

Monthly Chartbook

June 2007

The Cost of Cheap Money

Macro-economic research

What do we mean by “cheap money”?

Government controls the money supply and, as such, can increase or decrease the relative value of that currency. There are a number of policy explanations for why these decisions might be made, but another effect of increasing the money supply over an extended time period can be inflation (the cheapening of the value of the currency for those who use it).

Our thought is that recent and extended money supply growth is cheapening the value of the US \$ through a stealth inflation that is not being recorded in traditional inflation measures. It is, however, showing up in some asset prices, and that is what we mean by the cost of cheap money.

This topic is a result of several conversations we have had recently about asset prices, inflation and its measurement, and we will look briefly into each of these as a starting point for this discussion.

Something to think about...

I am currently teaching an investments course at a local university and found out the textbook for the course was priced at \$150 a copy; when I was in school, books cost about \$60. That works out to be inflation of over 5.5% per year (much higher than the reported numbers).

This example can be replicated across the board for most services (think about changes to the cost of your haircut) and many goods that are produced domestically.

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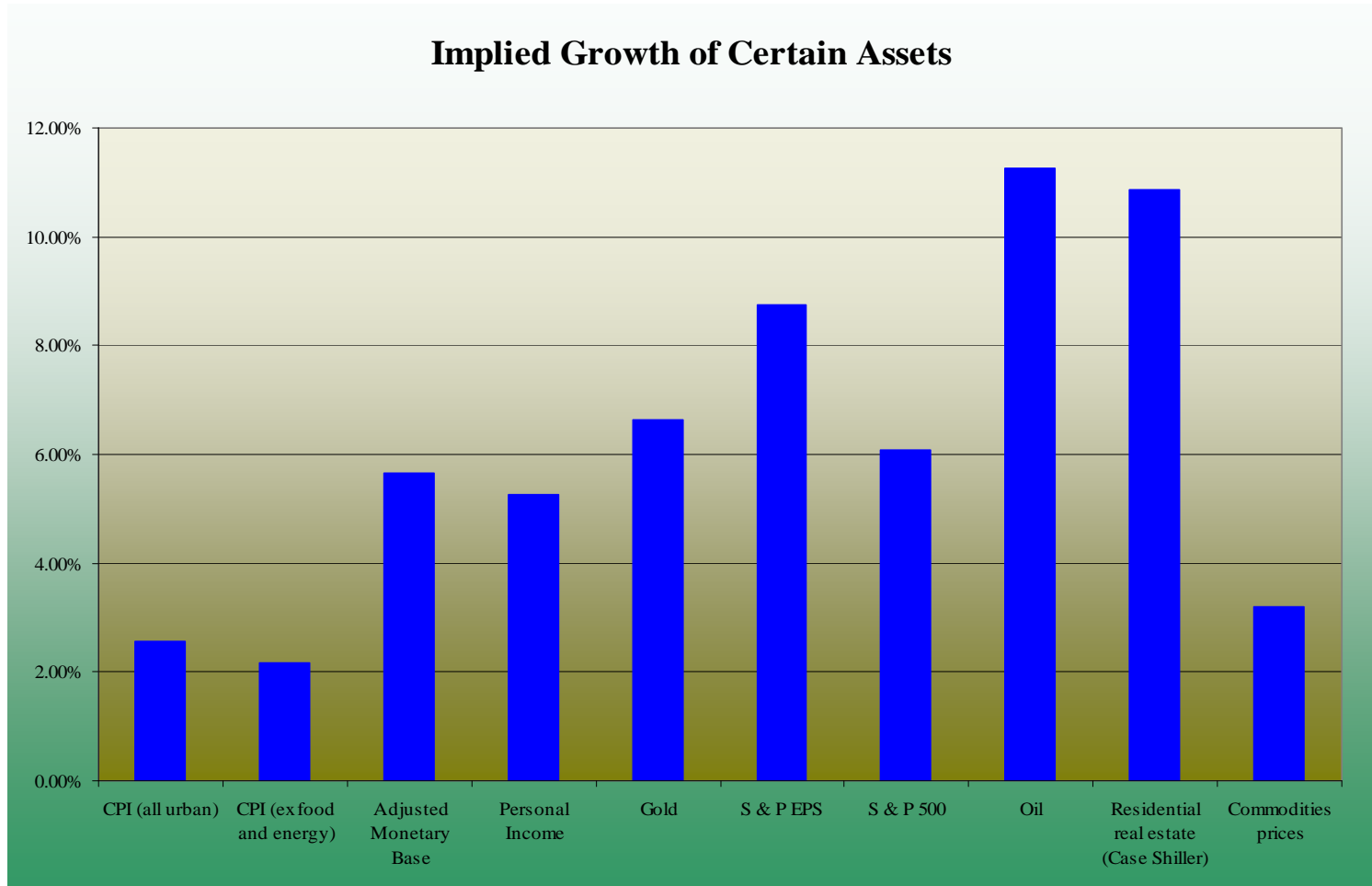
Here are changes in price for several assets (or important components of the economy) that offer similar results...

