

Symptoms of Inflation

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Although I was not a particularly dedicated economics student, one of the first economic laws I learned was that countries which have a relatively high inflation rate have weakening currencies. Considering the steep loss of value of the US dollar over the last few years, it would seem that “inflation” in the US was far higher than what the clowns at the Bureau of Labor Statistics would have us believe (see Figure 1).

Figure 1: US Dollar - Down and Down Courtesy of the Fed!



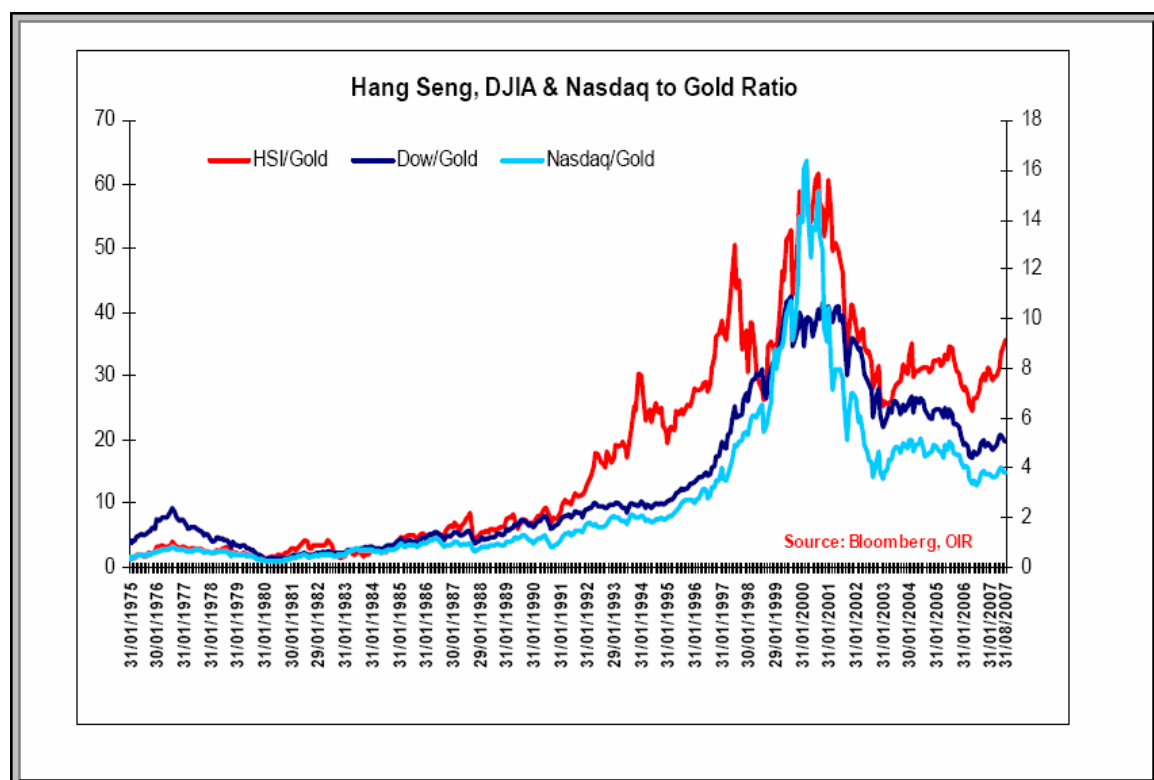
Source: www.decisionpoint.com

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I have maintained times and again that the US policy makers had two options: a strong dollar because of tight monetary policies but weakening asset markets or strengthening asset markets because of easy money and a weak dollar. Not surprisingly, on September 18, 2007, the Fed clearly showed the world upon which option it had decided! Stocks rallied, the US dollar fell and gold soared. So, whereas it is possible for US equities to make new highs in dollar terms, measured against a hard currency such as gold, stocks are likely to continue to drift (see Figure 2).

Figure 2: Relative Performance of Hang Seng Index, Dow Jones Industrial Average and NASDAQ compared to Gold, 1975 - 2007



Source: Ritesh Menon, DBS Singapore

A few observations: It is well-known that US equities have underperformed gold and other commodities badly since 2000. However, as can be seen from Figure 2, even strong stock markets such as the Hang Seng Index in Hong Kong (see red line) have also significantly underperformed gold. Moreover, whereas the Dow Jones marginally outperformed gold between May 2006 and July 2007, the easing moves by the Fed – first the discount rate cut and then the September 18 Fed fund rate cut – have again strengthened gold against equities (see Figure 3).

Figure 3: Sinking US Equities measured in a Hard Currency!

Source: www.decisionpoint.com

In fact, I would argue that because of artificially low interest rates around the world, paper currencies have lost one of their principal functions, which is to be a **store of value**. Paper currencies have become confetti! The confetti manufactured by a subsidiary of General Motors in the US are inevitably of poorer quality than the ones produced by BMW in Germany and the ones made in Chinese sweatshops, and so their values fluctuate against each other to reflect the difference in quality. But, they are all confetti nevertheless. And once people realize that these confetti, deposited in a bank or lent out at a low interest, do not adequately protect them from the ongoing monetary depreciation (inflation), they exchange them for all kinds of assets such as equities, real estate, art, collectibles, commodities and foreign confetti of better quality in order to protect the purchasing power of their savings. The exchange of cash into assets then leads to rising prices, which does not escape the attention of speculators who then acquire assets and foreign currencies with borrowed funds at the

prevailing artificially low interest rates. In turn, the increase in leverage drives asset prices even higher.

Now, someone could argue that there is nothing wrong with asset prices appreciating. Correct, if asset prices increase because of favorable fundamental factors. However, if asset prices soar because of excessive liquidity (money supply and debt growth), asset bubbles develop which cause considerable economic pain when they burst (and they eventually all do, see Figure 4).

