Essential Investment Partners

Inflation vs. Deflation

The Most Important Investment Decision You Can Make in the Next Five Years

Introduction

The recession of 2007-2009 is among the worst of this century. While another Great Depression seems safely out of view, likely in no small part due to timely and massive actions by the Federal Reserve, the Treasury Department and Congress, the effects of this recession will be felt for many years to come.

One debate currently raging is whether the policy actions initiated to fight the current recession and the credit crisis of 2008 will ultimately give rise to massive inflation. Some investors are already positioning themselves for what they believe is the inevitable resurgence of inflation. Others believe that deflation will be the real legacy of this recession, as massive deleveraging sets off a deflationary spiral similar to that which Japan has been mired in for nearly two decades.

Getting this analysis correct is extraordinarily important because of the grave implications for virtually all financial decisions. If you are in the inflation camp, you will want to own hard assets such as precious metals, commodities and real estate and you will avoid bonds. And if you are a borrower, you will want to borrow at current fixed rates with the longest maturity possible. If you are a deflation believer, you will do the exact opposite. You'll want to own long term bonds and cash equivalents and avoid hard assets and stocks. And, you will want to limit borrowing as much as possible as paying back future dollars will be more expensive than paying off debt today.

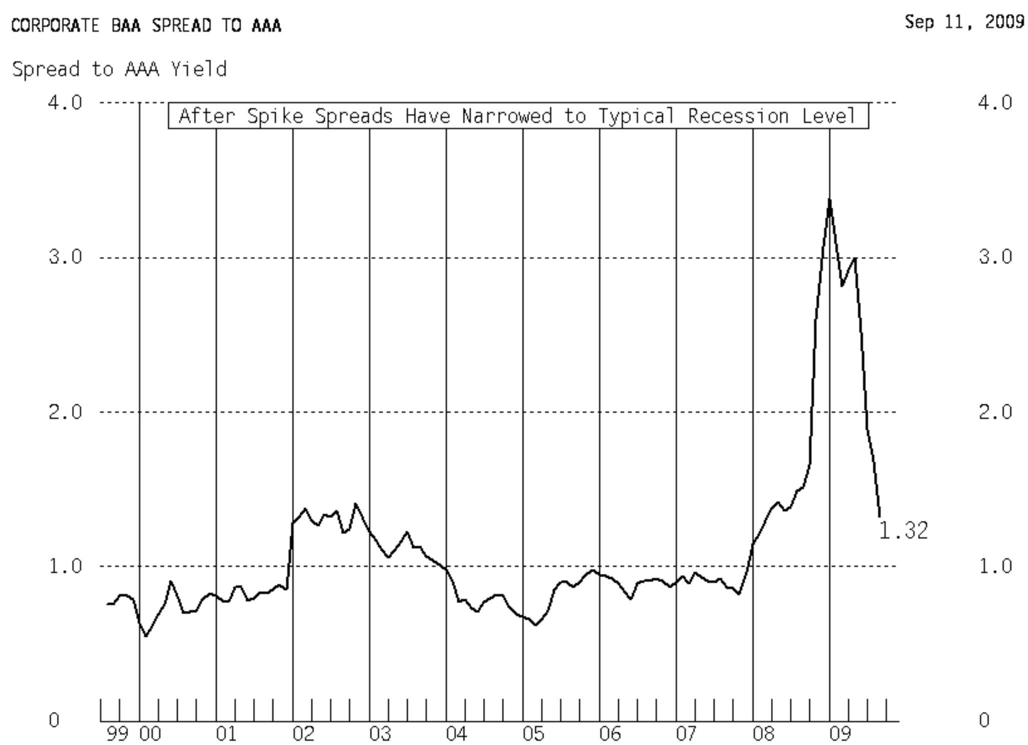
So let's examine the cases for inflation and deflation and outline our current thinking on this great debate.

The Inflation Case

The Federal Reserve has put in place a massive amount of monetary stimulus over the last year. The stimulus has taken many forms. They have reduced short term interest rates to near zero and plan to keep them there for "an extended period of time." The Fed also announced plans to purchase up to $300 billion of U.S. Treasury securities and up to $1.2 trillion of mortgage backed securities. The Fed has carried through on this plan, allowing rates on these securities to fall, and in the case of mortgage-backed securities, supporting mortgage issuance at lower rates.

