MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

The Great Debate

If the disastrous BP oil spill wasn't enough bad news, concerns surrounding worldwide fiscal imbalances dominated financial headlines for the last three months. Austerity measures are underway in the UK, Ireland, Germany, France, Italy, Spain and, of course, Greece, and are (understandably) being met with howls of protest from the affected populations. These tax hikes and spending cuts are also under fire from Keynesian economists and US Treasury Secretary Tim Geithner, who argue that governments would be making a terrible mistake to start cutting back when the global economic recovery is so fragile and uneven.

We believe that these policy debates ultimately come down to a disagreement over the likely result of our current fiscal distress: deflation or inflation?

Inflation certainly does not appear to be a concern in the near term, with substantial slack in both labor and product markets likely to keep a lid on prices. On the other hand, only a sharp retrenchment in emerging markets (especially China), accompanied by a big drop in commodity prices, is likely to lead to meaningful outright deflation for any *extended* period of time, and that is not our forecast.

But the mere possibility of deflation at a time of high and rising debt levels is simply unacceptable – debt service becomes impossible when government revenues and private incomes are falling, resulting in a ruinous, self-reinforcing downward spiral. This is well understood by Federal Reserve Chairman Ben Bernanke, an apt student of Depression-era policymaking. Dr. Bernanke famously told the National Economists Club that the Fed could always fight deflation by "dropping money from helicopters" if necessary[1]. Of course, his preferred outcome is to fight incipient deflation by preventing any deflationary expectations from taking hold in the first place, and reminding market participants of the Fed's unlimited ability to create money is vital to that process. In short, the Fed's boundless access to the monetary "printing press", and its willingness to use it, make it unlikely that any prolonged deflationary event will actually occur. An unprecedented doubling of the Monetary Base and tenfold increase in Bank Reserves from 2007 to 2009 is evidence enough that the Fed will act. Inflation is ultimately the result of excess monetary creation, although not enough money has yet flowed into private hands. Still, *fear of deflation now is laying the groundwork for actual inflation later.*

In our April edition of *Consilium*, we commented that "a significant curtailment of the growth in federal spending, especially entitlements, is the only solution with a fair chance of long-term success." While true, that does not mean it will be the solution our policymakers settle upon. We have reached a unique moment in US economic history when Congress' desire to rein in exploding debt and deficits painlessly is aligned with the Fed's desire to avoid deflation at all costs, and the policy solution is to create inflation. As unattractive as that may sound, it probably will work, and has worked for countries facing debt crises throughout history. Currency devaluation technically avoids default and unpopular belt-tightening, and merely asks debt holders to accept repayment with cheaper money. Put another way, which will our policymakers more likely "stiff": our foreign creditors, or domestic voters? Appreciating the nature of our political economy, the answer seems obvious.

[1] http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021121/default.htm

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We would like to reiterate that inflation is not an issue for investors now, nor perhaps even for several years, and therefore no drastic action is required at this time.

But some important adjustments eventually will be called for, and investors should be aware of what they might include:

- Maintaining short-duration bond portfolios
- Significantly reducing or eliminating government bond holdings, and emphasizing the highest quality corporate bonds, including floating rate notes
- Emphasizing common stock investments in companies with built-in hedges against inflation, such as distributors that routinely pass along cost increases or commodity/raw materials companies

A popular vehicle for speculating on an eventual return of inflation is gold. Gold has enjoyed occasional surges in popularity when paper currency is seen as being less attractive. While understandable, we do not endorse adding gold to client portfolios as gold has no intrinsic, measurable value, producing no cash flows for its owners in the manner of a corporation or a bond. In this respect it is no different than fine art or collectables, two other asset classes that we would likewise exclude from consideration for investment. We are not predicting that gold prices will not rise; we are merely indicating that we find it impossible to establish investment parameters for gold that we would routinely apply to other assets in a client's portfolio.

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The second quarter is ended on a sour note, with the S&P 500 equity index down 11.4%, bringing the year-to-date total return to -6.7%. Since April, the equity market has been "held hostage" by exogenous events, particularly the BP disaster, developments in Europe, and financial regulatory reform efforts on Capitol Hill. Stocks are largely ignoring clearly improving corporate performance, and valuations are once again attractive. Fears of a so-called "double dip" in the economy are almost certainly misplaced – there is very little historic precedent for such an occurrence. Although the market may remain unsettled and volatile as we approach the mid-term elections, we still believe the broad stock market indices will end the year roughly where they began, and hopefully poised for better performance in 2011.

Sources: Baseline
Federal Reserve System

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