

# **Deflation Remains In Our Future**

## **December 19, 2005**

**For the 13<sup>th</sup> time the Federal Reserve increased short-term interest rates by  $\frac{1}{4}\%$ . Short-term rates are now  $4\frac{1}{4}\%$  while longer term rates are somewhere in the neighborhood of  $4\frac{1}{2}\%$ . The government yield curve, which has in the past been the very best indicator of future economic activity, is near inversion. In other words short-term rates seem destined to be higher than long-term rates. If and when this happens (at least in the past) a recession has developed soon thereafter.**

**If you may recall over the last two years Wall Street has been projecting higher and higher long-term rates. Why? Because it seemed to make sense that if short-term rates were going to increase from 1% to  $4\frac{1}{4}\%$  long term rates should also move upward by 3% or so. But, of course, this has not happened just as we had expected. As a matter of fact long-term rates are even lower now than when the Federal Reserve commenced its campaign of fighting the war that no longer exists - inflation.**

**It was back in the early part of the new millennium that we began to caution investors that rates of return of the double-digit type were going to be a thing of the past in stocks. The reason being that worldwide capacity of plant, equipment and labor was over abundant. With the factors of production in over abundance the only way to compete on a worldwide basis was by lowering costs. Prices of goods and services, which have increased, have only done so because of large increases in borrowing primarily by the western consuming economies.**

**In reality all the worldwide economies, which now include the heavily populated areas of Asia, are locked in a deflationary environment akin to that of the late 1800's through the 1930's. We see nothing that will change this unless there is a world war or political instigated tariffs put in place. This lesson has yet to be learned by most market participants. The interesting and eventually rewarding thing about our allocation to long-term government bonds is under present circumstances we win either way. If we experience the "good" deflation long government rates go down. If we experience "bad" deflation long government rates go down even more. The only thing that can upset our apple cart is a return to an inflationary environment. We will need to be very careful that such an occurrence does not come to pass without our knowledge. There will be signs and we will be vigilant.**

**This being our last Buzz before Christmas let us take this opportunity to wish you a Merry Christmas and a Prosperous New Year.**