The Fed has also put in place other off-balance-sheet programs aimed at returning the credit markets to business-as-usual. These programs include a commercial paper back-up facility, guarantees of money market fund balances, the Public Private Investment Partnership that allows private entities to make leveraged purchases of "toxic" assets and guarantees of bank debt (by the FDIC). In addition, the Fed has guaranteed all or a portion of the assets associated with the takeovers of Fannie Mae, Freddie Mac, Bear Stearns and AIG.

As a result of all of these efforts, the credit markets have rallied strongly and all but the shakiest of issuers have been able to access the debt markets. In addition, as you might expect, the money supply has grown very quickly.



Supplementing this large monetary stimulus has been a large fiscal stimulus. In addition to the large deficit the federal government was already running before mid 2008, we have added the TARP program ($700 billion) that was mostly used to recapitalize banks and the American Recovery and Reinvestment Act ($800 billion) that contained a panoply of spending provisions designed to expand economic activity or avoid reductions by state and local governments.

The federal government is on target to rack up a $1.6 trillion deficit in 2009 – a post WWII record of 11.2% of GDP. On the current spending path, deficits will total more than $7 trillion over the next ten years and may reach more than $9 trillion if health care coverage is expanded, according to the Congressional Budget Office. Given that we don't know the form of health care coverage expansion or how much the economy will grow over this period, these estimates have a very large margin of error. We do know that the deficits are very large and may even grow, depending on the course of government spending.

More importantly, inflation bulls say that because these programs will not be sufficient to offset deflationary pressures, government will expand the programs even more over the next couple of years in an effort to fight deflation. This means:

- Even larger federal deficits, perhaps growing to a multiple of GDP
- Quantitative easing (printing money to buy debt) by the Fed
- More stimulus programs

By the time government tips the scales toward inflation with all of these programs, it will have debased the U.S. dollar and it will be impossible to scale back the programs so as to avoid the inevitable cascade of inflation. If the dollar loses its reserve currency status and is dramatically devalued, commodity prices will also skyrocket, adding further fuel to the inflation fire.

The Deflation Case

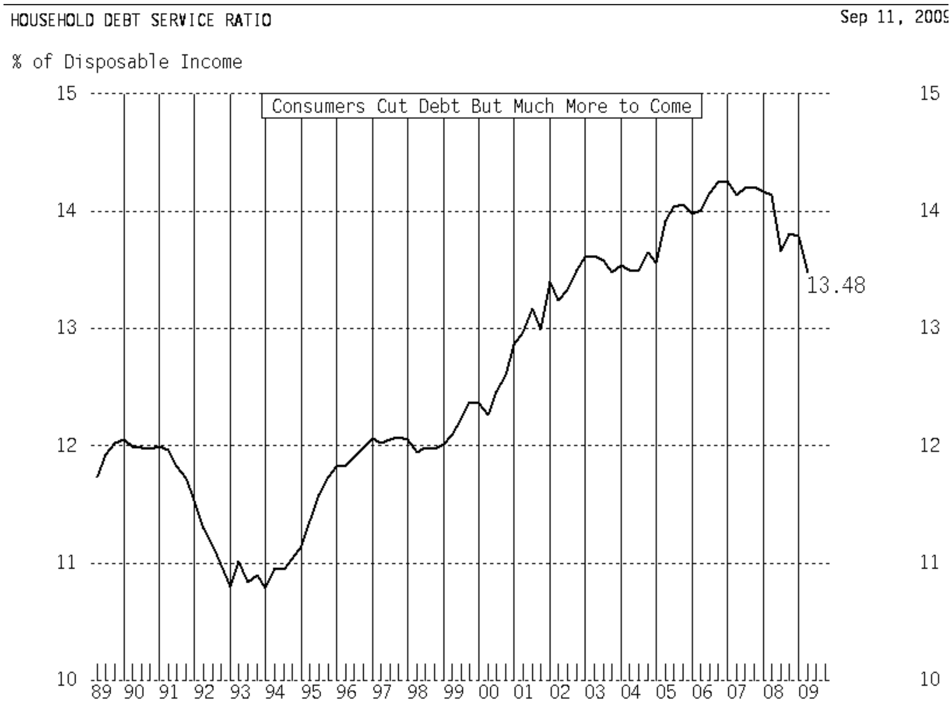
Much of the growth over the last ten years was fueled by increased leverage, particularly among consumers

