined. Global distribution networks expanded. All of these things enhanced productivity and created disinflationary forces throughout the global economy. But I do not believe that was the only explanation. Ironically, one of the reasons I don't believe that is because of Lacy himself. Building upon Irving Fisher's quantity theory of money, Lacy has long argued that declining velocity of money largely explains why inflation remained subdued despite money supply growth. He attributes declining velocity primarily to excessive government indebtedness, which suppresses productive investment and long-term economic growth. I find that explanation highly persuasive. Therefore, I do not believe globalization alone explains the disinflationary environment.

The question then becomes this: if disinflation had multiple causes and only one of them is changing, does the entire disinflationary framework necessarily disappear? I don't think we know that. Furthermore, I would point out that even the premise that globalization itself is ending remains a prediction rather than a description. I'm willing to assume it for the sake of examining the argument, but I don't fully accept it. Yes, supply chains have changed. Semiconductor fabrication has become more strategic. Our relationship with China has changed. Tariffs and industrial policy have introduced new considerations. Those things certainly could increase structural production costs. But that does not necessarily mean they already have. In today's written Dividend Cafe, I describe the current administration's industrial policy as "half-hearted, poorly implemented, anything but structural, not codified into law, erratically enforced, and lacking in the substance needed to suggest that it will become perpetual and embedded."

Certainly, the rhetoric has shifted toward less globalization. The rhetoric may imply structurally higher production costs. But market discipline has so far constrained many of those political impulses. Whether one views that as good or bad is a separate discussion. I simply view it descriptively. I am not suggesting there has been no change. I am suggesting it is a very large assumption to conclude that globalization's entire contribution to three decades of disinflation has now disappeared and reversed. I'm also not convinced that decades of productivity gains simply become obsolete overnight. But let's assume for a moment that they have. We then encounter another issue. We potentially lose one source of disinflation while another source—the one Lacy himself has emphasized for years—not only remains but intensifies: excessive government indebtedness, which continues crowding out private investment and productive growth.

This brings us to AI. Many people now argue that AI will become the next great productivity revolution, much as globalization and the internet previously were. Yet before AI delivers those productivity gains, it requires enormous investment. As Lacy writes, "AI is extremely capital and energy intensive. It requires massive investment in data centers, semiconductors, electrical transmission infrastructure, cooling systems, and high-performance computing hardware." That is entirely true. The argument, then, is that before we experience the productivity benefits, AI creates substantial inflationary pressures through extraordinary demand for capital, energy, and resources. The AI optimist responds that these infrastructure costs are temporary while the long-term productivity benefits are permanent. That is essentially the consensus view: inflationary pressures first, deflationary benefits later.

I think there is merit to that framework. Demand for capital is certainly growing faster than domestic savings. Monetary expansion cannot create the physical resources required for capital formation. How AI infrastructure ultimately gets financed is a legitimate question. At the same time, I also believe, following Michael Milken's philosophy, that financial capital itself is rarely scarce. When productive opportunities exist, financial capital finds its way there. Human capital is the truly scarce resource. Still, there is no question that demand for energy, labor, and physical resources currently exceeds supply. That creates inflationary pressure in the near term, particularly within specific sectors. The precise timing and magnitude are certainly debatable, but the broad framework is reasonable.

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The more important question is what happens after the build-out. Once the AI ecosystem has largely been constructed, do we experience a new productivity renaissance that reduces production costs, increases output, and ultimately offsets today's inflationary pressures? I think there are really two possible outcomes, and interestingly, both lean toward disinflation. One is very good. One is very bad.

If AI successfully lowers the cost of producing goods and services—as virtually every AI optimist expects—it becomes an enormously disinflationary force. Greater output per unit of labor is the very definition of productivity. Just as globalization enhanced productivity decades ago, successful AI implementation would do the same. Lower labor costs, greater efficiency, and increased competition would naturally pressure prices downward. But suppose AI fails. Suppose trillions of dollars are invested with disappointing economic results. That would obviously be disastrous for investors directly exposed. It would almost certainly be recessionary. And recession is among the most powerful disinflationary forces imaginable. I don't say that because I hope for it. Quite the opposite.

Lacy concludes that, absent a sustained recession, a favorable supply-side shock, or prolonged monetary restraint, structural inflation and Treasury yields are likely to trend higher. The recession scenario would obviously be undesirable, yet it would also be disinflationary. The favorable supply-side shock, however, remains very much on the table. I continue to believe AI productivity could become precisely that. As for prolonged monetary restraint, I suspect very few people expect policymakers to suddenly become disciplined enough to pursue that path for any meaningful length of time. My point is simply this: AI presents two very different possible futures. One is extraordinarily positive through productivity gains. The other is recessionary through investment disappointment. Yet both outcomes ultimately lean toward disinflation, albeit through dramatically different mechanisms.

My summary is straightforward. The structural dynamic of the U.S. economy remains excessive government debt and spending. That dynamic has depressed both nominal and real economic growth for well over twenty years, and I do not believe that has changed. The AI story introduces a potentially significant new variable. If successful, it becomes a powerful productivity-enhancing, disinflationary force. If unsuccessful, it likely becomes recessionary—and therefore disinflationary in a much less desirable way. Either way, I believe the longer-term implications continue to lean more toward disinflation than sustained structural inflation.

Thank you for listening to David Bahnsen's Dividend Cafe. Thank you for watching, reading, and listening. I look forward to seeing you again on Monday in the Dividend Cafe, where we'll do our normal trip around the horn. Have a wonderful weekend. Reach out with any questions.