Bull and Bear Bulletin

Return of Inflation

By: The Investment Committee

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With the countless dollars spent by our government with the intent of reviving the U.S. economy, there is a growing concern that inflation will become a significant issue in 2010. While expanding the money supply by over a trillion dollars certainly possesses the power to generate significant inflationary pressure, a majority of the economic data fails to indicate that inflation is an immediate issue. The unfortunate truth for our government is that tax dollars just do not spend like they use to.

Our government has historically relied on the economic school of thought that suggests higher government spending and lower interest rates fights recessions. The underlying principle of this strategy is that the government spending can help offset a portion of the lower consumer spending and that lower interest rates will ultimately encourage consumers to reduce their savings in favor of new spending and credit expansion.

While this tactic has successfully worked since the beginning of the twentieth century, the flaws in this theory appear to have been exposed. In the past twenty-four months, we have discovered that mounting indebtedness and dwindling savings can only be maintained for a finite period of time. After all, savings is what creates future economic growth.

When the government institutes an economic policy that encourages the cannibalism of future growth to help solve the current issues, the effectiveness declines compared to the previous recession and the government must incrementally increase the stimulus for each subsequent recession. As the government has now come to realize, the compounding of debt was the primary variable that allowed this policy to previously be successful.

In addition to the tsunami of debt that our society is now coming to grips with, we have started to see the consequences of this failing policy in the diminishment in the velocity of money or the rate at which money is transferred from person-to-person (Chart 1). It has become clear that, despite the expansion in the money supply, the expected benefit to the economy has continued to diminish over the past thirty years. As it relates to inflation, the velocity of money is a reflection of the level of consumer demand in our economy. As long as consumers maintain their preference for savings over debt and the banks maintain high lending standards, it is highly probable that the velocity of money will remain low and inflationary pressures will remain well contained.

As the consumer response to the increase in the money supply and lower interest rates has meaningfully declined, we are simultaneously experiencing the same diminishing return on government spending. The declining benefit of government spending should not be a surprise. With consumer spending accounting for over two-thirds of our $13 trillion economy, it is unlikely that government spending can offset any prolong decline in consumer spending.

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In addition to the waning benefit of government policy, it is also worth noting that the percentage of manufacturing capacity in the U.S. remains significantly under utilized following the recent recession (Chart 2). The historic low level of capacity utilization, coupled with an increase in the productivity of workers – as measured by output per hour – will only provide additional headwinds to any potential inflationary pressures created from the expansion of the money supply and low interest rates.

While the government ultimately acts in what it deems to be the best interest of our country, its focus is often short-sighted lacking in lateral vision. The Federal Reserve has probably come to realize that its standard approach to fighting recessions was built on flawed assumptions. It is not possible to promote credit expansion and a continual accumulation of consumer debt, all at the expense of personal savings for an infinite period of time. Eventually, the bubble that was consumer credit had to burst.

As consumers and banks continue to repair their respective balance sheets, it is unlikely that we will see a rapid expansion of the fractional banking system that has historically allowed the U.S. economy to respond positively to the government's monetary and fiscal stimulus strategy. Because of the diminished policy response and the variables indicated above, we expect inflation to remain well contained for the foreseeable future. With inflation likely contained and economic growth expected to be tepid for the next few months, we do not expect the Federal Reserve to meaningfully raise interest rates until at least the second half of 2010.

As inflation and interest rates relate to our asset allocation strategy, we will begin to reduce our concentration in fixed income when the economic data implies the need for higher interest rates and less government spending. In the meantime, we continue to favor the risk/reward relationship of short-maturity fixed income over the broad equity markets.

Chart 1

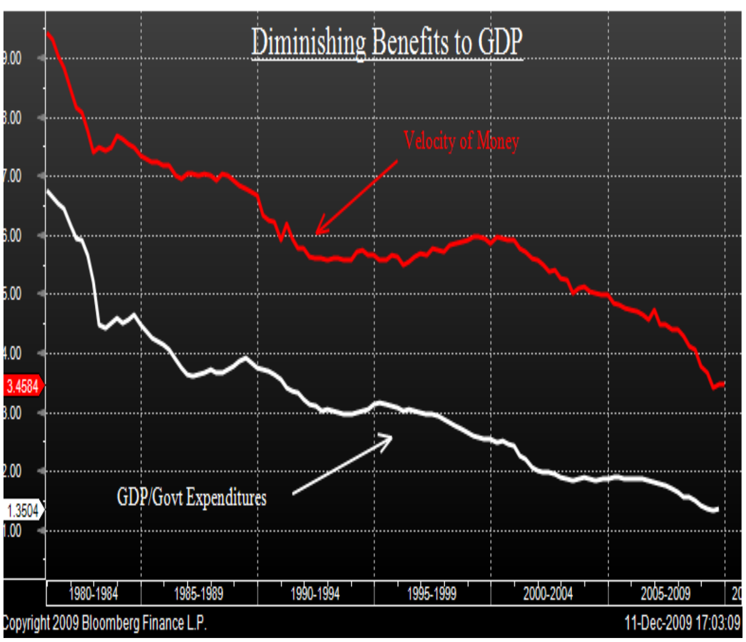

Chart 2