Figure 4: Nikkei Index (red line), NASDAQ 100 (yellow line), S15Home Index (white line), Shanghai Composite Index (green line), 1979 – 2007.



Source: Bloomberg, Myanville

The optimists will of course exclaim “what pain are you talking about? The NASDAQ bust caused a minor economic setback but look how strongly the economy recovered thereafter! Also, if Japan had pursued more expansionary policies after 1990, the bursting of the Japanese bubble and the subsequent economic stagnation could have been avoided”.

It is true that if Mr. Bernanke had been at the Bank of Japan in the 1990s asset prices might have declined to a somewhat lesser extent than they did. However, even under ultra expansionary monetary policies

some asset prices do decline as was the case for the NASDAQ after 2000 (see Figure 4) and for homebuilding and sub-prime lenders after 2005. This is important because even under the assumption that the Fed will continue to flood the system with liquidity and cut the Fed fund rate to zero it is far from certain that **all** asset prices will increase in value. As I have pointed out before, once a bubble deflates, the object of speculation changes and a new leadership emerges with the result that deflated bubbles stay down for a very long time. Also, I do not buy the “strong US economy” argument. Since the US economic recovery began in November 2001, employment and real median income gains, industrial production growth and capital spending has been disappointing. Not surprisingly consumer confidence has never fully recovered and is now trending down again (see Figure 5).

Figure 5: Consumer Confidence Index, 1995 - 2007

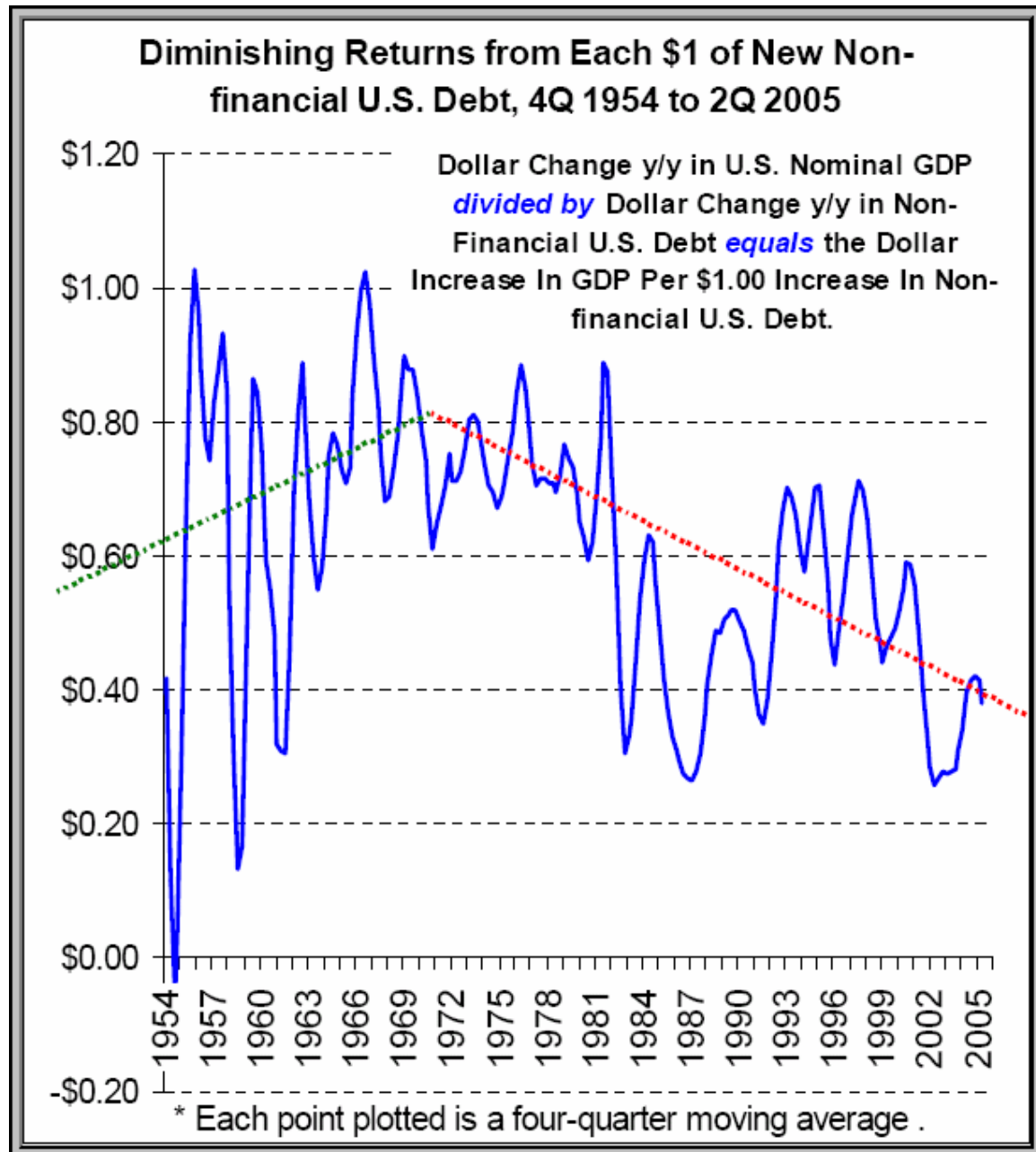


Source: Ed Yardeni, www.yardeni.com

Moreover, we should consider how this “strong US economy” was achieved. So far, in the current decade, GDP has grown by \$4.2 trillion while debt has increased by \$21.3 trillion, indicating just 20 cents in GDP

growth for each additional dollar of debt (see Figure 6, which does not include financial debt growth).