- Consumers borrowed heavily against home equity to fund purchases of both durable and nondurable goods
- Consumers stretched to buy homes they couldn't afford, often with mortgage products that they should never have used (e.g., option ARMs)
- Continued rounds of incentives by auto makers led consumers to gorge on new cars and trucks

As a result, the consumer spending portion of the economy grew to an all time high of nearly 71%, nearly 5 percentage points above the long term average. Homeownership rates also grew to historic highs. Similarly, cars/light trucks per household also grew to the highest level on record. Not surprisingly, the savings rate fell to zero.

When the music stopped in the fall of 2008, consumers found themselves over-levered, over-housed and over-stuffed. Over the last several months, consumer debt outstanding has dropped significantly, as consumers look to pay down their most expensive debt first.

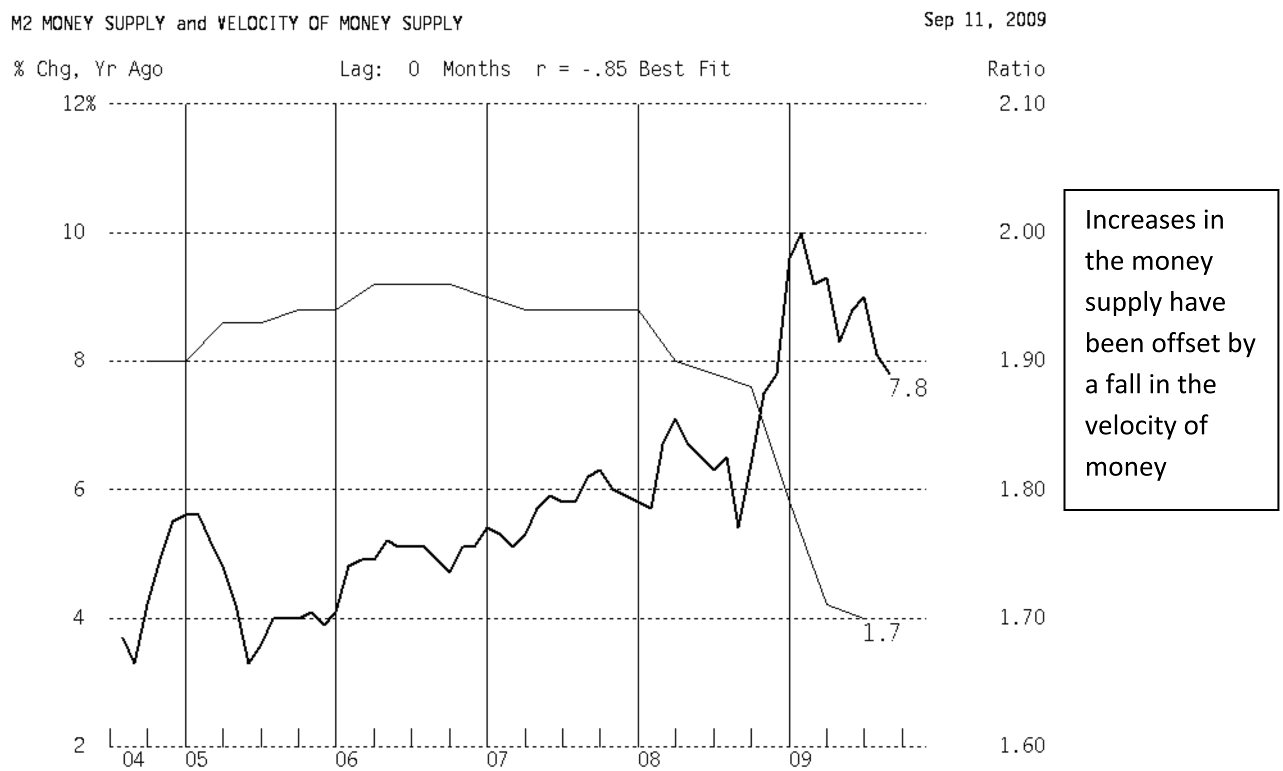
While the first two waves of housing defaults (subprime and alt A) are largely behind us, we are now experiencing the more typical types of defaults caused by high unemployment. This will continue to pressure housing prices, particularly in the middle and upper end homes, as it will take some time for these foreclosures to clear the market. The sheer volume of foreclosures, particularly in the context of a non-existent new home market, serves to reduce mortgage debt outstanding as well.