Consider from 1/1/1974 to 3/31/2007:

	1/1/1974	3/31/2007	% change
CPI (all urban)	46.8	205.1	338.25%
Gold	\$ 129.51	\$ 654.90	405.68%
S&P 500 EPS	\$ 7.68	\$ 81.42	960.16%
Monetary Base	\$ 85.27	\$ 844.71	890.63%
Oil (West TX)	\$ 10.11	\$ 60.56	499.01%
CRB	\$ 218.10	\$ 462.13	111.89%
Personal Income	\$ 1,171.80	\$ 11,429.10	875.35%
Nominal GDP	\$ 1,447	\$ 13,613	840.77%
US\$ (trade-weighted)	\$ 105.84	\$ 81.23	-23.25%

It appears that CPI doesn't capture all of these increases; how can it only increase a fraction of measures such as personal income and monetary base?

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And, the implied annual growth of these assets over the past ten years far exceeds the increases in prices provided by the CPI over that same period.

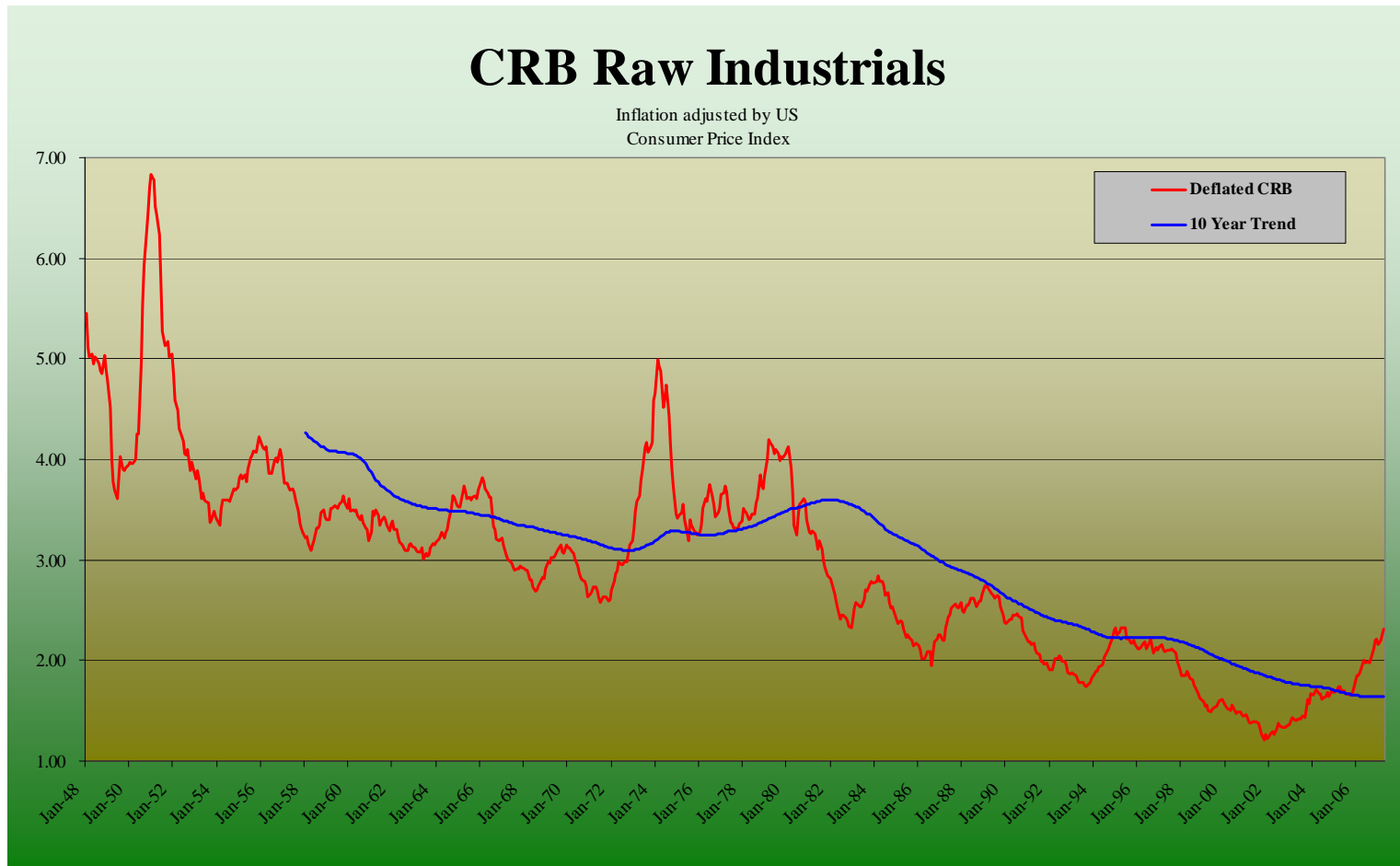
Inflation expectations

*The greatest danger to our capital markets is an **unanticipated** increase in interest rates due to inflation. Unfortunately, this is not an unlikely scenario.*

This can negatively affect asset values beyond the fundamental impact of discounting cash flows at a higher rate...

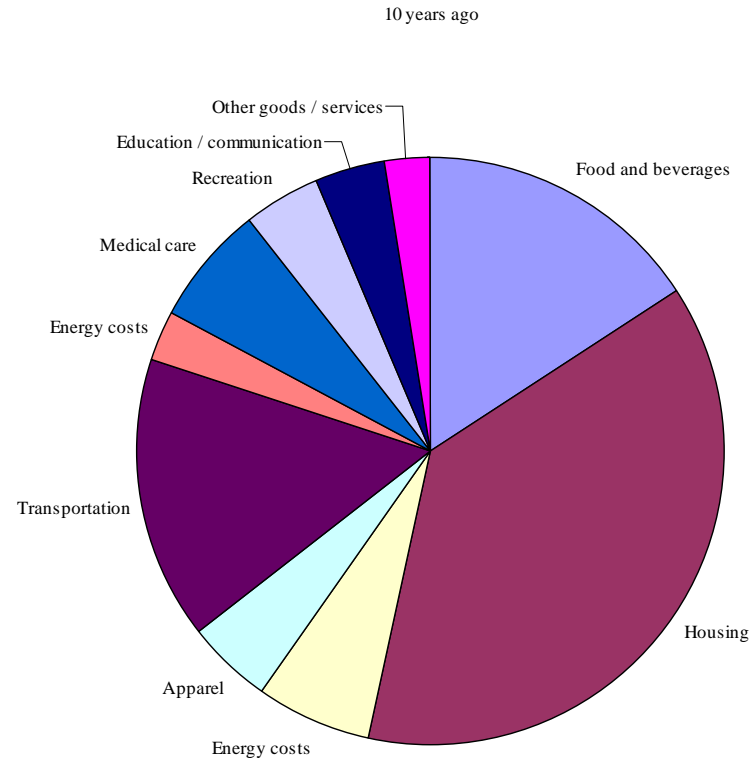
- it could make the US dollar less attractive to foreign investors (if there is minimal real yield); foreign investors are part of what is keeping longer-term interest rates lower than would otherwise be expected*
- hedge funds and institutional traders have increased trading volumes and concentrations on certain expectations; fast and forced trading can exacerbate new information*

