

The Great Reflation:

The Mother of all Financial Experiments

Chuck Prince, the former CEO of Citigroup, who presided over the bank's collapse, famously remarked in July 2007 that "as long as the music is playing, you've got to get up and dance. We're still dancing." Shortly after, the music stopped, the financial system broke, and Citigroup and other financial behemoths went under.

To rescue the economy and financial system from near-total meltdown, the government created an unprecedented package of bailouts, stimulus, free money and massive fiscal deficits. It succeeded, and a 1930s style debt deflation and depression were aborted. Liquidity, on a vast scale was unleashed into the financial system, demonstrating, once again, the power of such flows to drive up the prices of stocks, commodities and other risky assets.

In *The Great Reflation* we focus on how the authorities pumped air back into the balloon, and got the music playing again. Investors and banks, including Citigroup, are back out on the dance floor. However, just because the system was saved, doesn't mean it has been fixed.

Why do we say that the system isn't fixed? The major theme running through *The Great Reflation* is that we have been living through a multi-decade period of money and credit inflation that started back in the 1960s when the post-World War II global monetary system (Bretton Woods) began to break down. *The Great Reflation* is about this inflation and the consequences of the Act II, which is now unfolding.

From the late-1960s until 1982 we had out-of-control price inflation; after that, a series of asset bubbles and mini-crashes, leading up to The Big One in 2008-2009. One of the implications outlined in *The Great Reflation* is that we continue to live in an age of money and credit inflation and a monetary system that is unanchored and has no brakes. Until that is fixed, monetary inflation and instability will be a way of life.

The great reflation can only be understood properly in this longer-term context. It is a continuation of what went before, but with two main differences. The first is the sheer magnitude of the reflation this time—by far the biggest in peacetime U.S. history. The second difference is that the governments of the U.S. and other countries have had to transform collapsing private debt into a burgeoning public debt supercycle with projected government debt:GDP ratios heading to the stratosphere. This effort to reflate—pump air back into the balloon—had to be on a scale at least as large as the bubble itself. It is an experiment never before attempted in the context of U.S. experience, and it will have consequences unlike anything seen before.

No one knows exactly where the great reflation is going, what is going to happen, and what the end point will be like. However, there are some things we do know. When new money is created on a grand scale, it must go somewhere and have some major consequences. One of these will be greatly increased volatility and instability in the economy and financial system compared with the roller-coaster ride of the past 15 years when the private credit bubble was forming.

The Roller-Coaster

It is critical for investors to understand that there has been a linked sequence of events since the 1960s that lead to the disaster of 2008-2009. In particular, over the past 15 years, we experienced first the tech bubble, followed by a crash, then the recession and deflation of 2000-2002. Next came the

Federal Reserve's first effort at massive reflation to avoid a debt collapse. This led to new bubbles—in housing, exotic new financial products, commodity prices, energy, and world food markets. They were financed by an unprecedented credit bubble that was unsustainable. When the bubble burst, debt levels were much higher and more precarious than ever. In 2008-2009 asset prices were crushed, causing the collateral behind the debt to evaporate. That, in turn, is what triggered the mother of all reflation experiments.

This sequence of events has an ominous undertone. The great reflation effort has clearly given the economy a big boost, just as the preceding one did but it is very artificial, based on free money and unprecedented fiscal deficits and subsidies to spending.

Extrapolation of this out-of-control roller coaster suggests more bubbles in the short run. Hot markets have already begun forming in such things as commodities, gold, and world stock markets. There are many assets that could be recipients of the new money created. However, a warning for investors: We don't believe another inflation of asset prices will last as long as the previous one for several reasons. Private debt has been pushed to the limit; government debt will be pushed to the limit in a few more years; the U.S. dollar, as the world's main reserve currency, will not be able to withstand open-ended monetary and fiscal reflation; and finally, the world economy is too fragile to withstand another spike in energy and food prices which will certainly occur if monetary inflation continues.

The great reflation, if left unchecked, will run into a brick wall in the next few years, and another credit implosion and deep recession will occur. The result will be even bigger budget deficits and lower economic growth. Logic says that if the recent crisis was caused by excessive money and credit inflation, even more of the same should cause an even bigger crisis. The ultimate end point to this trend is worrisome, to say the least.

The Engine of Inflation

Inflation is the biggest enemy of investors in the long run. However, in the short term, inflation in its early stages is often a wonderful elixir, greasing the wheels of the economy and causing riskier assets like stocks, commodities and corporate bonds to levitate. Euphoria tends to build as people get richer. But, it is important to understand that inflation is an undue expansion of money and credit. It can have the effect of raising the prices of things we consume or the prices of assets that we own or want to buy. But those are the symptoms of inflation that, if extreme, tell us that a bust is coming. In the case of rising consumer prices, the central bank ultimately has to raise interest rates and curtail credit. Recession follows. Or, if asset prices rise on the back of credit expansion, debt servicing ultimately becomes unbearable and asset prices—the collateral—start to fall, but debt levels are fixed in the short term. When people can't service or repay debt, panics and crashes follow, and the risk of a debt deflation and depression rises dramatically.

Too much debt and falling asset prices caused the depression of the 1930s and almost another one in 2008-2009. One important reason that debt rose to such extremes, both in 1929 and 2007 was that the monetary system had a built-in inflationary bias. In the 1920s, it was called the gold exchange standard, whereby countries held both gold and currencies in their reserves. In the post-1971 world, it was called the floating dollar standard or Bretton Woods II. Countries held mainly dollars in their reserves. As a result, the U.S. could inflate at will and foreign countries had to buy the excess dollars on the foreign exchange market if they wanted to prevent their currency from rising. In a world of low and falling price inflation, as was the case after 1982, almost all countries want a cheap currency.

