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FIRESIDE CHAT

Chat No. 5 Deflation ... or Reflation?

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Talk of economic “green shoots,” both seasonal and symbolic, is in the air. Security markets, quick to discount real or illusory indicators of incipient recovery, have surged since March 9, with the Shiller Graham P/E returning to its long-term average of 16.3 times earnings. (Parenthetically, see Exhibit 3 on page 36 of the Martin Capital Management 2008 annual report for the hardcopy version of the 100-year chart). Perhaps a harbinger of better times to come, the University of Michigan Consumer Sentiment Index rose to 65.1 in April, the highest reading since November’s 55.3. Whether the green shoots are little more than a mirage for all of us parched for a sip of good news, or whether Mr. Market’s manic behavior should be imitated or taken advantage of, we can only speculate. What we do know is that the seriousness of the credit contraction, set alongside the enormity of the fiscal and monetary attempts to reverse it, is having the effect of baffling prediction and increasing the likelihood of chaos.

We also have little doubt about the overarching motives of the president and all of his men as they

frantically attempt financial and economic triage, like a huddle of ER docs in the middle of a natural disaster—except that the latter have method in their seeming madness, a noticeable rhythm and purpose indicating that this is not the first time they’ve been in the operating room. Lest there be any confusion about the metaphor as it applies to the constriction of credit, the patient’s flagging vital signs indicate it lapsing into deflation, an outcome deemed dire in economic terms. To the Fed chairman, presumed head of the triage team, deflation makes his blood run cold. Once deflation reaches pandemic proportions, containing it, let alone reversing its trajectory, is next to impossible using macro policy options. Inflation’s threat is more benign. As the former Fed Chairman Paul Volcker demonstrated in the early 1980s, rising prices can be choked into submission.

Deflation (falling prices) has two primary unwanted consequences. The first is antisocial, i.e., while it is no doubt advantageous to the individual to defer purchases of consumable goods and longer-lived assets if they can be bought later at lower prices, it is most detrimental to the

economy as a whole, which depends on a steady stream of growing aggregate consumer spending coursing through its economic veins. The second is more subtle and equally pernicious. Money and credit shrink in a deflationary environment, but debts, fixed in dollar terms, do not. Under deflation, a molehill of debt grows to become a mountain before a borrower's eyes. Deflation has few real winners. It's an old saw that debts never really go unpaid. If the borrower can't pay, the lender must.

Asset deflation is today's reality; inflation may be tomorrow's challenge. Deflation makes its own case. Falling prices caused by bankruptcy, debt destruction, grudging recognition of bank asset impairment, and other manifestations of deleveraging are the reality.

The last significant deflation scare occurred during the Eisenhower presidency. In 1955 the economy was relatively stable, and the debt burden was a comparatively benign 139% of GDP. Today the U.S. and global economies are synchronously slumping, incomes are falling, and U.S. aggregate debt totals an off-the-charts 370% of GDP. The forces in combination present far greater challenges to the triage team than faced the Eisenhower administration. Moreover, the greater the debt burden going into the slump, as noted in the aforementioned 2008 annual report, the more problematic becomes the Keynesian fiscal remedy of government borrowing and spending to fill the hole left by a suddenly recalcitrant consumer.

On the surface, the presumed mandate for a president pursuing any and all remedies is straightforward. If the patient's vitals are slipping threateningly, the longer-term consequences of such profligate presidential behavior become irrelevant in the moment. The remedy *de jure* is electric-charge paddles of reflation, to keep the economy's heart pumping, by restoring deflated asset prices to a "desirable level."

While it gets little press for obvious reasons, inflation makes it possible to reduce the burden of debt by cheapening the dollars by which it is retired. The creditors are sacrificed, but insidiously, with the extraction of wealth performed by a pickpocket, not an armed robber.

Assets, whose prices the wielders of power are hell-bent to jack up, include trillions held by financial institutions, the market prices of which are far below the value at which the banks carry them on their financial statements, the prices of houses, and stocks.

As for submerged bank assets, the alphabet soup of acronyms for the mutating government-instigated financial system bailout programs are proliferating like dandelions. The common theme: reflation of troubled assets that if priced on a mark-to-market basis (a discipline accommodatingly suspended during the crisis) would render banks, in the aggregate, insolvent.