Inflation expectations



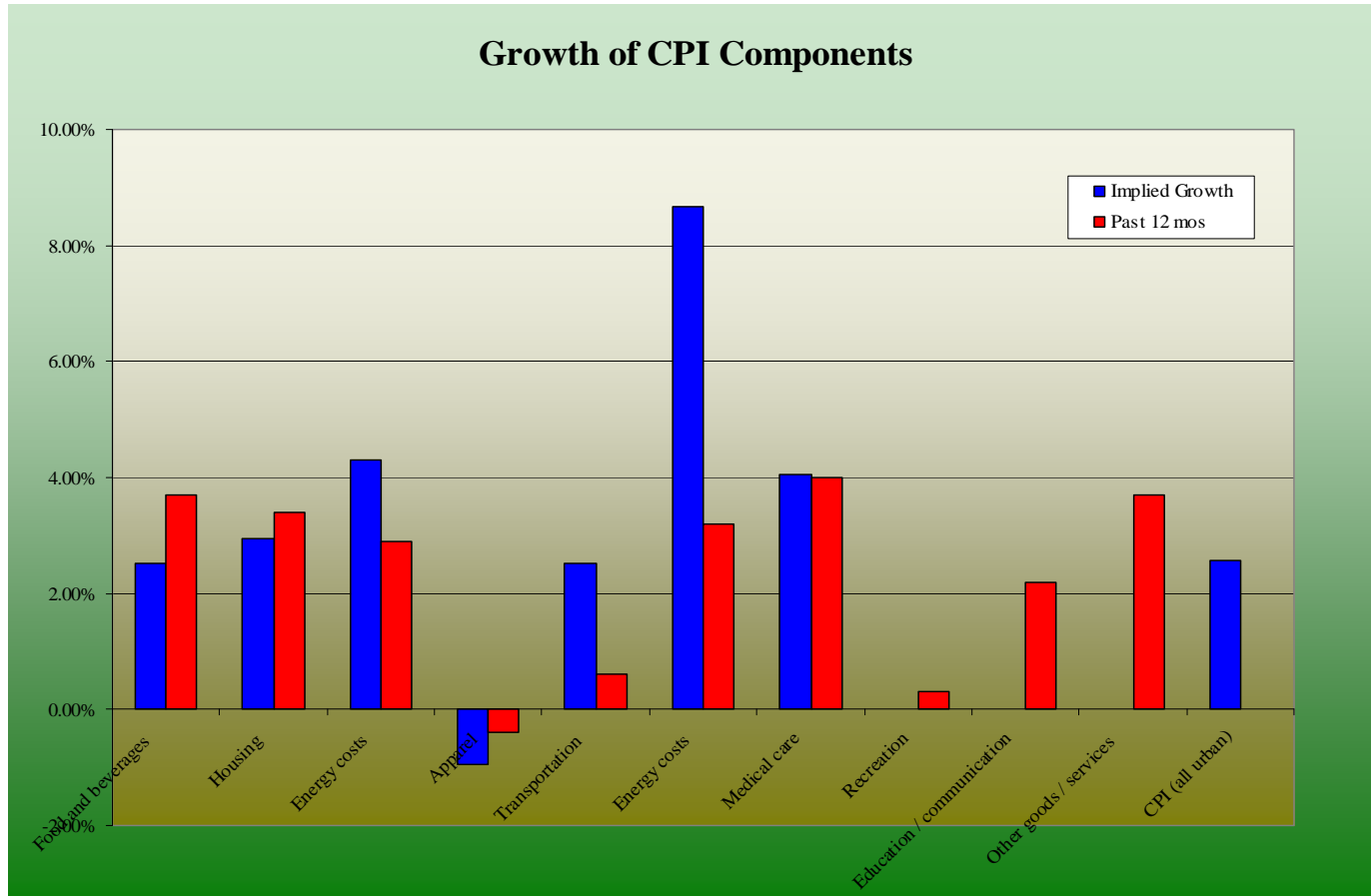
With continued global growth (especially Chinese demand), don't look for easing commodity prices.

