DJC

THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON

TUESDAY
October 2, 2012
www.djcOregon.com

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Our lost economic decade

FINANCIAL FOCUS

Robert Smith

Even though the collapse of Lehman Brothers Holdings Inc., which triggered the worst financial crisis since the Great Depression, happened nearly four years ago, our economy remains stagnant and unemployment rates remain nearly double those of the Bush years.

These are the primary catalysts for the Fed's announcement to pursue a new round of open-ended bond buying (QE3) and extend its zero-interest-rate policy into 2015. For investors who care to look, there's a pattern here; it's continuing to move the goal line.

When the Fed first announced its intention to keep interest rates at or near zero, the target date was 2011. Then it was 2012, 2013 and 2014. Now it's 2015. From this, we posit we are four to five years into our own "lost economic decade."

Interestingly enough, the bond market seems to agree. Larry Dyer, a U.S. interest-rate strategist in New York with HSBC Holdings PLC's securities unit, recently said, "The bond market is pricing in pretty close to a very prolonged period of low growth."

Investors should infer from this that the Federal Reserve's decision to jolt the economy a third time with monetary stimulus measures won't help the economy much, but could stoke strong inflationary pressures down the road.

Ironically, this decision to pump massive amounts of money into the economy via QE3 is intended to create inflation. By inflating the prices of assets such as stocks and real estate, consumers will feel wealthier. They will then take vacations to Disneyland, buy new cars, improve their homes, etc. Increased consumer demand in turn will translate into more jobs.

That's the theory anyway. All this good stuff is supposed to happen before a more dangerous form of consumer inflation takes hold that results in both skyrocketing prices and interest rates. Needless to say, this would cause the economy to tank again with ever more dire consequences.

I am inclined to think that the latter is more likely to occur than the former. To quote Dallas Fed President Richard Fisher, a noted inflation hawk, "with each program we undertake to venture further in (this) direction, we are sailing deeper into uncharted waters ... no central bank – not, at least, the Federal Reserve – has ever been on this cruise before."

The Titanic comes to my mind.

I would qualify Fisher's statement with the observation that even though we haven't been on this particular cruise before (three times increasing in the money supply), we have "scouted the waters."

In 1972, Richard Nixon was running for re-election with a less-than-robust economy. To make sure he was successful, Arthur Burns, then the Fed chairman, flooded the economy with money. Needless to say, this initial foray into "easy money waters" did not end well. Inflationary pressures continued to build throughout the decade, resulting in soaring prices for energy and other commodities.

I would argue that this same policy risks being even more inflationary to the U.S. economy today than in the 1970s. In the 13 months after QE2 was announced in June 2010, the dollar lost 18 percent of its value against a market basket of commodities. Since Bernanke revealed his QE3 plans, the dollar has dropped 6 percent.

I have been telling investors since 2008 that the next economic cycle would be a stagflationary one (albeit more severe) reminiscent of the late '70s and early '80s. The stagnation component is already in place; real inflation isn't far behind.

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