

"We Are For 'flation"

Herb Stein was Chairman of President Nixon's Council of Economic Advisors between 1972 and 1974. It was a depressing time with inflation rising and an attendant ascent in interest rates. Given his position, Dr. Stein was at the center of the economic maelstrom and consequently had to repeatedly respond to the inflation questions from a persistent press. After months of such questioning, a frustrated Herb Stein, when asked by a reporter to explain why inflation was getting so high, put on a straight face and said, "If you take out all the things in the Consumer Price Index that have gone up, the index would actually go down." At another press conference, when he got irked with relentless questions on the same topic, Herb announced, "The Nixon Administration is against inflation, and it is against deflation, we are for 'flation."

I recalled Herb Stein's *bon mots* while attending John Mauldin's conference over the weekend where the topic *du jour* was deflation. Indeed, the preponderance of speakers believe that the bursting of the generational "debt cycle" has to be followed by a deflationary spiral. In fact, other than myself, there was only one other speaker who thinks the seeds of inflation have been planted. The first such deflationist-speaker was Dr. Lacy Hunt.

Dr. Hunt began by stating that the current conventional beliefs are: monetary/fiscal policy is wildly stimulative and therefore inflationary; our debt problems are behind us; and the current account deficit is going to explode with a concurrent dollar dive combined with higher interest rates. Lacy went on to suggest that all of those beliefs are false. Certainly the Federal Reserve has been expanding its balance sheet, but the velocity of money (the frequency with which a unit of money is spent in a particular period of time) has been cut in half. Consequently, M2 money supply is growing at its slowest rate in decades, which is not sufficient to promote sustained GDP growth (according to Lacy Hunt). Speaking to fiscal policy, Lacy stated that the government spending multiplier is less than 1 and the tax multiplier is actually negative. This means if taxes go up by \$1 it takes more than dollar's worth of spending out of the economy. Lacy concluded that if over indebtedness is the problem, how can taking on more debt be the cure? He believes the risk premiums are, and have been, insufficient to buy stocks and therefore bonds are his preferred investment.

Refuting Dr. Hunt was Paulson & Company's Claudio Macchetto, who is bullish on stocks, thinking we are in a sustained economic recovery that might even be V-shaped. While he put the odds of a double-dip recession at only 5%, he did suggest that sovereign debt defaults are a real risk. He continued by noting the government is "printing" its way out of the problem (money creation). He thinks this will foster an inflationary environment accompanied by an increase in the velocity of money. One interesting point Claudio made was that last quarter banks loosened their lending standards for the first time in 10 quarters.

Next was the always entertaining, and brilliant, David Rosenberg, who began talking about heightened volatility. Still, over the longer-term, David thinks the equity markets are not going anywhere. His reasoning is that because everything is priced off of nominal GDP, stocks will go nowhere since GDP growth is going to be very low. To be sure, we have an economic recovery largely due to the government's stimulus packages; however, it is temporary and the weakest ever (according to David). Like me, he thinks there is an asset "mix shift" toward income by the retiring baby boomers. He recommended protecting portfolios from his envisioned deflationary outcome by making certain portfolios throw off "income." Rosie concluded by stating, "The day of reckoning is coming."

Like most of the speakers, Dr. Gary Shilling thinks deflation is the correct "call." While his case rests on many "footings," his major tenant is that the nation's 25-year borrowing and spending binge is over as the retiring boomers focus on income. Gary stated that every half of a percent rise in the savings rate takes 1% away from GDP growth. Accordingly, he thinks we are in for a low growth environment combined with a whiff of deflation. For such an environment he likes investing in treasury bonds, consumer staples and food, small luxuries, the U.S. dollar, investment advisors and financial planners, factory built housing and retail apartments, healthcare, productivity enhancers, and North American energy companies.