Inflation expectations



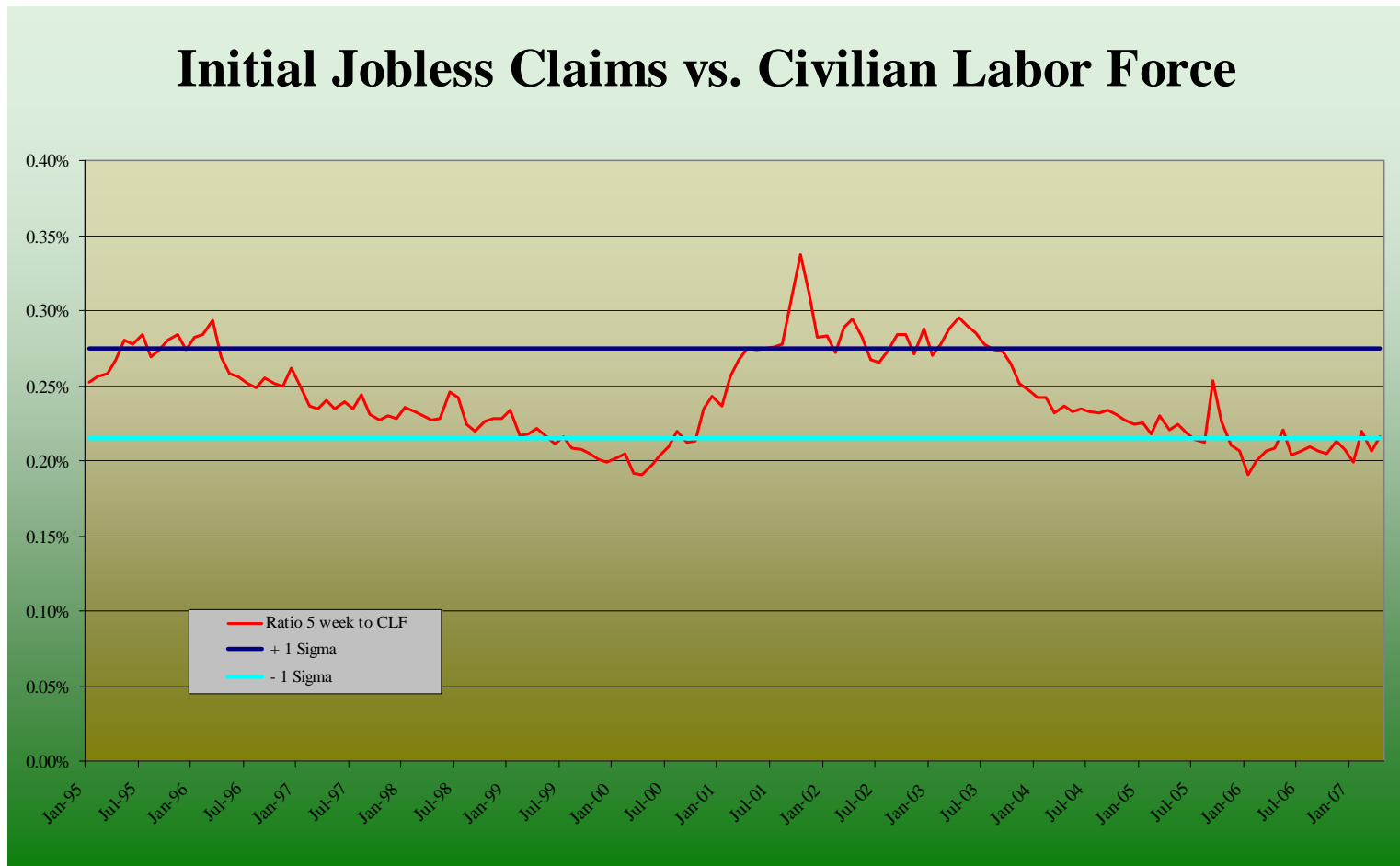
The composition of the CPI has not changed much at all over the past ten years. This chart demonstrates the percentage of each component in May of 1997.

