

# C *Economic & Market* ommentary

## The Twilight Zone

If you stepped into an episode of Rod Serling's *Twilight Zone* last New Year's Eve, and were isolated from newspapers, television, the Internet, and the obsession with valuing the daily gyrations in the economy and markets and then emerged from that alternate reality on July 1<sup>st</sup>, what would you find? The S&P 500 was up about 2 percent to 920, the 10-year Treasury bond yield rose by about 50 percent to 3.5 percent, economic activity as measured by the Gross Domestic Product (GDP) fell about 3 percent, and non-farm jobs in the U.S. dropped by over 3 million taking the unemployment rate to near 10 percent. In sum, a rather flat stock market, much higher interest rates, and a worse economy.

In last quarter's commentary *Déjà Vu or Something New*, we drew parallels to 1938, and suggested that the combination of regulatory change and massive stimulus provided a catalyst for stability and that the tide should turn. Since then, the tide has halted its relentless ebb and has risen a bit to cover up some of the jagged rocks and sunken ships in the harbor. The sea looks much calmer now, but backward looking economic data will continue to serve as a reminder of the past carnage. We will likely see a few more ships running aground as they attempt to navigate through the still treacherous harbor. The sea captains are still searching for the elusive catalyst for growth that will create a rising tide and make the harbor more navigable for commerce. The months of debate on this topic on news channels and in professional journals has yielded no real evidence of growth, and has caused the equity markets to stall. The question lingers, "how long will we wallow around in a less bad economy?"

In our investment meetings, where Dick, John, Phil and I delve into the details of the economy and markets, we have been discussing three major themes: geographic and industry growth centers, the U.S. Dollar, and inflation. Looking at current and projected U.S. economic growth rates, it's clear that less bad economic news is not a very clear path to growth. Comparatively, Asia seems better positioned for growth than America or -- for that matter -- many other regions. Even though we would like to believe that the sun rises and sets on the U.S. economy, consumerism, while still a significant part of the U.S. economy, is not likely to be a growth engine for us or the rest of the world until we create more jobs.

The sheer size of the stimulus monies available puts much of the U.S. economy's fate in the hands of our policymakers and their handling of the Fed's balance sheet. Three mutually exclusive outcomes related to the management of the national balance sheet are: 1) *Inflation*, where the Federal Reserve (Fed) does not shrink its balance sheet fast enough and eventually monetizes the government deficit, flirting with an inflationary spiral; 2) *Goldilocks II*, where the Fed gets it right, shrinking its balance sheet while methodically avoiding a monetization of the deficit, and achieving growth without inflation; or 3) *Deflation*, where the Fed shrinks its balance sheet too quickly, pulling the rug out from under the economy, worsening the recession and flirting with depression.

There is as much debate about inflation as there is about finding the elusive catalyst for growth. At times it has been a politically charged debate, with Republicans forecasting that the liberal Democrats' runaway spending programs will cause inflation, while the Democrats are blaming the Republicans for getting us into this jam in the first place. Entertaining as those debates may be, it is hard for us to fathom that the U.S. economy can avoid an inflationary bias with the amount of stimulus monies currently circulating, and three times that amount still ready to be pumped into the economy, plus the admitted bias of policy makers fearing deflation more than inflation.

The rational arguments for "no inflation" are mostly based on our economy having no upward wage pressure and plenty of spare industrial capacity...which are very good points. Our concerns, however, lie in the worth of the U.S. dollar versus the currencies of our trading partners, its effect on the interest rates U.S. debt issuers must pay to compensate investors for that weakness, the higher prices consumers might have to pay for the goods we import, and the additional cost that manufacturers might have to pay for raw and intermediate materials. This may not make headlines until later in the year because the year-over-year comparisons for commodity prices still reflect the sky high levels of last summer and do not yet flash the warning signs of inflation. As we move into the fall and winter, the differences will narrow and, at current levels, will show price inflation by the turn of the year. The Bernanke Fed has proven its mettle, and policymakers as a whole have done a good job of coordinating efforts. We hope the policymakers "get it right" but are still looking for inflation to begin increasing in 2010, with the Fed following -- rather than leading -- the market with regard to increasing short-term interest rates. This should yield a scenario somewhere between inflation and Goldilocks II -- call it "Inflated Goldilocks." We believe the U.S. economy will see a return to growth. It will not be a V-shaped "total recovery," but instead will be a less leveraged, slower growth version of its previous self, as those of us who weren't fortunate enough to be in the *Twilight Zone* have enough memories of the meltdown to last a lifetime.

The steep slide in the stock market that was re-initiated during the first quarter of this year was the straw that broke the back of both individual and institutional investors, keeping many on the sidelines, and it will have lasting emotional effects. The catalyst for stability in March spurred a combination of wishful thinking and less gloom and doom, and the resulting rally pushed the S&P 500 to a 35 percent advance from the market low in early March. To advance significantly past this point, some of these wishes will have to start coming true. Just as many did not see the depth of the downturn in the cards two years ago, many will also not see the potential for more a significant upturn either. The twist woven into this episode might be that the individual emerging from the *Twilight Zone* remains oblivious to the meltdown and the subsequent exuberance of the stock markets and, absent that emotional baggage, is able to better evaluate the economy for what it is.

Steve Taddie  
Managing Member  
July 6, 2009