Figure 6: Diminishing Returns from Debt Growth



Source: Barry Bannister, Stifel Nicolaus

Compare current ratio of debt-to-GDP growth to the 1950s, when total credit market debt increased by \$337 billion while GDP expanded by \$ 428 billion! The rate of change of GDP growth to debt growth has

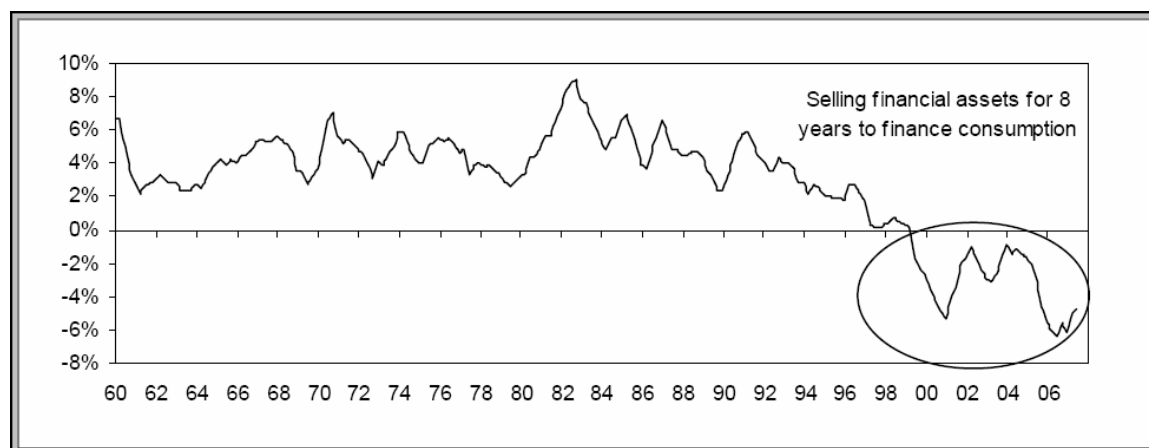
declined in each decade since the 1950s and the question arises at what point additional debt growth will generate **Zero** GDP growth.

Well, I am pleased to report that we have already reached this point. Of course we need to consider for a moment how to measure economic growth. If low quality confetti are no longer a store of value they are also useless as a unit of accounting. We therefore need to measure economic growth in either higher quality confetti like the Euro or in gold. And in both Euro and gold terms the US economy has been contracting since 2000.

Hearing this, the high priests of the “Goldilocks Cult” will jump off their seats and protest vehemently. “Look at US consumption! Look at corporate profits! How can you argue that the economy has not expanded?”

However, a closer examination why consumption and corporate profits expanded rapidly in the last few years takes us back to the \$21.3 trillion debt growth in this decade, which drove asset prices – notably home prices – higher and the savings rate down, and allowed US households to consume more than they earned through Home Equity Withdrawals (HEW). At the same time this over-consumption led to the growing trade and current account deficit and to the weakness in the dollar. In essence what occurred is that the US went on a spending spree because of “inflation” (money supply and debt growth) which was financed by growing debts and a liquidation of real estate and **also** financial assets (see Figure 7).

Figure 7: Net Financial Investment (%GDP)



Source: Bridgewater Associates

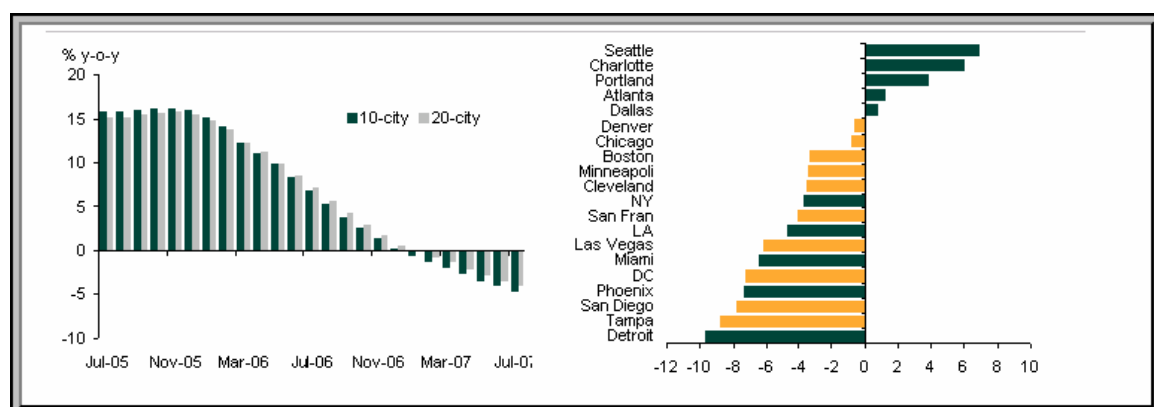
As can be seen from Figure 7, aside from increasing their mortgages and consumer debts US households have also been heavy sellers of financial assets (mostly equities) over the last few years in order to finance their consumption – not exactly a sign of economic strength!

Now, I concede that consumption can lead to economic growth if as a result of an increase in consumption capital spending increases. But this was hardly the case in the US where capital spending has remained lackluster. Where capital spending took off is overseas, because the “inflation” in the US kept the American price level elevated when compared to other regions of the world – most notably in the emerging economies. Simply put, I would argue that we had consumption in the US, but that “real” economic growth occurred in the emerging economies.