After piling on debt for 13 years, consumers have much to repay to get their debt load down to normal levels

Some of this deleveraging has also been forced by the banks who found themselves with too many loans on their books. Most banks have shied away from lending the capital they raised from the government or privately because they are being forced by regulators to write off loans sooner and to decrease the leverage on their balance sheets. Similarly, the shadow banking system (investment banks/brokers originating and reselling all types of financial instruments that supported additional lending) has all but disappeared as the investment banks have converted to traditional banks and are also having to dramatically reduce their leverage.

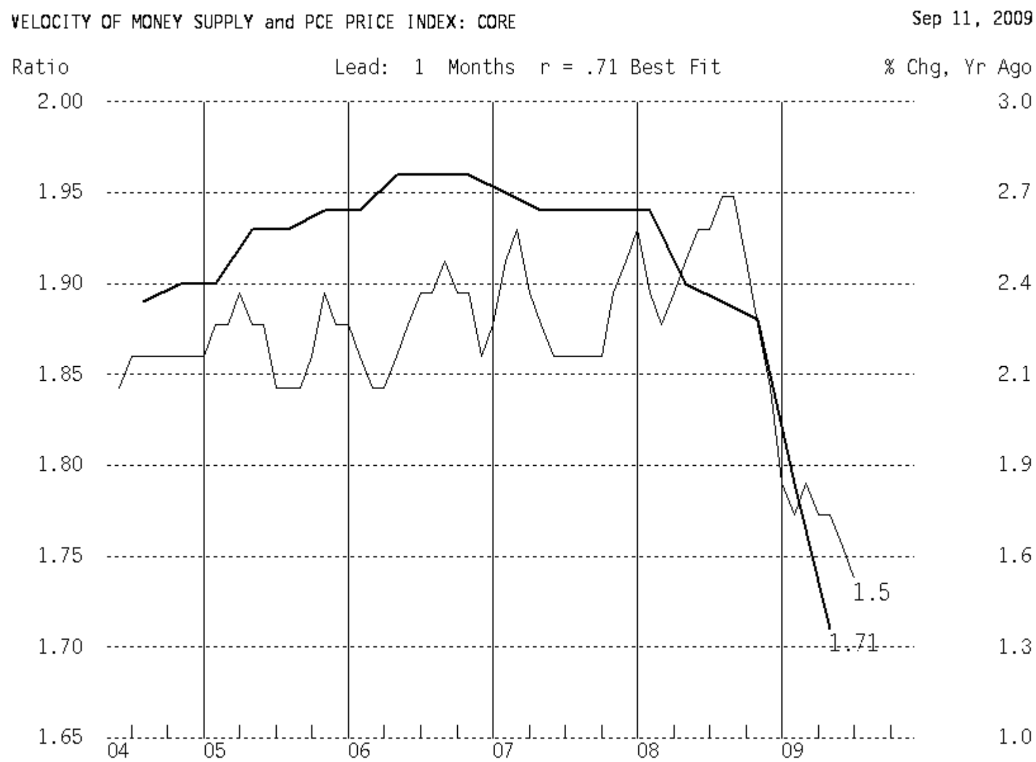
While this recapitalization and deleveraging of the banking system is an important element of reducing the risk of the collapse of our financial system, it has also had the effect of offsetting the great monetary stimulus that the Fed has provided. Why? Because even as the money supply has grown, the velocity of money (the speed at which it is re-transmitted through the economy) has fallen, effectively neutering the impact of the stimulus. Velocity has fallen largely because the lending processes that are so critical to the retransmission have been dramatically curtailed by banks and the shadow banks are not there to contribute.



So, this leaves consumers with little choice but to rebuild their balance sheets by saving more and cutting their debt. Absent huge incentives (e.g., cash for clunkers), consumers are deferring large purchases and cutting back on discretionary spending of all types. Businesses have responded by dramatically cutting back on inventory and reducing expenses by cutting jobs. But businesses still have lots of unused capacity so periodic spurts in demand leave them with little pricing power. Left unchecked, this process gives rise to a deflationary cycle as demand falls, prices fall and the return on saving (holding cash) goes up. This is the cycle that Japan has been trying to break for most of the last two decades, without real success. And this is the cycle that the Federal Reserve is trying to prevent from taking hold.