Inflation expectations



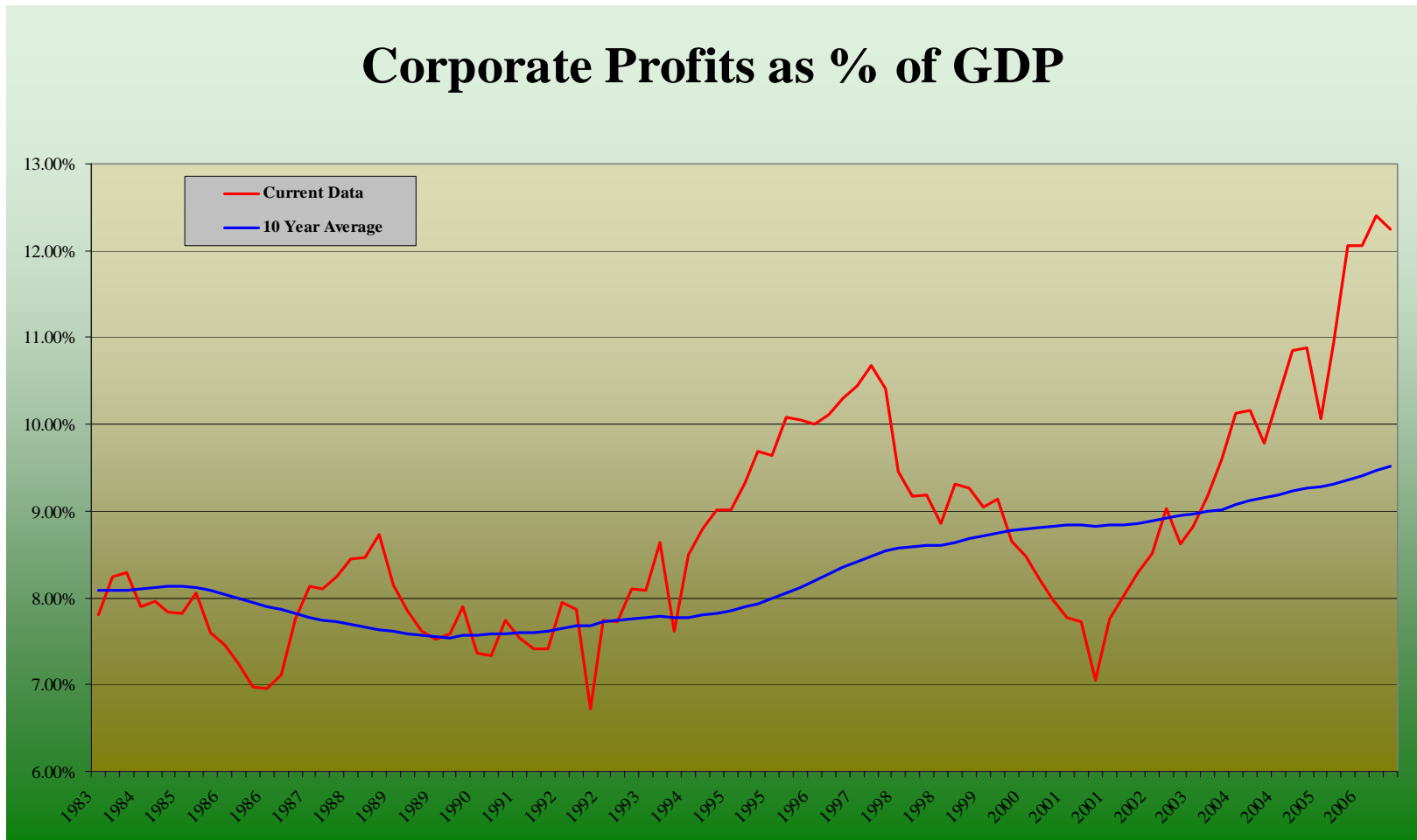
But, growth in some of its individual components has changed. CPI growth (on far right) over this period is contrasted with the growth in each component (where this data is available) and with the growth rate over the past twelve months.

