

1st Quarter 2009

## INFLATION / DEFLATION

My two favorite managers / economists are Van Hoisington and Lacy Hunt, Ph.D. of Hoisington Investment Management of Austin, Texas (a fund manager) and David Rosenberg, departing economist at Bank of America / Merrill Lynch. They are my favorite because they have been right for a long time and they express their rationale for their opinions very well. I will paraphrase their latest opinion in this report.

Both continue to believe that we are in a severe recession / depression that isn't going to end any time soon. As of this writing the stock market has experienced a six week rally that some think is a sign that the worst is over. Rosenberg believes that this is a "speculative bear market rally" that will not last.

### INFLATION / DEFLATION—HOISINGTON

Over the next decade, the critical element in any investment portfolio will be the correct call regarding inflation or deflation. The overwhelming consensus view is that sooner or later inflation will return. This inflationist view of the world seems to rely on two general propositions. First, the unprecedented increases in the Fed's balance sheet. The Fed has to print money to restore health to the economy, but ultimately this process will result in a substantially higher general price level. Second, an unparalleled surge in federal spending and massive deficits will stimulate economic activity. This will serve to reinforce the reflationary effects of the Fed and lead to inflation.

These propositions are intuitively attractive but do not stand the test of history or economic theory. Betting on inflation as a portfolio strategy will be as bad a bet in the next decade

as it has been for the disinflationary period of the past twenty years when Treasury bonds produced higher returns than common stocks.

If inflation and interest rates were to rise in this recession, or in the early stages of a recovery, the expansion would be cut short and the economy would either remain in, or relapse into recession. In late stages of economic downturns, substantial amounts of unutilized labor and other resources exist. Thus, both factory utilization and unemployment rates lag other economic indicators. For instance, reflecting this severe recession, unused labor and other productive resources have increased sharply. The yearly percentage decline in household employment is the largest since the current data series began in 1949. In March the unemployment rate stood at 8.5%, up from a cyclical low of 4.4%. This is the highest level since the early 1980s. The labor department's broader U6 unemployment rate includes those less active in the labor markets and working part time because full time work is not available. The U6 rate of 15.6% in March was the highest in the 15 year history of the series and up from its cyclical low of 7.9%. The operating rate for all industries and manufacturing both fell to their lowest levels on record in March. Manufacturing capacity was around 15% below the sixty year average.

Given these conditions, let's assume for the moment that inflation rises immediately. With unemployment widespread, wages would seriously lag inflation. Thus, real household income would decline and truncate any potential gain in consumer spending.

In the past year, the Fed's balance sheet, as measured by the monetary base, has nearly doubled from \$826 billion last March to \$1.6 trillion, and potentially larger increases are

indicated for the future. The increases already posted are far above the range of historical experience. Many observers believe that this is the equivalent to printing money, and that it is only a matter of time until significant inflation erupts.

These gigantic increases in the monetary base (or the Fed's balance sheet) and M2, however, have not led to the creation of fresh credit or economic growth. Not surprisingly, from December to March, bank loans fell 5.4% annualized. Bank credit plus commercial paper posted a record decline. The bottom line, however, is that it is totally incorrect to assume that the massive expansion in reserves created by the Fed is inflationary. Economic activity cannot move forward unless credit expansion follows reserve expansion. That is not happening. Too much and poorly financed debt has rendered monetary policy ineffective.

The highly ingenious monetary policy devices developed by the Bernanke Fed may prevent the calamitous events associated with the debt deflation of the Great Depression, but they do not restore the economy to health quickly or easily. The problem for the Fed is that it does not control velocity or the money created outside the banking system.

Based on the calculations of the Congressional Budget Office, U.S. Government Debt will jump to almost 72% of GDP in just four fiscal years. As such, this debt ratio would advance to the highest level since 1950. The conventional wisdom is that this will restore prosperity and higher inflation will return. Contrarily, the historical record indicates that massive increases in government debt will weaken the private economy, thereby hindering rather than speeding an economic recovery. This does not mean that a recovery will not occur, but time rather than government

action will be the curative factor.

By weakening the private economy, government borrowing is not an inflationary threat. Much light on this matter can be shed by examining Japan from 1988 to 2008 and the U.S. from 1929 to 1941. In the case of Japan, government debt to GDP ratio surged from 50% to almost 170%. So, if large increases in government debt were the key to economic prosperity, Japan would be in the greatest boom of all time. Instead, their economy is in shambles.

This recent Japanese experience mirrors U.S. history from 1929 to 1941 when the ratio of U.S. government debt to GDP almost tripled from 16% to near 50%. As the U.S. debt ratio rose, long Treasury yields moved lower, indicating that the private sector was hurt, not helped, by the government's efforts. The yearly low in long Treasury yields occurred at 1.95% in 1941, the last year before full WWII mobilization. In 1941, the S&P 500, despite some massive rallies in the 1930s, was 62% lower than in 1929, and had been falling since 1936. Thus, two distinct periods separated by country and considerable time indicate that stock prices respond unfavorably to massive government deficit spending and bond yields decline.

