

By Christopher E. Grant

Fear of 'Flation But Which One?

One of the most important though confusing economic debates of today is focused on 'flation; inflation, deflation and, for those of you under 40 who didn't suffer through the double whammy of a stagnant economy combined with inflation in the 1970s, "stagflation."

Pumped Up Inflation

Investopedia defines inflation as "a sustained increase in the general level of prices for goods and services" meaning that, as inflation rises, every dollar you earn buys a smaller and smaller percentage of a good or service. On a more practical front, **the U.S. consumer defines inflation as watching the gas pump suck up the better part of a \$100 bill rather than a \$50 bill to fill the tank of your Sudden Unpopular Vehicle.** And while the battle over the "official" rate of inflation rages on (John Williams of Shadow Government Statistics argues that the rate is over 11% using the same methodology the government used to calculate inflation in the late 70s and 80s), simple market statistics show the cost of gas and home energy up 21% and 9%, with college (6%) and food (5%) both above the "official" 4.2% year-over-year increase reported by the government's Bureau of Labor Statistics in May.

Inflation is not just a domestic problem either. A recent Morgan Stanley study states that **50 countries around the globe, representing over 3 billion people, have inflation running at 10% or more.** China and India, two of the world's fastest growing economies, are also struggling to control what is beginning to look like runaway inflation, up 7.7% and 8.8% respectively over the past 12 months. In an effort to head off inflation, the Chinese central bank has raised interest rates six times in the past year while the Reserve Bank of India has just recently initiated rate hikes. Here at home,

Fed Chairman Ben Bernanke's intervention has so far only been verbal with a coordinated campaign to talk down inflation and talk up the dollar.

At the far end of the 'flation spectrum is deflation. Again turning to investopedia, deflation is defined as "a general decline in prices, often caused by a reduction in the supply of money or credit. Deflation can be caused also by a decrease in government, personal or investment spending. The opposite of inflation, deflation has the side effect of increased unemployment since there is a lower level of demand in the economy, which can lead to an economic depression."

Deflating the Real Estate Bubble

Now suffering a one-two punch, U.S. consumers are absorbing the added insult of asset deflation to the existing injury of rampant food and energy inflation as they watch the value of their homes plummet. For the 12 months ending in February, the S&P Case/Shiller Home Price Index, which tracks 20 of the largest housing markets, showed prices falling 12.7%, the biggest decline since the index began tracking prices in 2000. Ten of the 20 cities posted double-digit dips with values in Las Vegas, Miami and Phoenix all down more than 20%. **With some 155,000 homes lost to foreclosures in the first quarter of 2008 and approximately 2.28 million properties vacant and up for sale – the highest quarterly number on record since 1956 – there is no sign of a bottom in the numbers.**

For both policy makers and mortgage lenders, this is a particularly precarious time. Having just passed through the largest part of the mortgage interest rate reset cycle, when promotional and teaser rates were adjusted to market, we are now entering the "high risk of foreclosure" period which begins roughly 180 days beyond the reset date. (see Market Review chart). During the final two quarters of

'08, \$5 billion in "reset mortgages" will enter this time-critical pool, doubling the total to over \$1 trillion. According to Dean Baker, co-director of the Center for Economic and Policy Research, \$6 trillion in home values could be wiped out from the top of the market in June 2006 to the end of '08. It is little wonder that the Fed so far has limited its inflation fighting policy to rhetoric, as the initiation of interest rate hikes would only exacerbate the existing real estate debacle.

A Return to the Stagflation of the '70s?

The third of our 'flations is stagflation, the two-headed economic monster that terrorized us in the '70s. **Characterized by rampant inflation and stagnant business activity, the most damaging side effect was the heightened unemployment rate.** Inflation fed upon itself as people began to expect continuous increases in the price of goods, boosting demand and consumption. With higher prices came demands for higher wages, which pushed prices even higher in the now infamous "cost-push" wage/price spiral. Labor contracts, as well as Social Security payments, increasingly included automatic cost-of-living adjustment clauses tied to the Consumer Price Index. While beneficial to workers and retirees trying to cope with inflation, they only perpetuated the problem.

Then President, Jimmy Carter (1977-1981) unsuccessfully attempted to fight inflation with voluntary wage and price guidelines while combating economic weakness and unemployment by increasing government spending. Somewhat more successful was the "deregulation" of numerous industries including airlines, trucking, and railroads. The U.S. also responded to the scarcity of oil by both increasing energy efficiency and by driving up oil production domestically and worldwide. Most important, Paul Volcker, Chairman of the Federal Reserve, limited the growth of the money supply by dramatically increasing interest rates. Inflation, which peaked at 13.5% in 1981, was successfully lowered to 3.2% by 1983.