The goldilocks believer will of course point out that increased debts are entirely bearable because asset prices (homes and equities) increased. But as I indicated, asset prices hardly increased in strong currencies and declined in gold terms. In this respect I should like to mention that nobody would measure asset price increases in high inflation and weak currency economies (e.g. the ones we had in Latin America in the 1980s or Zimbabwe nowadays) in local currencies. The common unit of account for economic growth, consumer and asset prices in high inflation economies is usually a strong foreign currency or gold. So to measure US asset price increases and economic growth in dollars is very questionable.

But now, a new factor needs to be added to the equation: in most areas of the country US home prices are no longer rising but declining (see Figure 8).

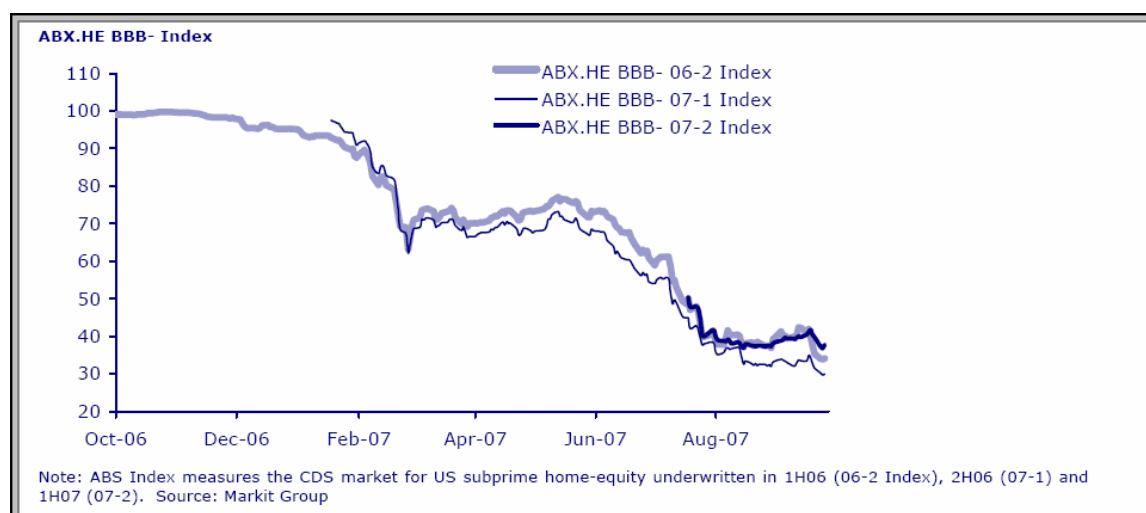
Figure 8; Case-Shiller Composite and Regional Home Prices (% y-o-y)



Source; S&P Case-Shiller

In addition, conditions in the credit markets have deteriorated badly for any borrower with less than an AAA rating (see Figure 9).

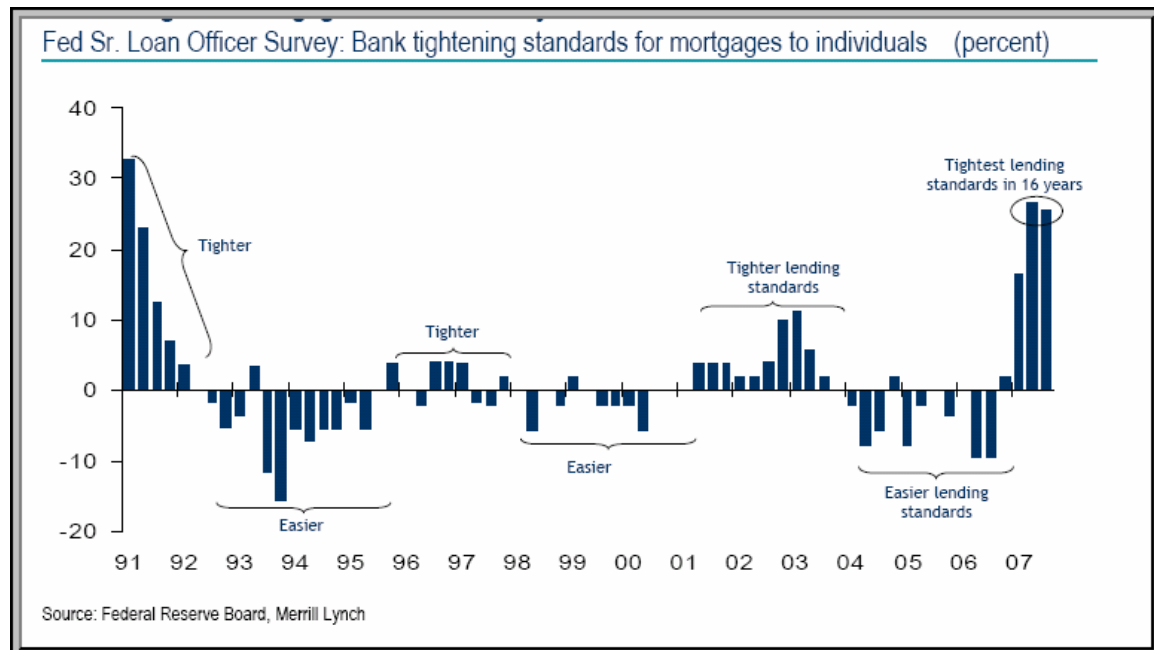
Figure 9: Not much Help from the Fed: ABX Sub-prime Indices



Source: Chris Wood, CLSA

Declining home prices and worsening conditions in the credit market inevitably lead to slower credit growth, which means “recession” in a credit addicted economy. Naturally, the Fed will try to revive credit growth by aggressively supplying liquidity to the system and by cutting interest rates further. However, these monetary measures may not help the economy because lending standards have tightened considerably (see Figure 10).