Our View

Over the next couple of years, the forces of deflation are likely to be much greater than the forces of inflation (absent some external, unanticipated shock to the system). Consumers must pay down a mountain of debt to get their balance sheets back to where they were ten years ago and they need to save what extra cash they do have to regain some of the net worth lost in their homes and stocks. And banks will continue to be reluctant to lend because they need to rebuild and de-leverage their balance sheets. The shadow banking system is gone and very unlikely to return in any fashion similar to its size in 2007. So we think that the velocity of money – a key indicator of future inflation – will stay depressed for a while.

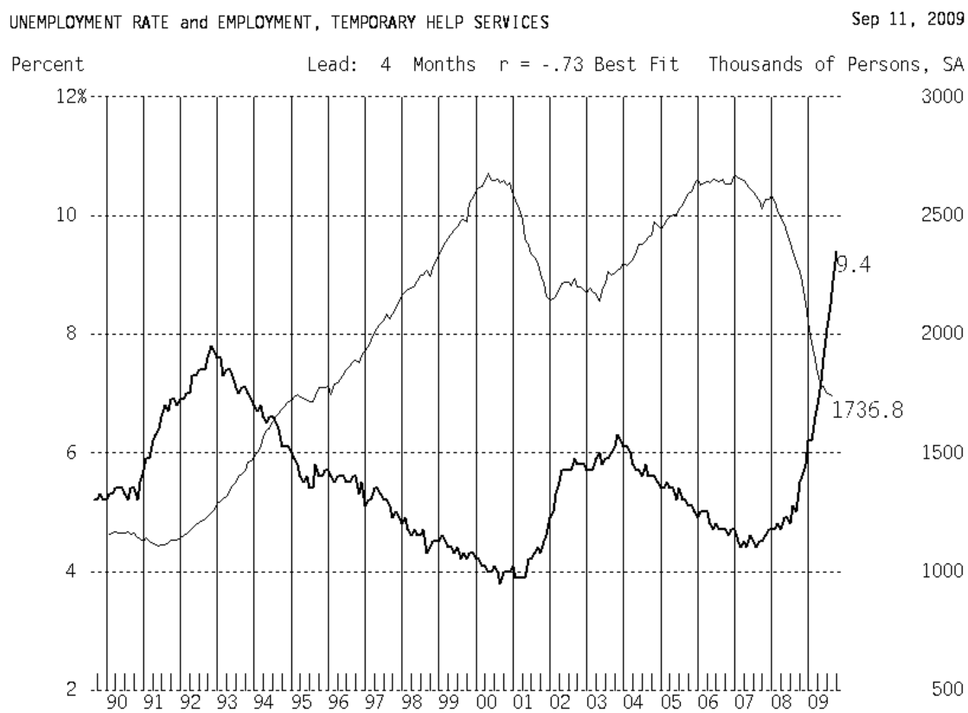


Increasing the velocity of money – by spurring bank lending – is critical to the return of inflation

Faced with tepid demand from consumers, companies will keep inventories lean and hiring to a minimum. As a result, unemployment will stay stubbornly high, further depressing consumer demand.

However, over the longer term, we also think it is unwise to bet against the Fed. It is facing a challenge the likes of which the modern Fed has never faced. However, Chairman Bernanke, a student of the Great Depression, understands the problem and is determined not to let a deflationary spiral take hold. Remember that our Fed has a two-fold mission: price stability and full employment. For virtually all of the post-WWII period, the Fed has been concerned with taming inflation and has not had to worry too much about employment as a rapidly growing economy provided a plentiful job market. Now it faces completely new challenges – deflation and stubbornly high unemployment. How it chooses to fight these challenges will be most interesting to watch because it will affect each and every one of us.

Our expectation is that the U.S. economy will have very slow growth for the next two or three years. Growth will be so slow that most will think that the recession never ended (even though it has likely "officially" ended as we write this). During this period, prices will fall, although the vagaries of how the government reports inflation will keep the numbers from being very large. Unemployment will stay very high so consumers will keep a tight hold on spending and will increase their savings significantly.

