

CALM THE WATERS - GUARANTEES DEFLATION

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Ben Bernanke felt it necessary to inform the marketplace recently that (1) he is aware of the need to tighten money at some point in the future and (2) he indicated some of the ways in which the Fed might go about effecting this withdrawal of liquidity from the banking system. The very idea that he felt it necessary to inform everyone leads us to the conclusion that it will not happen anytime soon.

Why? The marketplace has gotten so used to fearing inflation that any little move or lack of action on the part of the Fed conjures up thoughts of the 1970s and, even worse, the Weimar Republic of the 1920s in Germany. Old fears are hard to change. What one has to do is look around at the deflationary aspects of:

1. Unused capacity worldwide
2. High unemployment worldwide
3. High debt worldwide
4. Lack of income growth worldwide

There is only one thing that indicates the possibility of inflation and that is the extremely high level of free reserves that the banking industry has in their deposits at the fed. But even this is not inherently inflationary. In order for this to create inflation (more money chasing fewer goods), there must be willing lenders and borrowers of money in order for the money supply to grow. This has not happened to date and, in our opinion, will not for several years to come. Maybe longer than one can even imagine! Who will lend and who will borrow?

Looking forward, what are the rules of the game? What are taxes going to be? Who will be bailed out next? Short-term fixes like the stimulus before and the jobs bill contemplated now will do little if any lasting good. The only sure

result from such efforts is higher taxes on the productive people down the line. In effect, it borrows money to buy Band-Aids when surgery is needed. As Ronald Reagan once said, "Government is not the solution to our problem (economic growth); government is the problem."

We continue to be amazed how few understand that inflation is as dead as a doornail. However, in the final analysis, it will be this non-understanding that will make deflation almost certain - for example, withdrawing the liquidity from the banks too soon. It is the perception of future inflation that required Bernanke to talk withdrawal and probably will make him tighten too soon, not now, but probably at some point, which will kill any recovery we think we are having.