

**Today's Notes:****1. THE "D" WORD**

I have had a hectic travel schedule. Sorry for the lack of Morning Notes recently. I am here in God's Country near the Blue Ridge Mountains in Charlottesville, Virginia where we lived for many years, I taught at UVa and James Madison University and my children grew up. It is wonderful to be back. Yesterday I spoke to a group in Lynchburg, Virginia. The topic surrounded the issue of the deflationary /inflationary tug of war ongoing in the world.

This AM I write on that ongoing struggle between the two titanic forces of deflation and inflation. It is so difficult to suggest one or the other because they are so obviously at opposite ends of the economic spectrum. Deflation is recognized by the decline of asset values and prices and along with this the shrinkage of the economy as defined by the GDP. In a deflation holding debt is damaging because the currency becomes more valuable. Hence you repay fixed debt in more valuable dollars.

Most readers including your truly are not very familiar with deflation; it has been a product of 1990s Japan and the last great US episode was in the 1930s and 1940s. Very few of us remember that time. My father however was a child of the depression. He was born in 1912, the oldest child of 9 children. The trials of the Great Depression were indelibly etched on his psyche. He was forced to quit school to support the family. He learned trades because he had no choice. He was, in the end result, a self-made man molded, in part, by his experiences in the Depression. He never owned a credit card, burned his mortgage document in the fireplace with great satisfaction and did not believe in debt. I suspect his experience may resonate with many of you. More recently of course the US and Canada have become countries whose populations revered easy debt and all the "good things" that debt could bring.

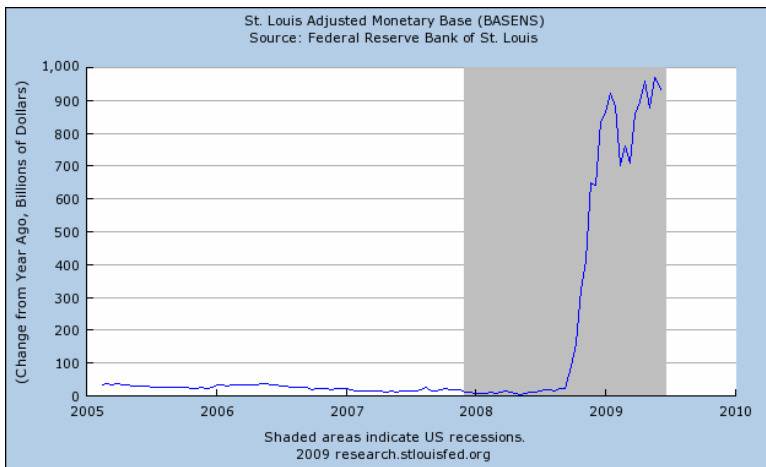
I think we all know inflation well, on the other hand. The loaf of bread that cost \$.25 in 1960 cost \$2.50 today. Between 1913 (the initial year of the Federal Reserve) and today the purchasing power of the fiat dollar has fallen 95%. Things are more expensive. This is OK as long as wages keep pace however that has not obtained recently. Real wage levels have fallen.

There is little doubt that the US and Canada have lived "high on the hog" by exporting inflation through a debasement of the fiat dollar. Yes indeed, we have had much experience with inflation – so much so that most policy makers and economists are fixated on a forecast forthcoming hyper-inflation. It has become de rigueur to proclaim that the trillions of dollars recently injected into the system will force an inflation experience of extraordinary proportion.

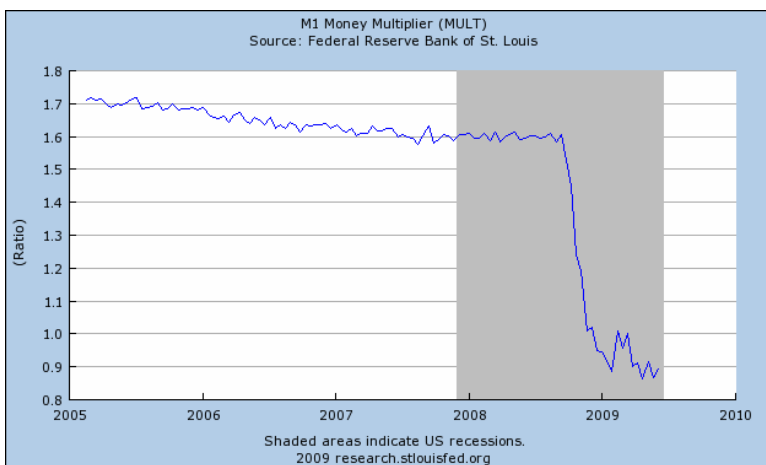
Recently Arthur Laffer suggested that the Federal Reserve should take action now to avert such a situation as it would be catastrophic. He suggested a Central bank tightening that would risk throwing the economy into a deeper recession – sort of a good purging of debt.