Joseph Stiglitz, the 66-year-old Nobel Prize winner in economics, revealing the significant in

the trivial, exposes the asymmetrical risk-sharing structure of the latest iteration of the bank bailout plan, the Public-Private Investment Program (PPIP), which to one extent or another is the template of its predecessors. Sparing the listener the details, which, for the curious, can be readily accessed by searching the *New York Times* for an April 1 op-ed piece “Obama’s Ersatz Capitalism” by Stiglitz, I proceed directly to the effect. Because the taxpayer bears much of the risk and the select private sector participants, such as megamanagers BlackRock and PIMCO, garner a disproportionate share of the spoils, the private sector buyers can purchase what are effectively options on troubled assets at significant premiums to their intrinsic worth and still triple their money based on the assumptions that Stiglitz hypothesizes—and which I find reasonable. The longshot bet that Treasury Secretary Geithner is making is that this makeshift asset reflation sleight-of-hand will, for the most part, go undetected, with the end justifying the means.

Likewise, the Fed’s unprecedented attempt to preempt the free market and muscle mortgage rates downward by purchasing intermediate-term treasury bonds to arrest and ideally reverse the deflation in home prices is not without a host of unintended consequences, some of which are surfacing as this Fireside Chat goes to press. Other seemingly complementary tactics, like the Obama administration’s \$75 billion program of incentives for mortgage servicing companies to reduce payments for troubled homeowners (announced in February), are getting little traction

in stemming the tide of foreclosures. Needless to say, reducing the supply of bank-owned homes coming on the market is essential to the Fed’s goal. The Treasury confidently claimed it would spare as many as 4 million homeowners from foreclosure. In February that same number, 4 million loans worth \$717 billion, were in jeopardy, a jump of more than 60% in dollar terms, compared with a year earlier. In recent days, three months after the relief program was announced, the Treasury Department sounded melancholy. It estimated that the number of loans that had been modified thus far totaled somewhere between 10,000 and 55,000.

It matters not that deflation is a demon of our own making. In the leveraged economy of recent years, prices were lifted by debt. In 2004–06, net annual additions to residential loans averaged \$1 trillion. In the final two quarters of 2008, annual rates of shrinkage in mortgage credit amounted to more than \$400 billion. That is a deeply disturbing reversal in trend. As Jim Grant observed recently: “It is no wonder that industrial production plunged at 20% rate in the first quarter or that manufacturing capacity utilization slipped to 65.8% in March, the lowest since 1949 and some 15 percentage points below the 60-year average of 81%. The broad unemployment index—U6—encompassing those involuntarily working part-time and those who have given up looking, is 15.6%, the highest in the 15-year history of the index and double its cyclical low.”

Grant goes on to hypothesize: “If inflation is a monetary phenomenon, perhaps deflation is a credit phenomenon? If inflation is too much money chasing too few goods, deflation is too much debt chasing too little income.” If this definition fits, how can deflation be stopped?

The Fed has the power and authority to create dollar bills. But can it thereby create a nominal income with which to service the debts? About that, we cannot be so sure. A bumbling General Motors bankruptcy or the impending shakeout in commercial real estate debt, with \$800 billion falling due in 2009 and 2010, could prove indigestible. Of course, there is the Federal Reserve, the spender of last resort. Ben Bernanke is quoted as saying, “Under a paper-money system, a determined government can *always* generate higher spending and hence positive inflation.”

Wait a minute. What about the “circulation” of money? Money in the mattress is not the same as money on the move. The main analytical chasm between the inflation and deflation camps is their respective assessments of what the Fed can actually do. In ordinary circumstances, the central bank is the puppeteer. In today’s crisis, the central bank’s actions are untested, and the consequences, therefore, are unpredictable. The Federal Reserve makes no bones about manipulating markets to promote dollar debasement, which we’ve defined as reflation. If there is anything without precedent about this great recession, it is the Fed’s *carte blanche* authority to intervene indiscriminately.

