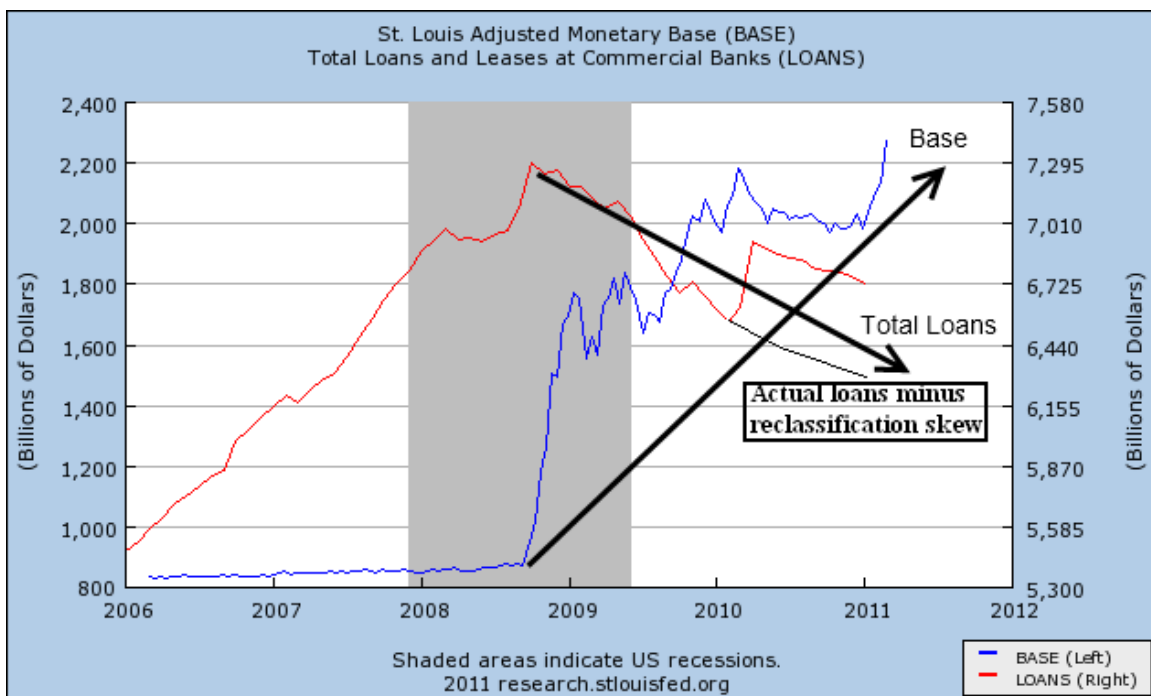


INFLATION NOW?

WEB BUZZ 2011.03.14

We believe it is necessary to provide additional information concerning the current stagflation scenario as well as concern that the economy is overheating. Implied in this also is the worry that interest rates are about to move sharply upward as there will be no buyers of dollar-denominated government debt.

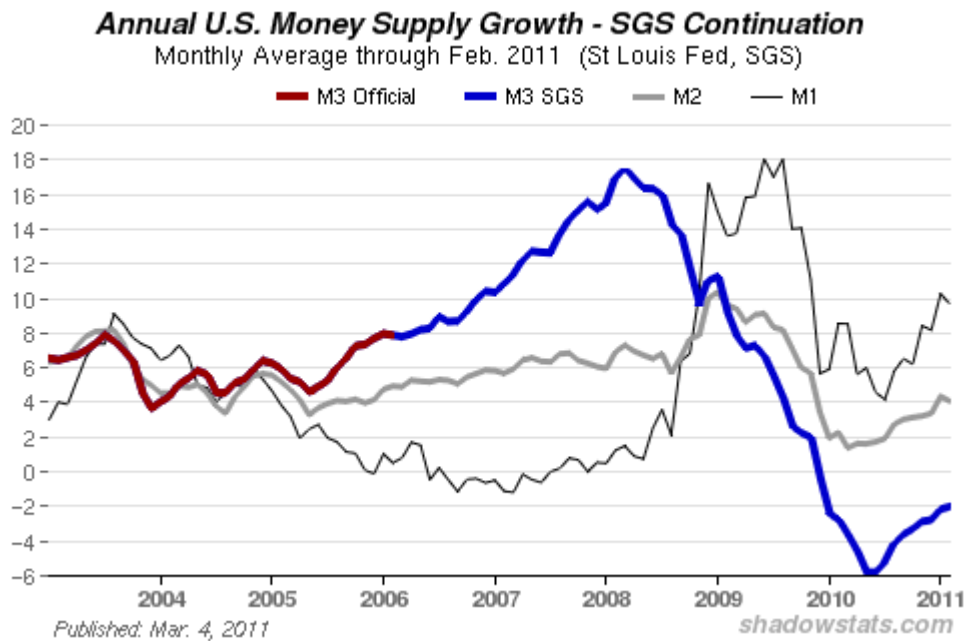
First of all, please note the chart below which comes from the St. Louis Fed's data.



Adapted from pragcap.com

It clearly indicates that the monetary base, which primarily consists of commercial bank reserves, has advanced from approximately \$800 billion at the end of 2007 to over \$2.3 trillion now. This, of course, is what has everyone concerned about the pumping of money into the economy which they fear will

result in serious inflation to hyperinflation. As the saying goes, it takes two to tango. Please note the red line showing that loans have declined from \$7.1 trillion to around \$6.3 trillion, including loans charged off, from late 2008 to date. *There has been no increase in loans for approximately 18 months.* Banks won't lend or can't lend due to economic circumstances. The following chart verifies this situation by noting that M3, which is the broadest measure of U.S. money supply, is now negative.



Adapted from pragcap.com

Now as to inflation - Milton Friedman once said, "Inflation is always and everywhere a monetary phenomenon." We agree.

The stagflation that is predicted by many has to do with the sharp increase in commodities, in particular oil and grains. Both of these are inelastic demand items; therefore act as a tax rather than being inflationary. Labor costs are still declining due to practically no wage increases along with strong productivity gains. There is no stagflation here.

Now as to interest rates - if all the above is true, the last and only concern, as Bill Gross recently opined, is who will buy government bonds when the Fed won't? The answer, in our opinion, is previous stock buyers and those who will be running to cover during the next recession, which may not be too far off. Think about it - if government interest rates go up appreciably, the economy goes into a possible depression. We ask, what will interest rates be then? Maybe 0%.