I doubt that there is any human, within or outside Washington, with the chutzpah to pull such an economic trigger in these times of 10% unemployment (U3).

My point is this. At present there is no inflation evident in the system. The following graph of the money multiplier shows that whatever has been injected is stuffed away and not being multiplied by banks no longer eager to lend to equally non ravenous consumers. In fact the savings rate in the US is now near 6% - quite a jump from zero just a few short months ago. While the Treasury, Fed and the Obama Administration desperately want to see the all-important US consumer re emerges it is not yet happening. Mom and Pop have been hurt. They are licking their wounds and attempting to restore some semblance of normality to their future plans. They are saving not borrowing and spending. Add to this the ongoing reversion of oil prices to higher levels and it is indeed unlikely that a strong economic recovery will ensue and with it the hallmark inflation. We think it will take a significant timeframe (3 to 4 years) for the necessary de leveraging to occur that will then set the stage for a vibrant economy with real investment drivers.



As you can see the Money Base has been expanded dramatically (as of September 19, 2008 and the Lehman and AIG fiascos). However at the same time the velocity of money fell out of bed and is now making a 25 year low. Inflation cannot rear its head, in terms of asset prices, till this measure of the velocity of money reverses its course. We shall watch this indicator with much interest.



Yesterday the always reliable folks at FTN Financial published the following data. PPI is down 5%, electricity and residential gas prices have fallen. Apparel, food and capital equipment also declined in May. FTN expects housing to decline further and industrial production to fall with it. To quote the author of the FTN report,

***“Bottom line: Inflation fears remain a long term concern. More pressing are the deflationary pressures facing the economy with a tremendous labor and output gap still waiting to be filled. Remember, however, inflation is a lagging indicator which can take up to two years to recover after the economy itself shows signs of stabilization and ultimately a return to positive growth.”***

***Where do we stand today?***

- 1) There will be a weak economic recovery in fourth quarter of 2009. This recovery in positive GDP growth will be the sole result of the Obama fiscal program finally catching up with the markets.
- 2) The banking crisis that began in earnest last September has been averted. The potential of a complete meltdown of the banking system is much reduced.
- 3) Inflation is not now the concern – instead we think the Bernanke crew at the Federal Reserve would love to see a little inflation in the system. That will be a difficult hurdle for this economy at this time.
- 4) Longer term (2011) we think it will be equally difficult for the Fed to judge when to tighten – that is when to remove the excess stimulus from the system. The US Federal Reserve failed repeatedly in this task in the 30s (saved by WWII) and Japan’s economy is still suffering after 20 years of quantitative easing and zero interest rates. She lingers on, in lungfish mode, in brackish economic backwaters. Central bankers not only disagree on the deflation / inflation tradeoff (neither of which are desirable steady state solutions to our quality of lifestyle) but they do not pick relevant turning points with any degree of alacrity.

What does this mean for your investing strategy?

- 1) In the next two to three years as this confrontation rages on you must accumulate hard discovery assets that will become even more underpriced.
- 2) Once inflationary expectations begin to obtain it will be too late to participate.
- 3) You must hedge your total wealth portfolio against the ultimate devaluation of the dollar. Discovery Investing can assist in this effort.

Incidentally this evening I will speak to a group here in Charlottesville Virginia at the Glenmore Country Club. Time is 7 PM followed by a question and answer session. Topic is “Where Do We Go from Here?” If you are in the area you might want to drop by and participate. Glenmore is a beautiful Club with all the necessary facilities; it is located in some of the most beautiful scenery in the country. Tomorrow I travel to Richmond, Virginia to speak. June 29<sup>th</sup> I will Chair the Latin American mining Conference in Miami. Finally, July 21<sup>st</sup> I shall once again present my revised geopolitical picture at the Federal Reserve (FFIEC) in Arlington, Virginia. Hope to see you at one or more of these meetings.

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