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It's Deflation, Stupid

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In the same way that investors always put their money where it should have been, the news media always focuses on yesterday's problems. Much has been made of high inflation, runaway commodity prices and a return to 1970's stagflation.

We believe the greater threat is the present asset price deflation. Houses, buildings and stocks are not inflating at all. Treasury bill yields have collapsed, long bond yields have fallen and risk spreads on a variety of assets, from GSE's to commercial mortgages, have widened to near Bear Stearns panic levels. These are all strong signs of deflation, not inflation.

Many argue that the Fed Funds rate of 2% is too low and is producing a negative real fed funds rate. These arguments would concern us if interest rates themselves mattered.

We believe two things: interest rates don't matter, and interest rates alone do not signal that Fed policy is easy or tight. What does matter is the amount of liquidity the Fed provides - the supply and the demand for money. The fed funds target rate is merely the rate at which the Fed will add or subtract liquidity. Too much liquidity produces asset price inflation, too little asset price deflation. Investors should stop worrying about the Fed's level of interest rates and instead focus on whether assets prices are inflating or deflating.

Once the focus moves from concerns about interest rates themselves, to concerns over asset prices, the picture becomes much clearer. Asset prices are falling. The drop in house, building and stock prices have large effects on the financial system and on all of our balance sheets.

These balance sheet losses have a much more damaging effect than the income statement effect of rising inflation through higher food and fuel costs. What bothers people more, the 30% drop in their home price or paying \$4/gallon for gasoline? We certainly do not support inflation, but we fear balance sheet deflation far more and think the Fed should add liquidity to stop this asset price deflation. When they do, investors will want to be long U.S. stocks.

Russell Redenbaugh, CFA and James Juliano are portfolio managers for Kairos Capital Advisors LLC. Redenbaugh has built a 40 year investment career learning that the best way to build wealth is through anticipation of changes in government policy.