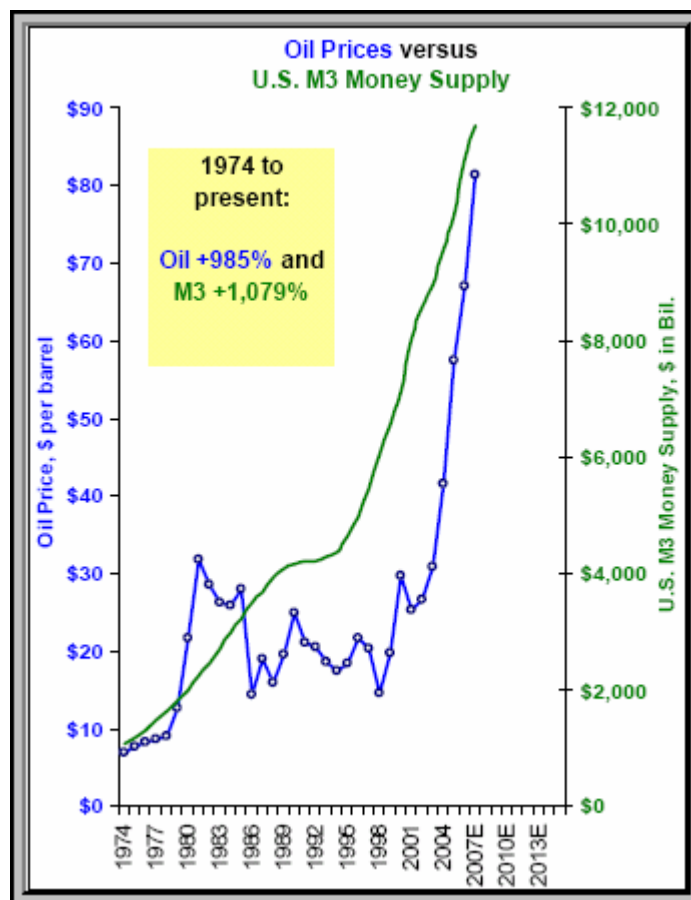
Still, it is conceivable that the Fed, by cutting aggressively interest rates, could engineer another bubble – this time in equities, commodities, and foreign currencies as the dollar continues to decline. In fact, if the dollar continued to decline against the Euro, I suppose that at some point the ECB would come under intense political pressure to cut interest rates in an attempt to lower the value of the Euro against the dollar. However, if investors came to the conclusion that the ECB has effectively become hostage to the Fed’s monetary policies they would likely abandon any faith in paper money as a store of value and rush into precious metals.

Figure 10: Tightest Lending Standards in 15 Years!

Source: David Rosenberg, Merrill Lynch

Also, it is far from certain that the bond market would rally if central banks were to engage in expansionary monetary policies in order to keep the value of their currencies down. A more likely outcome would be that bond investors would become deeply concerned about the inflationary impact of these easing moves and sell their bonds, thus pushing yields higher.

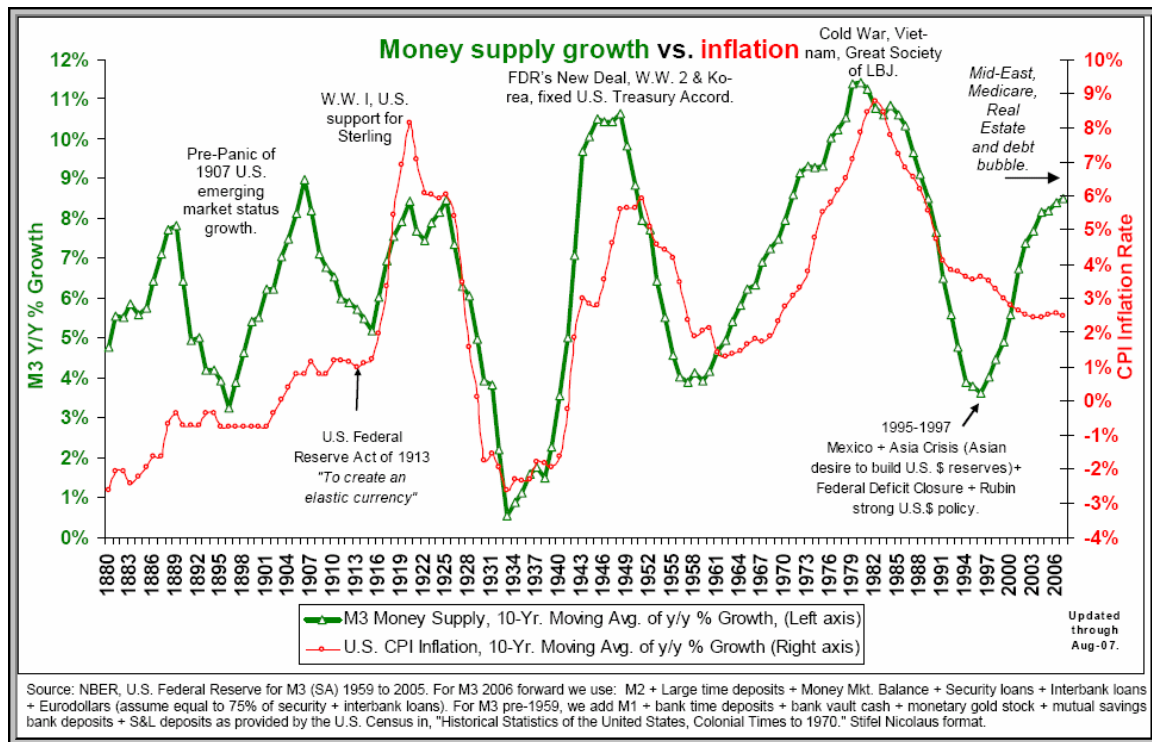
What I am driving at is this: Central banks can pursue ever more expansionary monetary policies even if these require **extraordinary measures** such as buying mortgages and equities. However, the real economy may not benefit as money and credit growth shifts into assets and also into the prices for goods and services. The result would then likely be a further increase in asset prices but at the cost of higher producer and consumer price inflation and rising long term interest rates. In this respect I should like to point out that, over longer periods of time, oil prices and M3 track each other rather closely (see Figure 11).

