the advisor

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INFLECTION POINT?

We appear to be at one of those interesting cross-roads in this most unusual business recovery. This could be an inflection point in the struggle for ascendancy between capitalism and governments.

For most of the 1960s & 1970s, the economy was dominated by governments and the public sector. Much of what was accomplished was for the good: we have a fairer society and cleaner environment because of it.

For the last twenty years, however, governments have been in retreat – as evidenced by tight monetary policies, by tight fiscal policies and by loose regulatory policies - and capitalism has been in the ascendant. For twenty years, the markets reacted favourably. In 2000, the party abruptly ended with the bursting of the "bubble".

Now government influence is once again becoming more obvious in the economy. This struggle between capitalism and government is best examined from a deflation-inflation perspective.

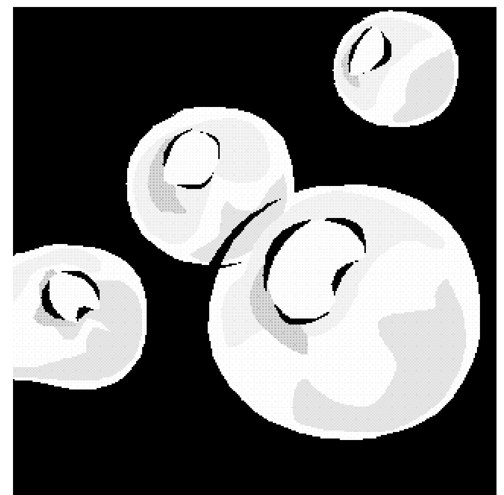
Deflation, a general fall in prices, is hazardous to a whole economy (just look at what Japan went through from 1990 to 2003, when house prices and the stock market dropped for over 10 years). From 2000 through 2003, there was the danger of deflation overwhelming the West. The worst of the deflationary risks appear to have waned. However, deflation in consumer goods prices is also a by-product of capitalism; the greater the competition, the lower the price becomes.

The risk of deflation to the whole economy came about because of all the spare capacity in the system left over from the last market top. That market top saw excessive stock valuations, excessive business investments and excessive corporate leverage. Stock valuations corrected violently, business investment dried up and companies have been scrambling to reduce the amount of debt they carry ever since.

To give businesses support for all of that spare capacity and an opportunity for firms to de-lever themselves, the central bankers of the world, led by the U.S.'s Federal Reserve, dropped interest rates to forty year lows. The "bubble" burst at a 2 percent inflation rate, which meant the economy had a fundamental need to reflate: fighting deflation was paramount.

The main beneficiary of the deflation fight has been China, where the command economy is in full retreat. China has become the workshop of the world. It no longer peddles only textiles. China has been drawing in huge amounts of commodities, processing them and selling the finished product (consider the price of DVD players or of computers) back to the West. China's low cost labour manufacturing has also kept Western manufacturers profit margins under pressure. China's pressure on consumer goods prices is likely to continue.

(Cont'd on reverse)



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Inflection Point (cont'd)

Compounding this pricing pressure from China has been high Western consumer debt levels. This will force people to consume less - unless interest rates stay low. China's low manufacturing costs have led to huge net exports to America in exchange for a massive inflow of US dollars to China. However, China recycles those US dollars into US Treasury Bonds - effectively financing this trade imbalance. In other words, China's demand for US debt allows the US to keep interest rates low. Low interest rates in turn prop up American consumers allowing them to purchase Chinese manufactured goods.[1]

On the other hand—and in economics there's always another hand—the US government has created the largest swing ever in its income statement, moving from a surplus of 2.5% of GDP to a major deficit of 4.5% of GDP. Under the Bush administration fiscal spending has increased 29%, the largest increase since the 1960s.[2] More people work for the public sector than ever before. At current rates of deficits, the federal debt could balloon to US$4 trillion over the next decade. As a result, policy makers are motivated to create inflation (a general rise in prices), which lowers the amount of debt in real terms.

With the US running twin deficits, in its current account (foreign trade) and in its budget, more downward pressure is likely on the dollar. Indeed, the dollar may have to fall much further against the Euro, the yen and our dollar. China's currency, the renminbi, is pegged to the US dollar so the cost of Chinese goods remains low. Dollar cycles tend to last several years and the bear market in the US dollar may have only begun.[3]

Moreover, the Commodity Research Bureau index has breached its 20 year downward trend-line and is up 50% in the last two years. Oil is at its most expensive in real terms in twenty years, though 20% of the price is attributed to a fear premium. Housing prices appear to be frothy in a number of areas. All these factors are also indicative of resurgent inflation, now running at over 3% in the US.

What of interest rates? The "neutral" rate - a rate that is neither too loose nor too tight - is around 4% in the US, 2.25% higher than current rates.

Depending on which factor, deflation or inflation, is stronger will determine the level of interest rates. If deflation is much of a drag, expect rates to climb only slowly back to a neutral position. If commodity prices continue to surge, expect rates to climb much quicker and possibly above 4%.

Today we also have the reverse of American economic policies followed during the prior twenty years. Now we have loose monetary policies, loose fiscal policies and tighter regulatory policies. If we are at an inflection point with capitalism in retreat and the influence of government increasing, it is fair to conclude that inflation will rise[4].

If inflation is going to rise, this development holds many implications for investment portfolios. The going may become a lot tougher for stocks and bonds. Nevertheless, you will want to ensure you have adequate exposure to both, especially to non-US securities, as well as to tangible assets such as the resource and commodity markets.

The bull market of the 1980s and 1990s arose from a bull market in capitalism, from smaller government influence and from falling inflation. Those are not the conditions of today and we cannot afford to extrapolate from the immediate past. If this is an inflection point, guard against deflation and prepare for inflation.

Sources:

1 Prospects, Fred Sturm, Mackenzie Financial Corporation, July 2004

2 Economist, 23 August 2004

3 Sterling's World Report, William Sterling, Trilogy Advisors, LLC, July 2004

4 CFA Institute Conference Proceedings, Paul McCulley, Pacific Investment Management Co., Feb. 2004