Strangely, creditors thus far have not blanched at the Fed’s interventions. They are standing in line to buy the very low-yielding dollar-denominated securities the Fed is in the process of debasing. Within recent weeks the *Financial Times* reported on the existence of a Federal Reserve staff memorandum that makes the case for a -5% funds rate. “A central bank cannot cut interest rates below zero,” the story notes. “However, the staff research suggests the Fed should maintain unconventional policies that provide stimulus roughly equivalent to an interest rate of a -5%.”

The socialization of finance costs money, with much of it printed with that purpose in mind. Fortunately, so far, the number of dollars that the Fed is creating and that the Treasury is spending is matched by the reluctance of lenders and borrowers. Non-U.S. government credit market debt was rising at an annual rate of \$4.3 trillion as recently as the fourth quarter of 2007. A mere 12 months later, it was higher by just \$1.5 trillion. As noted earlier, the massive growth in the Fed’s balance sheet is effectively an effort by policymakers to replace the collapse in non-government credit. This is no trifling matter. Grant argues that the combined U.S. fiscal and monetary response to this recession is on track to be 10 times greater, at least, than the average policy response to the 10 preceding post-World War II recessions. Moreover, it’s no mean feat to make the leap from theory to practice. The 140% rise in the size of the Fed’s balance sheet over the last 15 months has been necessary to generate a 14% increase in M-1, the narrow empirical

measure of money—currency and checking accounts—most amenable to Fed manipulation.

The target of boosting bank asset and housing prices is consistent with the reflation theme espoused by Yale economist Irving Fisher in 1933 as the only means by which a depression, namely one caused by *over-indebtedness* to start with and *deflation* following soon after, can be attacked. Fischer warned of what he called the great paradox, which he hypothesized was the chief secret of most, if not all, great depressions: “The more the debtors pay, the more they owe.” This, he argued, cannot be allowed to happen.

A modern-day Fisher (literally) offers another point of view. Richard Fisher, president of the Federal Reserve Bank of Dallas, finds it disquieting that “nothing has more strength than dire necessity.” At heart, the Texan is an advocate for letting markets clear on their own, i.e., the whole idea of reflating asset prices to somebody’s idea of a “desired level” is antithetical to his belief in the ideal of free markets doing the job. “You know that I am a big believer in Schumpeter’s creative destruction,” he says, referring to the term coined by the late Austrian economist. “The destructive part is always painful, politically messy, [and] it hurts like hell, but you hopefully will allow the adjustments to be made so that the creative part can take place.” Texas went through that process (during the oil bust) in the 1980s, he says, and came back stronger.

To be sure, Fisher’s “destruction” was contained within Texas and a few other oil-producing states. America’s legacy industries, from GM to Citigroup, or so the argument goes, are, unlike the oil industry in Texas, simply “too big to fail.”

And yet, a political and economic philosopher may well question the application of the “too big to fail” doctrine beyond services such as the electricity grid and the water supply, the transport system and the telecommunications network without which life as we know it would grind to a halt. To be sure, the consequences of the failure of GM or Citigroup would no doubt be as bad or worse than the “destruction” visited upon Texas, particularly because of the contagion effect. However, failing to recognize the power of unleashing the “creative” forces is to underestimate the dynamism that has been the heart and soul of America during every crisis in its history. In democratic societies with market economies, the only real mechanisms of accountability are the ballot box and the marketplace. One cannot escape the irony inherent in the conflict between the doctrine of constitutional laws that brought Obama to power last fall and his subsequent repudiation of a different set of non-statutory “laws” that are the only legitimate and enduring measures of accountability in the economic realm.

An organization exempt from either of these disciplines represents an unaccountable concentration of power. We are effectively poisoning the well from which the Microsofts and

Googles of tomorrow would otherwise draw nourishment. Who, our grandchildren will ask, was Joseph Schumpeter?