Figure 11: How the Fed finances higher Oil Prices!

Source: Barry Bannister, Stifel Nicolaus

I am in no way denying that the incremental demand from China and now also increasingly India had a material impact on oil and other commodity prices. But what I am suggesting is that even if global demand for commodities were to decline because of slower global growth or a recession, commodities could continue to remain firm or increase in prices courtesy of expansionary monetary policies. After all there is a close long term correlation between M3 growth, commodity prices, and Consumer Price Inflation (see Figure 12).

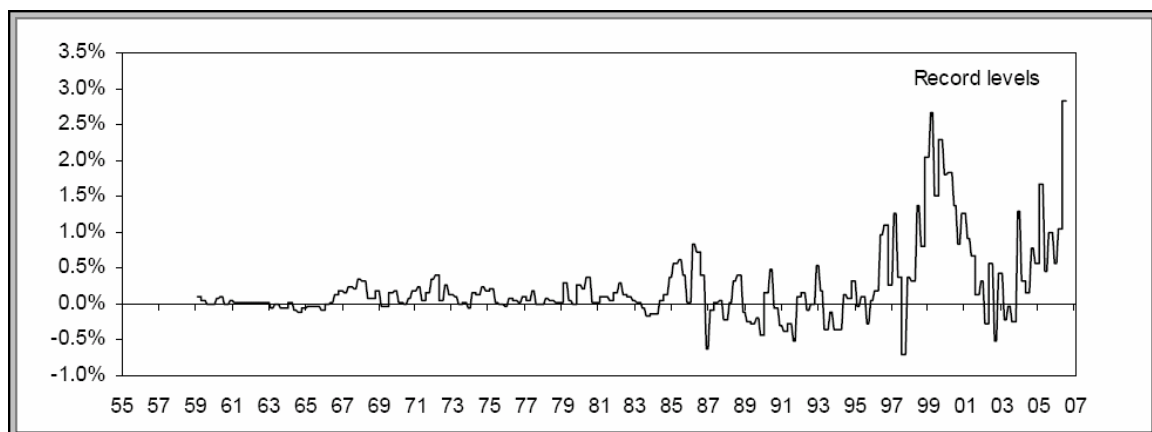
Figure 12: Money Supply Growth and CPI, 1880 – 2006



Source: Barry Bannister, Stifel Nicolaus

There is one more point that I should like to make. Foreign investors have been rushing into US equities at a record pace in the belief that US equities are relatively inexpensive (see Figure 13).

Figure 13: Foreign Buying of US Equities (% GDP), 1955 - 2007



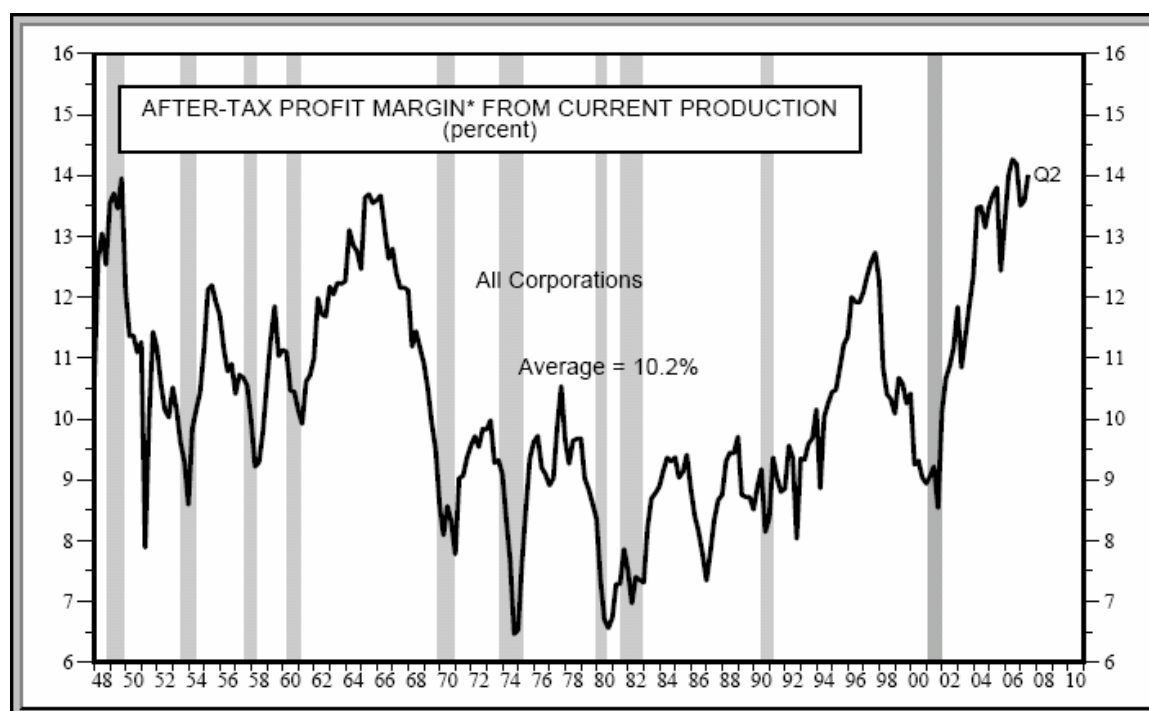
Source: Bridgewater Associates

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I suppose the argument is that in an environment where the Fed prints money at the expense of a weaker dollar, investments in equities are more attractive than cash and bonds, because US corporations derive a substantial portion of their earnings from overseas and are a better inflation hedge than bonds. I have no problem with this line of argumentation with the exception that US corporate profits could be in for a nasty surprise, if we had the combination of rising price pressures and a weakening economy at the same time. If we look at Figure 14, we can discern two major trends in US companies' after tax profit margins: during the inflationary sixties and seventies margins contracted. Conversely during the "disinflationary" period that followed up to very recently we had a huge margin expansion, which boosted profits substantially (at least measured in dollars).

