

Either Way We Win (But we Don't Know When)

June 21, 2004

It becomes more certain as time passes that we are reaching a critical point in both the real economy as well as the financial economy. While Alan Greenspan extols the virtues of the Federal Reserve's handling of the financial economy, the real economy has entered a major struggle between the revival of the industrial sector and the possible retrenchment of the heavily indebted consumer. We say "possible" out of a sense of conservatism – we really believe the proper word is "certain." The question becomes "will the strength in the durable goods sector offset the decline in the nondurable?" We find that unlikely. Although the consumer sector (70% of the total economy) does have within its category some durable goods (autos) it still remains a much larger sector than durables (capital spending).

The dilemma is this – the huge amount of monetary and fiscal policy stimulus is now being withdrawn. The Fed is talking short-term rate increases and the tax cuts are over. The economy is now on its own. The industrial area does have traction and we are seeing increases in employment and that's welcome and beneficial. On the other hand, consumer debt has gone through the roof. During the 1st Quarter of this year, the household sector increased debt at a record annualized \$1.0 trillion. This compares to average annual increase during the 1990's of \$307 billion. The problem? If the Fed raises interest rates by oh so little, even that should have serious implications for the buying power of the average consumer. If, on the other hand, the Fed does not, at some point, become somewhat restrictive, the intense psychological fear of inflation will certainly result in the financial markets doing the job for them. In other words, the "bond vigilantes" along with the speculative players in the stock market will make certain inflation come to a screeching halt.

How do we and our investment position stand under such circumstances? We could not be better situated for the final result. With the huge debt among all economic sectors, the Fed and/or the financial markets will bring this madness to a halt. At that time, only income will pay off debt as there will be a liquidity trap. We must remain patient. The entire investment community is positioned for inflation as this is being written. Can you imagine the buying power available when deflation arrives? When it does and it will, we will let them have our bonds and move to the sidelines in anticipation of our next move.

We will close with Richard Russel's astute observation: "The global situation is very deflationary. There's too much debt – and too much global production at viciously competitive prices."