This is an important consequence of our flawed monetary system. Countries that buy dollars to keep their currency depressed, experience money and credit inflation. Bubbles result. When those

countries re-invest their dollars back into the U.S., the U.S. financial markets remain highly expansionary. Lenders keep lending and borrowers keep spending beyond their means. In a fixed exchange rate system in which countries do not hold dollar reserves, a U.S. international payments deficit results in a drain on domestic liquidity until the deficit is corrected. In the current system, the U.S. can inflate and run huge balance of payments deficits with no pain and no mechanism to stop it, other than a financial panic. It is like a fast car with no brakes. Sooner or later a crash occurs.

This fundamental flaw in the international monetary system remains. The combination of this with the unleashing of the great reflation has created a toxic brew. There is little wonder that people fear even greater monetary instability in the future than we have experienced.

When looking for scapegoats to point the finger of blame for the crash, it is natural that people have looked to the appalling performance of the regulators. That is valid, and it is also right to highlight the greed-driven excesses of lenders and the virtually criminal conflicts of interest of the ratings agencies. But these characteristics—greed, conflict of interest and criminal behavior—are always present when inordinate inflations and manias occur. It is the inflation that is the real villain.

The Long Wave and Deflation

The money and credit inflation following the breakdown of the Bretton Woods I system in 1971 originated, we believe, from the deflationary forces of the long wave decline that became quite evident after 1973. The private debt supercycle build-up and overspending in the 1982-2007 period caused a countertrend, but artificial, recovery in some long wave economic forces. Employment, earnings and wealth in industries that benefitted from the credit inflation, such as real estate, the financial industry in general, retail spending, technology (from the 1990s bubble) rose quite strongly, masking the continued

downward pressure on capital intensive industries and particularly, but not exclusively, in the capital goods industry itself. Growing excess capacity resulted. Middle-class incomes on average continued to erode and the gulf between rich and poor widened dramatically as in the late 1920s.

With the end of the private credit bubble, the long wave decline has resumed its downward course. No one knows how long that will last until the natural, Schumpeterian forces of long-term renewal take over. This would include the implementation of new technologies and the development of new industries. Our guess is that it could take another five years or so.

Policy and Markets

In *The Great Reflation*, we look at the inflationary causes of the credit bubble and the ensuing crash of 2008-2009 and the consequences of the massive monetary and fiscal program that was needed to abort an incipient debt deflation like the 1930s. The world, and in particular the U.S., will remain very deflationary for a few more years as the post-crash stimulus will soon begin to dissipate. The recovery engineered by the authorities will face additional headwinds from the unwinding of the private debt supercycle, the resumption of the long wave economic decline and the coming massive fiscal restraint. The U.S. and almost all other governments, at both national and lower levels (states, provinces, municipalities, hospitals, etc.) will rein in expenditures and raise taxes. That is the new imperative—no one wants to hit the wall like Greece. However, massive fiscal restraint also carries risks, just as the lack of restraint causes risks of a different sort. The big issue is whether there exists a middle ground that could eventually bring us to stability. That will only be revealed in the fullness of time.

Spending and borrowing excesses of governments and the public have a long and dangerous history, suggesting a deeper malaise is affecting the nation. Moreover, there are other serious signs of

long-term decline, and policy and leadership will have to be particularly adroit in steering the U.S. through the difficult few years ahead. It has been documented that the latter stages of a long wave decline are parochial, nasty and politically unstable. People are fed up with the system, their loss of wealth, jobs, and income. Traditional politicians are blamed. People look for quick and easy solutions and are open to simplistic solutions provided by demagogues. It is difficult to sell the austerity, sound policies and pro-growth strategies needed to transition through the long wave trough before really big crises occur. Countries in denial face the prospect of repeating Greece's calamity.

The risk for the U.S. and other countries is that politicians will cater to populist pressures and impose spending and tax policies that are counterproductive. In the aftermath of the Great Reflation, this could mean more government programs (e.g. health care), failure to raise taxes, where appropriate, out of fear of losing office, and excessive monetary ease because the Treasury bond market cannot absorb government funding on its own.

However, we should avoid the temptation to get too pessimistic. It is important never to underestimate the ability of the U.S. to recover from adversity, rejuvenate itself and get its house in order. Its long-term track record is pretty good, and realistic hope should not be jettisoned too readily. The question remains however, as to whether the U.S. needs an economic Pearl Harbour before serious action is taken. Investors have seen empty promises many times before and hence should be sceptical until they see clear, positive evidence that such action is being taken. Until then, they should take the attitude "show me".

The Investment Challenge

The great problem for investors in today's environment is that there is no return on short-term, safe

assets yet the higher risk levels on longer-term, higher return assets are too uncomfortable for most people. There are a number of conservative strategies that investors can employ, which are discussed at length in *The Great Reflation* and in our *Boeckh Investment Letter* (www.boeckhinvestmentletter.com), which, for lack of space, cannot be discussed here.

The centerpiece of our own strategy, and outlined in the book, is understanding liquidity flows. They are the single most important force driving investment markets both up and down. Contracting liquidity caused the crash in 2008-2009 and dramatically expanding liquidity since March 2009 has triggered one of the greatest bull markets in U.S. history. The next bear market will also be driven, at some point, by a contraction in liquidity flows. However, as long as the great reflation is doing its work, that day can be postponed. Chuck Prince, if he were to comment today, would probably point out that the music is playing again. People are back out on the dance floor. But, if the great reflation is as artificial as we believe, then this is still musical chairs. When the music stops, there won't be a chair for everyone, just like the last time.

Tony Boeckh
Date: May 4, 2010
www.BoeckhInvestmentLetter.com
info@bccl.ca

*All chart data from IHS/Global Insights, and may not be reproduced without written consent.