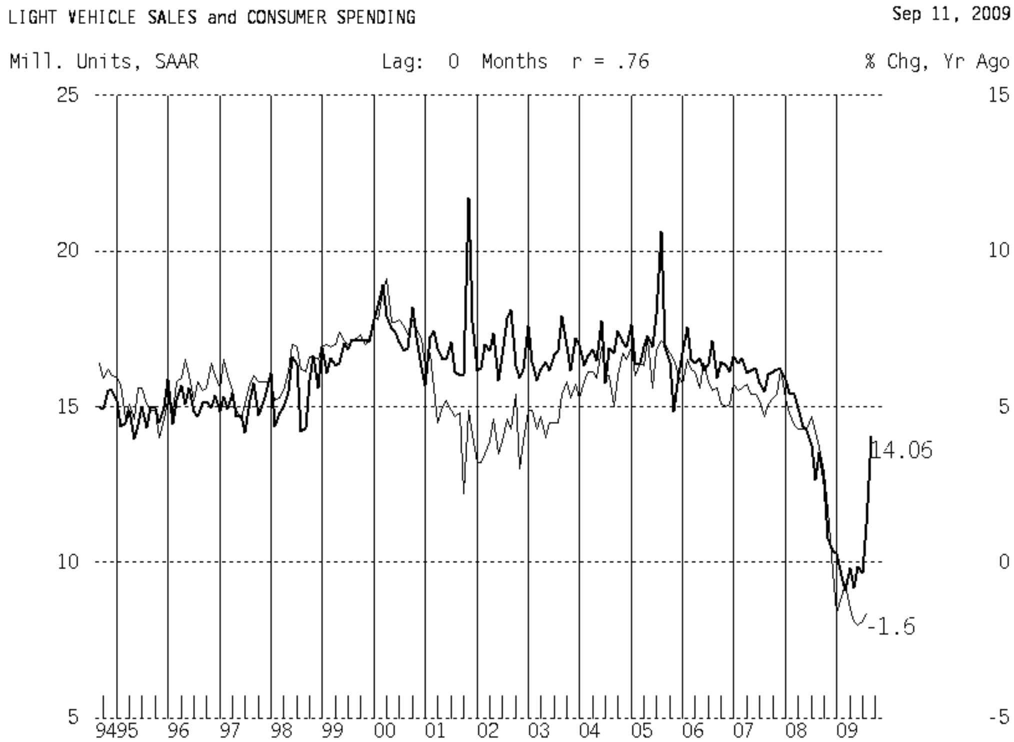


Temporary help increases lead the change in unemployment by several months – look for temporary numbers to improve before expecting employment picture to get better

Banks will very slowly begin to lend again, but only to those with the best credit and with the widest margins of safety. The big decline in housing prices is probably behind us but we don't expect much of a rebound, as widespread losses on housing discredit the view of housing as an investment.

Without getting into a political discussion, we think there is a significant risk that politicians will grow uneasy with the sluggish economy and high unemployment. There will be an urge to do more, sooner, through additional "stimulus packages." If these take the form of unproductive, "make work" projects, we believe they will be not only wasteful but will only prolong the problem, with each successive stimulus being less effective (again, see Japan for the last fifteen years). We are hopeful that we don't fall into this trap as the consequences could be dire. We take heart in Congress' general inability to get things done, particularly those of sufficient size to cause real harm to the economy.

We do expect that, given enough time to work, the Fed's policies will ultimately tip the scales toward growth and inflation. When this begins to happen, the Fed will have to execute a delicate balancing act as it will need to withdraw its stimulus plans in such a way that the recovery doesn't stall. We think the Fed will error on the side of over-stimulating the economy to ensure this doesn't happen because it believes it can more readily deal with inflation than deflation.



Cash for Clunkers provided a bump in car sales but overall consumer spending was hardly affected

The Treasury Inflation Protected Securities ("TIPS") markets are discounting the deflation now/inflation later scenario now. With the breakeven inflation rate on five year TIPS at about 1.4%, that works out to two years of 2% deflation followed by three years of 3.8% inflation.

Bottom line, we believe that it is very likely we will see deflation for the next two to three years while consumers and financial institutions are deleveraging. Once their financial health has been restored, it should actually set the stage for more positive, sustainable growth in the economy several years out. This will also allow inflation to become a more routine problem for the Fed to deal with. However, the path to more sustained growth over the next few years is likely to be slow and rocky.

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