

As We See It

The appearance of periodically recurring economic crises is the necessary consequence of repeatedly renewed attempts to reduce the natural rates of interest on the market by means of banking policy.

— Ludwig von Mises

Reflecting over the last fifteen months it's amazing how far we've come, how little we've changed, and perhaps how far we have yet to go. Twelve months ago, we were in the midst of a financial panic (which is beginning to be referred to as the Great Recession) where the worst fears were that the global financial system would collapse. Global economic activity was falling faster than in the 1930s. As a result of the fastest and broadest government response in history, the system remained operational—in spite of the problems of a number of large financial institutions. In order to pull the economy out of the steepest slump since World War II, the Federal Reserve injected hundreds of billions of dollars into the system while the government guaranteed some of the biggest companies and the largest banks.

Although the cause of the economic decline is typically thought of as the bursting of the housing bubble, the root cause of this recession was three-fold in nature—too much leverage, too much debt, and too much money printed by the Fed—which together led to excessive credit growth within the economy. The housing bubble collapse was simply the result of the aforementioned causes. Most pundits and the media seem to be treating this recession and its potential recovery as if it were part of the traditional postwar business cycle—but the cycles of the 2000s have been anything but traditional. Typically, recessions have been caused by the Fed raising interest rates to fight inflation with consumers reacting by cutting back on big-ticket items, companies reducing inventories, and business activity slowing causing unemployment to rise.

Since the Asian crisis of 1997 and the collapse of Long-Term Capital Management (a U.S. hedge fund) in 1998, the Fed has pursued a *cut and flood* policy whereby they lowered interest rates and flooded the system with money in an attempt to avoid consumer recessions. A side effect was the creation of asset bubbles. Each asset bubble grew to huge proportions and then popped. When the 2000 capital spending bubble burst, the Fed again cut interest rates and flooded the system with money creating the beginning of the massive credit bubble which drove housing prices to unsustainable levels. What has been the Fed's solution to this most recent bubble popping? Interestingly, more money was printed, more debt was issued, and leverage was increased. It seems the solution to the problem utilized the same tools which caused the problem. There appears to us to be a substantial amount of collateral damage with unrecognized ramifications from the bubble—in spite of Wall Street's positive reaction.

We believe the result of the Fed's action may be higher prices and higher interest rates in the near future. With the money supply and credit having doubled without a commensurate increase in output (gross domestic product) we believe prices will adjust upward due to more dollars chasing the same amount of goods. The Federal Reserve appears to be aware of this situation—their public response being they believe they can pull the excess funds out of the economy without any adverse results. Privately, they seem somewhat worried. We are concerned. In an economy whose primary stimulation has been from spending and liquidity, any reduction could result in an economic slowdown. In addition, reducing liquidity could harm the stock market. Herein lies the Fed's quandary—if they leave things the way they are they run the risk of higher prices and interest rates; whereas if they begin to pull liquidity from the system they run the risk of a double-dip recession.

Also of concern is the reaction of our major creditor nations—primarily China and Japan. Economic conditions prevailing during a crisis are magnified by the international status of the dollar. Our creditors are watching the actions of the U.S. government carefully. They don't want to see their investments in U.S. dollar assets become less valuable from dollar depreciation—a direct result of monetary inflation.

In summary, even though we have come a long way from the crisis of 2008, there remain potential problems which may develop very undesirable results without the enactment of proper fiscal and monetary policies. We are somewhat skeptical that the government and the Fed will get everything right. Companies involved in energy production, basic materials, and agriculture as well as companies whose business is heavy into exports would be the most attractive in an inflationary environment.

Year End 2009