

# How do you spell relief? I-S-A-B-E-L

September 22, 2003

Having been bullish on bonds since 1981 (good lord that's 22 years), we are asked almost daily "What would change your mind?" It's a good question and deserves an answer. But as we do **please keep in mind our bullish stance now applies to only full faith and credit U.S. Government bonds.**

Inflation is the killer for all financial assets, particularly bonds. Inflation occurs when public policy (monetary and fiscal) goes bad. Such was the case from Lyndon Johnson through Jimmie Carter. The bookends for this period were supply siders John Kennedy and Ronald Reagan, whose economic policies were near perfect. Since Reagan, things have begun to go down hill. Government is expanding again and that will become inflationary in time. So that's answer #1 Bad public policy will cause us to change our mind. Answer #2 is an accelerated war on terror. What is being spent currently is peanuts in regard to the size of the economy. That being the case, it would take years and years at a much greater spending rate to cause inflation. Answer #3 should be according to conventional wisdom Fed induced monetary ease (throwing money out of airplanes). There have been many times past when we would agree – but that was when debt levels were near non-existent and that no longer is the case. Velocity is declining. The Fed is pushing on a string.

That's all from the inflationary side, but what else could cause interest rates to go up? Our answer to that is deflation – but only as it applies to less than quality bonds. It's a credit quality problem and it's a disaster waiting to happen. There may be no interest rate which can offset serious looming bankruptcy.

You can tell from our answer that as far as governments are concerned, interest rates will continue to decline, particularly long term government rates, for some time to come.

To conclude on a particularly goofy note – it looks as if the government will be shut down for a few days due to hurricane Isabel. It won't stop the spending, but at least no new bills will be passed for a while. Have you noted the China bashing? Please take another look at the cycle of deflation below. Do you see where we are now?

# The Cycle of Deflation