Figure 14: US After-Tax Profit Margins, 1948 - 2007



Source: Ed Yardeni, www.yardeni.com

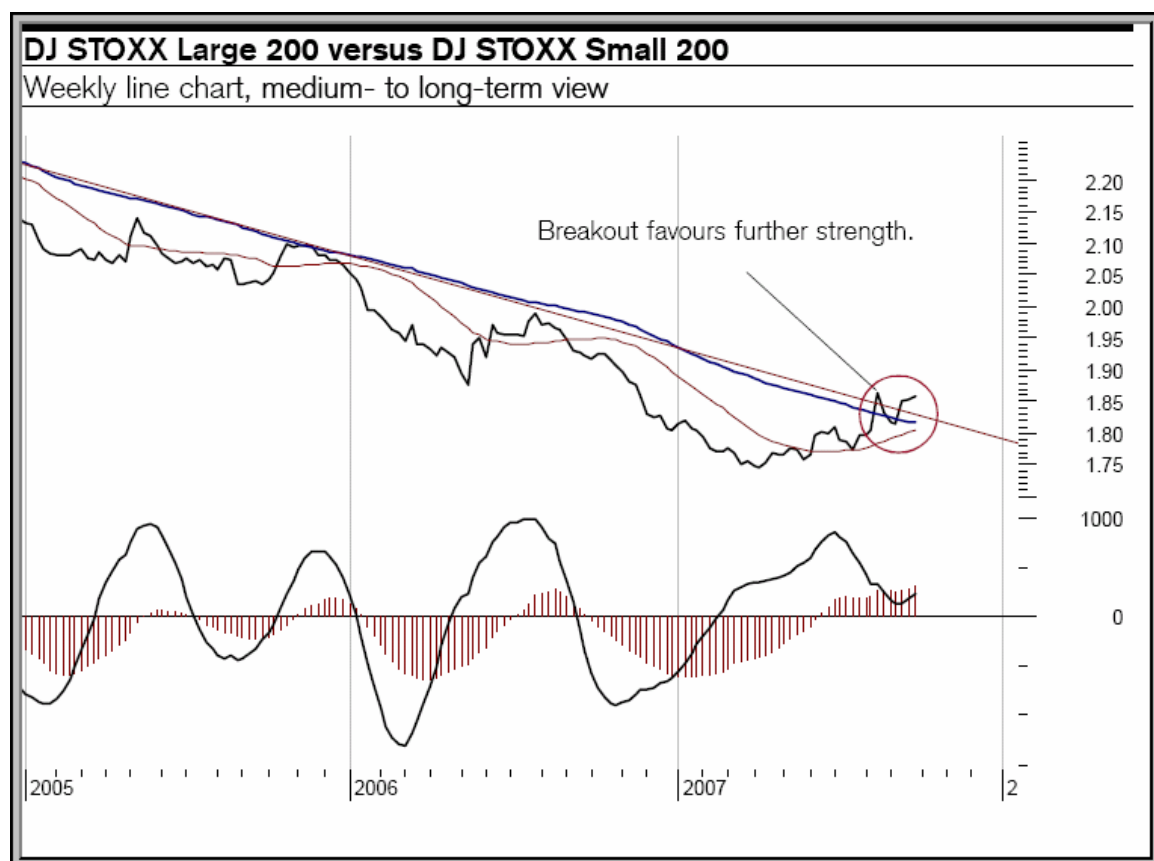
In particular, margins expanded during the 1980s and 1990s when commodity prices and interest rates declined meaningfully. However, if we move into an environment where cost pressure will become more common, while at a time of a slowdown in revenue growth occurs, profits could begin to disappoint and put some pressure on equity prices.

Investment Observations

Focusing on short interest on the NYSE and on NASDAQ, which fell sharply between August 15 and September 15, it would appear that the stock market rally was largely driven by short covering. Market breath, the number of stocks reaching 12 months new high, and the performance of financial stocks were all disappointing.

Worldwide, large market capitalization stocks seem to be outperforming small capitalization stocks, which is logical when credit conditions deteriorate (see Figure 15).

Figure 15: Large Market Capitalization Companies to Outperform Smaller Companies!

