

## INFLATION OR DEFLATION?

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The recent stock market rally can best be understood if one subscribes to a rubber band-like snapback theory for the market after a lengthy and steep decline.

In a response to rapidly slowing sales, American businesses cut prices as well as production in an effort to get inventories down to a manageable level. Eventually this exercise depletes inventories to a point at which demand is sufficient to stabilize inventory and production levels. After all, inventories will not go to zero. Reaching this point of stability seems to have been the catalyst for the recent market snapback. After a snapback of significant magnitude, the market begins to discount future growth and in that process sets itself up for some disappointment. All this recent talk about green shoots has set us up for a fall if those green shoots don't develop further. This best describes the current investment environment and takes concerns back to key economic considerations. Are we about to encounter inflation (as most expect) or another bout of deflation as more assets are liquidated at lower prices?

Economists describe inflation as too much money chasing too few goods. It is true that the Federal Reserve has been printing money and throwing it into the system in an attempt to stem a financial crisis. Many are seeing this monetization as representing the *too much money* piece of the inflation equation. The *too few goods* piece of the equation can be explained by inventory and production cutbacks in response to the recessionary slowdown. But how about the *chasing* factor in the equation? Can we be sure that the sheer printing of money will precipitate higher demand for goods "chasing" these objects of production?

We have been concerned about inflation and the possible effects of a weak dollar brought on by the printing of so much money for quite a while, and have positioned portfolios to benefit in either event. In so doing, we have escaped a short-term collapse of the Treasury market where 10-year rates have increased by 150 basis points (1½% per year) and long-term bond prices have declined by well over 15%. Commodity prices have risen as well, creating a nice return for oils and other commodity producers. But...back to the "chasing" of too few goods question. While the markets have been discounting higher inflation, we have become less confident and comfortable with this view, believing that we could be seeing the early signs of another bout of asset deflation.

The reality of the current environment is that banks are reluctant to lend. They are fearful of getting "stuck" with another round of bad loans and having to return to bail-out status and more government control.

Other businesses are also reluctant to hire and spend because the immediate future is laden with increased taxes, more regulatory costs, increasing healthcare costs, and a consumer who has been cut-off by his/her banker. All in all, it is not a growthy outlook and one that seriously challenges the ability of consumers to "chase" fewer goods.

This reassessment of the near-term probability of inflation has brought us full circle to where we were three months ago: having to rebalance portfolios to protect against another possible wave of deflation. The entire market is also schizophrenic, swinging from a belief that reflation has worked to the fear that it has *not* worked. These mood swings will likely keep markets quite volatile. It is our distinct belief that over time (perhaps in 1 or 2 years) we will likely experience higher inflation along with a deteriorating dollar. Over the short run, however, we need to be sensitive to market volatility in order to preserve portfolio values, especially if we have to endure another deflationary sell-off.

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