Plainly, the debate of the conference was deflation versus inflation with most participants coming down on the side of deflation. Yet as an investor, how do you position your portfolio to benefit from either outcome? That question was answered by John Mauldin's partner Jon Sundt (CEO of Altegris). He began by talking about his surfing trips to Indonesia, where the trick is to bring the right surfboards for conditions. Typically Jon brings a big wave board and a small wave board. However, with them he always takes three

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“all weather” boards. Expanding on that analogy, he proceeded to discuss why historically equal amounts of money placed into three select “investment buckets” has had the best record of successfully navigating all market environments. Those “buckets” are a long/short equity sleeve, a global macro sleeve, and a managed futures sleeve. Jon suggested that an equal dollar investment in each of these vehicles should position portfolios for the best risk-adjusted performance under either outcome (inflation or deflation), and I agree.

While he wasn’t one of the economic or stock market speakers, George Friedman (CEO of STRATFOR) gave a geopolitical presentation that “rocked!” He noted that our government’s central thesis, until 1991, was to prevent a single power from dominating Eurasia. With the “fall” of the Berlin Wall that Russian-centric policy changed as we fought a number of mini-wars until September 11, 2001. Following 9/11, the new policy has been to prevent any more terrorist attacks. George stated that this new central policy was/is unattainable and has focused all of our resources into one region. That, in turn, gave Vladimir Putin the opportunity to flex Russia’s muscles in the “Georgias” of the region. He went on to opine that our government made the strategic mistake of thinking the Iraqi invasion would bring about an America-friendly Iraqi government. Now we face the disturbing question – “should I stay or should I go?!”

If the U.S. doesn’t leave, we won’t have the resources necessary to contain the “Russia” of the world. The quid pro quo is that if we leave Iraq, the Saudi oil fields become vulnerable. Indeed, ex-U.S., there is nobody in the region capable of “balancing” Iran. Meanwhile, Iran is conducting military exercises in the Strait of Hormuz, demonstrating its ability to close those straits if Iran is bombed. George surmised that if you can’t stay, leave, or bomb, you cut a deal. He concluded by suggesting negotiations are currently ongoing. If those negotiations are successful, tensions could ease. If they break down, “things” could get real ugly real fast.

As for me, I think we have already seen much of the deflationary fallout, although I must admit some things are indeed deflating while others are inflating (read: The New Abnormal). Nevertheless, I think the “seeds” for inflation have been planted. When that inflation shows up, and how strong it will be, is anyone’s guess; but for centuries anytime you created excess money, and piled on debt, the outcome has been inflation. Moreover, the spread between Fed Funds and GDP has been this wide only a few times; on every occasion inflation has followed. Accordingly, I am betting on ‘flation.

The call for this week: Much of the no growth/low growth deflationists’ argument rests on a sated consumer who is not spending, but rather saving. I think we have already seen the spending cutback because one should never underestimate the ability of U.S. consumers to spend money even if they don’t have it! Moreover, U.S. consumers are currently saving about a half trillion dollars a year. At that rate they can match income and spending. And as Milton Ezrati observes, “If incomes rise by 1 – 2% consumers can raise spending by 1 – 2% and continue to pay down debt by \$500 billion a year. This amounts to about 4% of outstanding liabilities, so what consumers are doing is adjusting their balance sheets by 4% a year. That’s not great, but it’s not bad either.” As for inflation, ISI’s temporary employment company survey of wage pressure has increased from 24.2 to 32.4, apartment rents are rising, import prices are up nearly 6% (annualized return), commodity prices have surged an eye-popping ~77% from their lows (MSCI), steel prices are scheduled to increase by a third, my son’s university tuition is going up, inflation is accelerating sharply in the emerging markets, and the list goes on. Speaking to the stock market, again I have been too soon’ly cautious, which is tantamount to being wrong. That said, investment accounts should still be pretty fully engaged, while my best idea for trading accounts is to bet on a pick-up in volatility.

P.S. – This week I am at the RJFS National Conference in Nashville, so these will be only comments of the week.

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