Which 'Flation Is In Our Future?

Returning to the present, there is no argument that food and energy costs are skyrocketing and that housing values are continuing to deteriorate. On the other hand, "expert" evaluations of current economic conditions as well as prognostications for the future are as divergent as the forces of inflation and deflation themselves. And since investment strategy and performance will, at least in part, be dependent upon which way the economic winds blow, it is prudent to weigh the evidence for each case.

Among those stating the case for stagflation is Malcolm D. Knight, General Manager of the Bank for International Settlements (central banker to the central bankers of the world). He concludes that, **"we appear to be entering a period of serious stagflation with sharply rising expected and actual inflation combined with large downside risks to growth and employment."** Further, Knight argues that "what we are seeing is an acceleration of expected consumer price inflation in the context of a sharp expansion in global liquidity. It is hardly surprising that the prices of those commodities, such as oil, for which the short-run price elasticities of supply and demand are low, move upwards strongly when there is a rise in expected general inflation."

Monty Guild and Tony Danaher of *Canadian Business Online* see much today that reminds them of the 1970s. Both then and today, Guild and Danaher see the government wanting us to believe that: **1) Inflation is not actually as bad as we know it really is, 2) The U.S. dollar is going to remain strong, even as it continues to fall, and 3) Commodities are rising because of speculators, not because of unwise long-term U.S. and foreign government fiscal and monetary policy.**

Two of their most cogent arguments relate to the continuation of worldwide inflation. First, they cite the decisions by governmental leaders in the newly industrializing world to

create a new and much larger urban middle class. **By encouraging the growth of industry while shrinking the percentage of the population engaged in agriculture, there has been an unprecedented migration to the cities from the countryside, causing soaring demand for infrastructure, building goods and services.**

Second, Guild and Danaher point to the world banking crisis which, they say, is “just getting started,” and which will, as a result, virtually tie the hands of the Federal Reserve. **In order to bail out the banking system, the Fed will have no choice but to keep interest rates low, electing inflation over bank failures.**

Setting forth one non-stagflation scenario (and maybe even stating the case for deflation) is financial columnist John Mauldin. He, too, focuses in on the interrelationships of the three dominant factors of money supply, food and energy costs, and housing devaluation. Addressing the money supply first, Mauldin states that **the primary source of the ballooning money supply has not been the Fed but rather the growth in credit offered by banks (in the form of mortgages, home equity loans and credit cards) along with the massive U.S. trade deficit, as consumers tapped their new-found and inflated real estate wealth.**

With banks now struggling to rebuild their balance sheets due to sub-prime mortgage losses, they have substantially tightened lending standards. Consumers faced with higher gas and food costs are also tightening their belts and, due to the declines in real estate values, are less likely to have access to equity in their homes. The trend in money supply expansion via credit extension has shifted into reverse.

Both the food and energy sectors are supply/demand driven. While Mauldin recognizes the current imbalance in such areas as world demand for grain, he argues that, as has historically been the case, **there**

is every reason to believe that farmers around the world will respond to high food prices and that the imbalance will self correct.

Oil prices are also subject to the same economic laws. We have already seen the beginnings of “demand destruction” in response to high prices as consumers drive less or purchase vehicles with greater fuel efficiency. Carrying the scenario further, **a decline in oil prices would mean fewer dollars shipped overseas resulting in a boost in the value of the dollar, which would further lower the cost of all commodities.** Strengthening this argument is the history of the commodity boom of the ‘70s which ended with a 30% correction. A similar adjustment today would translate into sub \$100/barrel oil.

Out of Crisis Emerges Opportunity

Whether one sides with the inflation, deflation or stagflation scenario, none paints a very pretty short-term picture. No doubt, the credit, mortgage and energy crises have more pain to inflict and certainly, none will be solved overnight. **Our response is patience rather than pessimism or panic.** Through a long history of wars, depression and natural disasters, our free-market economy has always emerged stronger, driven by competition and creativity. While our investment strategy is well positioned to withstand further shocks to the markets, we optimistically anticipate the creation of a multitude of new opportunities.

Grant/GrossMendelsohn, LLC

36 South Charles Street, 18th Floor

Baltimore, MD 21201

Office: 410 685-9685

Facsimile: 410 752-1148

E-mail: Chris@GGMWealthAdvisors.com