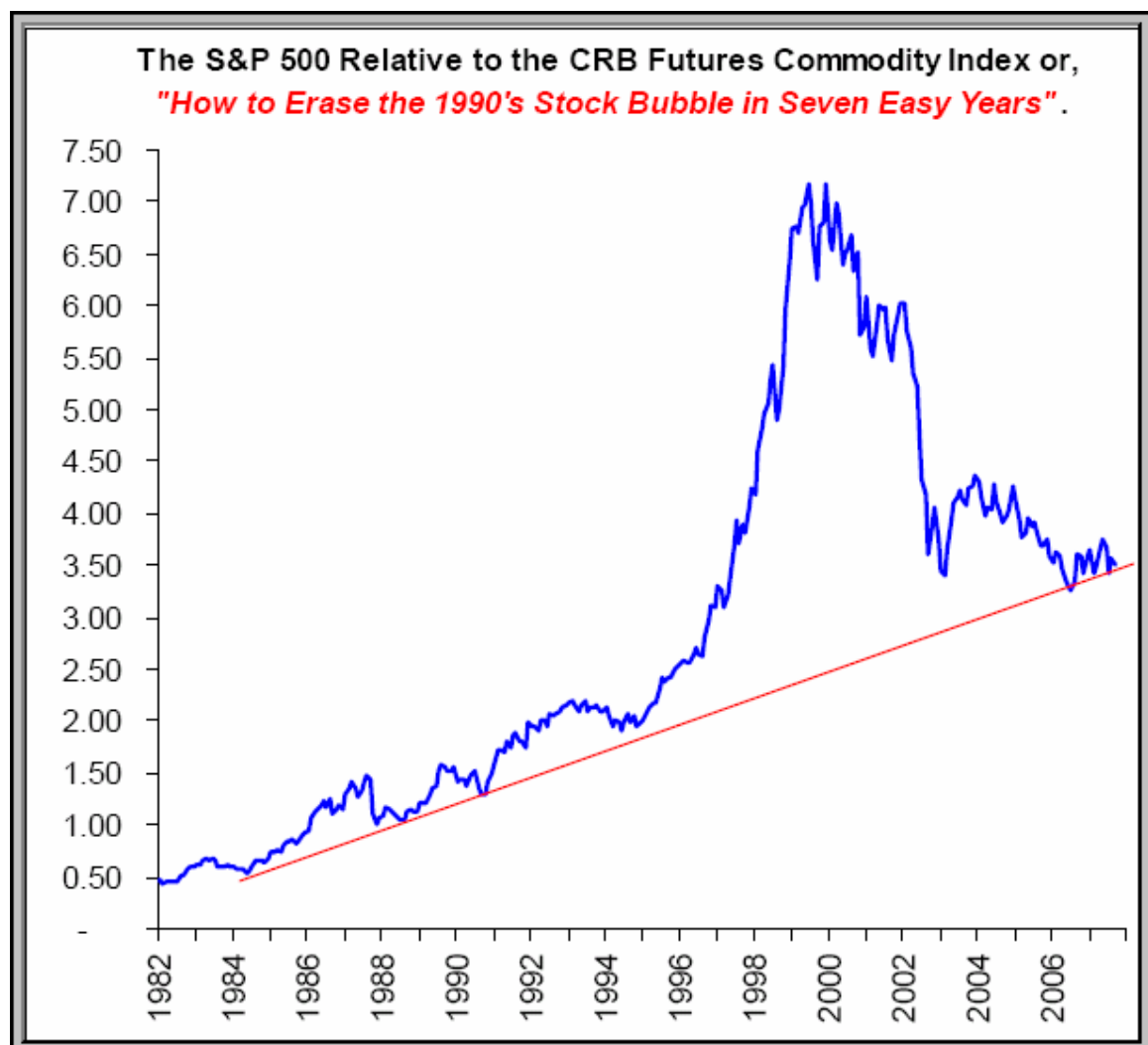


Source: www.credit-suisse.com/techresearch

This does not imply that large market cap stocks will necessarily increase in value but that they would be better positioned than small cap companies in the current environment of stagflation, which is likely to put pressure on corporate profits and widen credit spreads.

Investors have reached a crossroad: Either you believe that the expansionary monetary policies of central banks will lift asset prices further or you take the strongly contrarian view that they will not work and that the world will sink into a deflationary recession. As I indicated, I am a believer that money printing will work for some assets (precious metals and commodities in general) but not for others (housing, US equities measured in gold terms) and not for the economy (see Figure 16)

Figure 16: Out-performance of Commodities to Continue!



Source: Barry Bannister, Stifel Nicolaus

This does not imply that commodities cannot decline as well, but it should be clear that the supply of confetti, equities and bonds can be increased ad infinitum whereas the supply of precious metals in particular is extremely limited. Moreover, confetti have lost their function as a store

of value because of artificially low interest rates, which of course favors precious metals over paper money, cash, and bonds. Consequently, I expect commodities to continue to out-perform financial assets including equities – although I admit that gold is now significantly over-bought from a near term perspective (as is the dollar over-sold).

How would gold perform in a deflationary global recession? Initially gold could come under some pressure as well but once the realization sinks in how messy deflation would be for over-indebted countries and households, its price would likely soar.

Therefore, under both scenarios – stagflation or deflationary recession – gold, gold equities and other precious metals should continue to perform better than financial assets.

In the US there is a renewed love affair with high tech stocks. Driven by the superior performance of Google (GOOG), Apple (AAPL) and Research in Motion (RIMM) the NASDAQ 100 has recently exceeded its July high and with its out-performance has lured the momentum players into tech stocks. But there are two points to consider: GOOG, AAPL and RIMM are already extremely over-extended and have become overly popular among investors at a time at which these companies' growth rates are likely to slow down. Also, the high tech industry's best customers are consumers and the financial sector. Since the demand from both these sources is likely to slow down and possibly even decline, the fundamentals would not seem to support the recent rise in high tech stock prices.

Emerging stock markets have fully recovered from their July/August declines and several markets are making new highs. However, market breath has deteriorated and declining volumes are arguing for some caution (see Figure 17).

There is no doubt that we are dealing with bubbles in China and in India. Can these bubbles be inflated by another 100%? Possibly, if Taiwan and Japan in the 1980s serve as a model! However, risks are high (as they are for the NASDAQ 100) and once these markets tumble (and they will – see also Figure 4) the shaky global financial system will be tested one more time.

Figure 17: Shanghai Composite Index, 2007



Source: CLSA