

Opportunity is Knocking

March 29, 2005

The single most important call an investor needs to make over the next five to ten years is inflation /deflation. Most likely if inflation is in the cards, then both stocks and bonds will decline in value. There is nothing that is more destructive to financial assets than inflation. A cyclical increase in inflation is taking place right now due, in our opinion, to the massive increase in liquidity manufactured by the Federal Reserve and Fannie & Freddy. Now the F's have retired from the fracas, but the Fed although currently raising short-term rates continue to flood the system with money. The commercial banks, which were slow to join the party, have done so over the last year through their aggressive lending practices, thereby assisting the Fed due their work.

Will the cyclical increase in inflation morph into a secular (long-term) affair? We don't think so. Why? Too much debt, too little income, no savings, and a huge bubble in housing which just must be on borrowed time – pun intended. Reports are that between 25 and 30% of all purchases are being made by “investors” playing the greater fool theory. That is “dotcom” all over again and is certain to end in considerable grief.

We strongly believe that deflation is the most likely result of the financial landscape due to the enormous build up of debt over the last five to ten years. Total debt in this country is over 300% of GDP and growing. There is no way one can borrow himself to prosperity. The hope of inflation believers is that the debt will be paid off by cheaper dollars. However, in order for that to happen, conditions must be such that those who owe the debt can stay active long enough to work it out. Without decent increases in income, there can be no staying power and the recent bankruptcy law changes are coming at just the wrong time. In our opinion, the 2005 Bankruptcy Law will be similar in ultimate result to the 1986 Tax Bill which killed the real estate market.

All of this “doom & gloom” (if we are right) plays neatly into our Asset Allocation Program between long government bonds and short government money market funds. If we can come close to timing our return into the long government correctly, (we know it would be purely luck if we hit it perfectly) there is no reason we can't return near double digits in an environment of income drought. Also the more conventional wisdom remains that the recent up tick in inflation is secular, the better it will be for us. An important opportunity appears right around the corner.