

PAY ATTENTION TO THE WORD REAL

WEB BUZZ 2009.05.18

We have experienced what is commonly called a perfect storm. What were the causes? According to Horace “Woody” Brock, a well-respected consultant to the financial community, the following is the answer:

1. A mistaken market forecast of some exogenous event that impacts security prices (defaults on mortgages).
2. A high level of pricing model uncertainty bedeviling bank assets (complex securities).
3. An unprecedented high degree of leverage (40:1 rather than 10:1).

The result was a worldwide lockup in interbank transactions—available credit dried up.

The question is whether typical fiscal and monetary policy can restore growth? The answer is no.

Why? Because the large government deficits will cause much higher REAL long-term interest rates, which will offset the GDP impact of fiscal stimulus being applied.

Dr. Brock’s scenario is being bought into by the trading community with a vengeance, as long-term U.S. government bond rates have moved up almost 200 basis points since the beginning of the year. Why, then, is Central Plains Advisors, Inc. so bullish on 30-year government bonds? The answer is simple:

1. The trading community, which again can borrow money from the money center banks (who, by the way, haven’t a clue as to what is going on), is attempting to blow another bubble in the commodities market, stock market, while shorting government bonds.

- 2. The trading community is stuck in the last economic paradigm—inflation, inflation, inflation. The new paradigm is deleveraging, which will cause deflation. If one combines the year-over-year change in the CPI, which is –5% to today’s long government bond rate of 4.4%, you have a real rate of almost 10%—my friends, that will drive the economy into an absolute disaster. Of course, the -5% is from the inflation rate of a year ago to now—the actual deflation/inflation rate is 0%.**
- 3. Our future (when the traders have caught on) will be a CPI of -2% and a long government bond of 2%, with a real rate of 4%, which might allow the economy to recover, but not by much.**

We continue to be amazed by people who should know better claiming that inflation remains the game to play. Following the wrong economic model and listening to Wall Street and Washington seems to be the reason. A rude awakening is awaiting those who live in the past. We guess only time and losses will change minds in today’s environment. No doubt those who can trade based on psychological trends will do well. Those who buy and hold and/or do not take advantage of the recent strength in the “old assets” to sell may be fraught with buyer’s remorse.