Back to the present moment ... We raised doubts earlier about “reflationary” efforts to boost the prices of impaired bank assets and the still falling home prices. We now raise the question: Are there limits to the equity market’s attempt to reclaim its past heights and restore its past glories, the one market still standing that isn’t directly under the government’s thumb? Lest we forget, the Shiller Graham P/E ratio, to which we referred at the outset, has been as high as 25 in 1901 and 1966 (excluding 1931, when earnings vanished, and 2000, when technology and the Internet were priced for eternity) and as low as 6.5 in 1921, ’32, and ’82. If the market marches upward (unrestrained by deteriorating corporate earnings to which it is ultimately tethered) to the optimistic heights of, say, 1966, then the S&P 500 could rise to 1380, a further gain of 480 points—or 50% above current levels. If, on the other hand, the current reflexive optimism proves misplaced, and the pendulum swings back toward the other extreme, the S&P could theoretically sink to 360, a decline of 540 points—or 60%. The end of reflation in equity prices would have profoundly negative effects on other asset markets, which, of late, have followed the lead of common stocks higher. If you haven’t reflected recently on the relevance of Pascal’s wager, now is the time to do so. (In a nutshell, and as it might be applied to the equity markets, it says that even if the probability of a decline to lower extremes is only 5%, the

consequences are so disproportionately calamitous that all precautions should be taken to avoid it.) Whether the S&P moves up or down roughly 500 points, the mathematical symmetry doesn’t begin to explain the intensely disproportionate influence each would have on investor, consumer, lender, and borrower sentiment. Even the current reading of 65.1 for the Consumer Sentiment Index also must be viewed in its historical context: It fluctuated between 100 and 110 from 1998 through 2000.

At bottom, it is the economy, along with the incomes and profits it produces, that undergirds the value of all assets. While a growing consensus of economic forecasters is calling for the recession to end later this year (those on the fence being nudged over by the presumed supremacy of the markets), the history of their lemming-like behavior should give one pause. Nobel Prize-winning economist Paul Krugman, 56, no member of the mainstream pack, agonized recently that the world economy may face near stagnation for 10 years similar to Japan’s “lost decade” in the 1990s, because of the ineffectiveness of the various bank bailout and fiscal stimulus programs. Though Krugman is in the minority, he is not alone.

Worldly wise (and word wise) Charlie Munger, almost ebullient at the May 2 Berkshire Hathaway annual meeting, struck a darker, more moralistic chord a month or so earlier in an interview with the *Stanford Lawyer*. To call Munger an economist would be as limiting, if not as insulting, as typing Benjamin Franklin simply as a politician. When

asked if the economic crisis is “worse than the Great Depression,” Munger, as usual, didn’t mince words: “The economy hasn’t contracted as much as [it did] during the Great Depression, but the malfeasance and silliness, the triggering events for today’s crisis, were much greater and more widespread. In the ’20s, a tiny class of people were financial promoters and a tiny class of people were buying securities. Today, it’s deep in the whole culture, and it is way more extreme. If sin and folly get punished appropriately, we’re in for a bad time.”

Finally, Stiglitz offered scant comfort at a forum in Beijing in mid-May when he opined (paraphrasing Churchill): “We are at the end of the beginning, rather than the beginning of the end. The global economy may be declining at a slower rate, and we may see a bottom soon, but it doesn’t mean a full recovery.”

It is unlikely that the message implicit in the dollar’s descent, or the ever-louder rumblings about an eventual downgrade in the rating of the United States’ sovereign debt, will soon quiet the ardor. That’s tomorrow’s problem and, in crisis mode, it’s outside the worry timeframe. Students of behavioral economics know that emotion plays a huge, and often counterproductive, role in investment decision making. Moreover, the shorter the time between action and result, the greater the emotional reinforcement—positive or negative. On the other hand, the long term is very abstract, effectively neutralizing the brain’s emotional response mechanism and thus allowing

the rational mind to process methodically. The communiqués from MCM have always focused on the largely solitary space of distant tomorrows. We do our best to avoid the short-term impulse to chase prices but, rather, to wait patiently, allowing them to come to us. To the long-term thinker the current rally, which packs no emotional wallop, looks entirely different than it does to the emotions-driven speculator.

Rising intermediate-term Treasury yields (at 3.75% for the 10-year, the highest since November, and a record spread against the two-year note) perchance might announce the return of the bond vigilantes. If they ride into town, people just might notice.

As for the prices of assets, whether the situation resolves into debasement, deflation, or something completely different is the urgent and open question. We wish we had the answer.

Until we chat again,
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