Since the 1870s, three extended deflations have occurred—two in the U.S. from 1874 to 1894 and from 1928 to 1941, and one in Japan from 1988 to 2008. All of these deflations occurred in the aftermath of an extended period of “extreme over indebtedness,” a term originally used by Irving Fisher in his famous 1933 article, “The Debt-Deflation Theory of Great Depressions.” Fisher argued that debt deflation controlled all, or nearly all, other economic variables.

Therefore on a historical basis, U.S. Treasury bonds should maintain its position as the premier asset class as the U.S. economy struggles with declining asset prices, over indebtedness, declining income flows and slow growth.

core crude and intermediate price pipeline is probably a sign of what is still coming down the road in terms of final goods prices.

## INFLATION / DEFLATION—ROSENBERG

### 1) **Deflation risks have actually intensified:**

The market is beginning to price in reflation across a fairly broad front. This is most evident in the 120 basis point run-up in 10-year TIPS breakeven levels since the start of the year. This is rather amazing since even with 'green shoots' emerging as the new macro mantra, from our vantage point, deflation risks have actually intensified of late.

2) **Pricing power is fading across a very broad front:** This is not just a case of energy prices still sliding from their lofty year-ago levels. Looking at the CPI data sequentially and by sector, it is increasingly obvious that pricing power is fading across a very broad front. Appliance prices fell 0.3% month-over-month in March, apparel prices also dropped 0.3%, hotel rates sagged 2.4% and are down six months in a row, airline fares also slipped 2.3% and have now deflated seven months in a row, and home improvement materials fell 0.3%. In addition, autos, communication services, restaurants and recreation were all basically flat.

3) **More deflation coming down the road:** Producer prices in March sank 1.2% sequentially and a record -3.5% year-over-year. This time last year, the YoY rate was +6.7%, for a compression of over 1,000 basis points. The sustained deflation in the

### 4) **Home prices declining at an accelerating rate:**

Case-Shiller home prices are actually declining at an accelerating rate and are down a record 19% year-over-year. The pace of decline is accelerating with the three-month trend running at a -26.5% annual rate.

### 5) **Real estate values of all types deflating at a record rate:**

Real estate values of all types are now deflating at a record rate: -11.5% YoY for apartment buildings, -3.3% for industrial properties, -6.1% for office buildings, and -2% for retail complexes.

6) **Record amount of spare capacity:** The capacity utilization rate in manufacturing has declined to an all-time low of 65.8% from 66.9% in February and 77.7% a year ago. Only one other time in recorded history has the CAPU rate fallen so far so fast.

7) **Slack in the labor market at a lifetime high:** The broadest measure of resource slack in the labor market is the U-6 unemployment rate and it rose to a lifetime high in March as well to 15.6% from 14.8% in February and 9.1% a year ago. Never before has the jobless rate risen so fast.

8) **Bank credit has contracted for three straight months:** Bank credit contracted at a 2.9% annual rate in March and has declined now for three months in a row. Data into early April point to a fourth monthly decline, which would be unprecedented.

9) **Record decline in household incomes:** Nominal personal incomes less government transfers deflated 0.5% in March and have now fallen for six months in a row. Since last August, the personal sector has lost \$234 billion of organic income (wages/salaries, rent, interest, dividends, and proprietary). Take it from us that such a decline in household incomes has never happened before.

10) **Household net worth has contracted \$20 trillion:** Household net worth has contracted \$20 trillion or by 30% since the third quarter of 2007. The lags on consumer spending and the savings rate can last as long as three years.

**We fail to see how stimulus will offset private contraction:** Since the credit collapse began in late 2007, the Fed's actions have expanded the money supply by \$1 trillion. We also have around \$800 billion of federal fiscal relief, though at least one-third of that is being offset by restraint at the state and local government level. We still fail to see how all of this "stimulus" is offsetting the combination of declining bank credit, declining organic incomes and declining personal wealth.

**We remain on the sidelines:** We have remained on the sidelines during this speculative bear market rally and continue to advocate a cautious income-oriented investment posture that includes buying Treasuries on their periodic dips. Nothing we see today resembles 1975, 1982, 1990 or 2003 when bear

markets ended on the cusp of durable expansion in economic activity and corporate earnings. All we have learned from the last month is to cover shorts when new lows are achieved and that nothing moves in a straight line. As painful as it has been over the short-term, we are still not believers in the sustainability of this rally and as such remain on the sidelines.

## CONCLUSION

The bottom line is that the government is printing money and putting it into the economy hoping to turn the economy around. These smart men do not believe it will work and history is on their side. We will not see inflation for some time because the velocity of money will not pick up and the government debt is pushing private debt out of the way. Expansion of the economy is provided by the private sector, not government.

There have been three periods in the U.S. when bonds outperformed stocks. The first was from 1803-1871 (68 years); the second was from 1929-1949 (20 years) and the third was 1968-2009 (41 years). There are times to be invested heavily in bonds and this is one of them. Hoisington and Rosenberg believe that bonds provide the best chance for positive returns in 2009. That's why we continue to recommend a tactical asset allocation of 20% stocks and 80% bonds.

Jamison Monroe, CIMA  
Chairman & CEO  
Director of Corporate Values