Inflation expectations



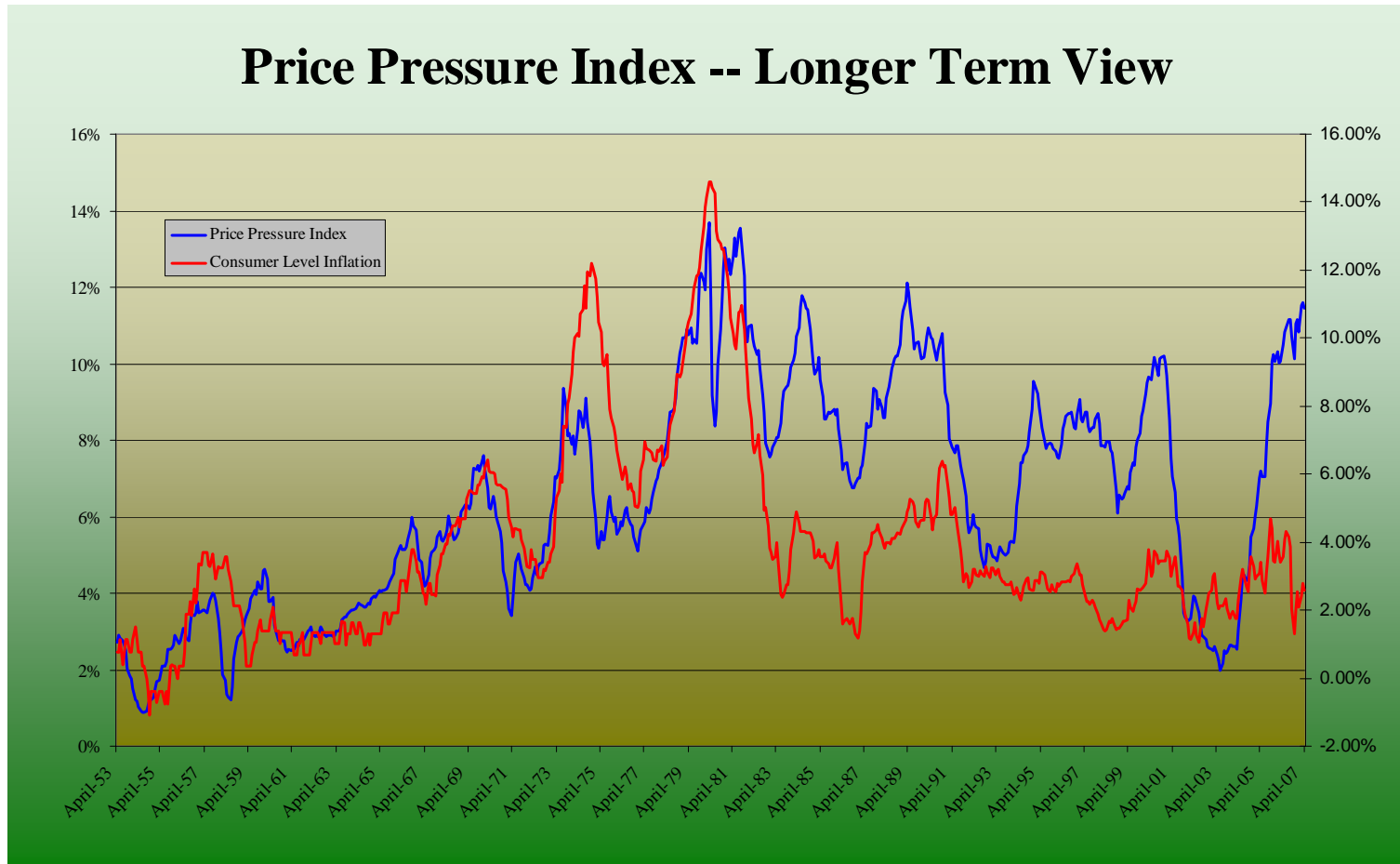
There continues to exist pressure on wages...

Inflation expectations



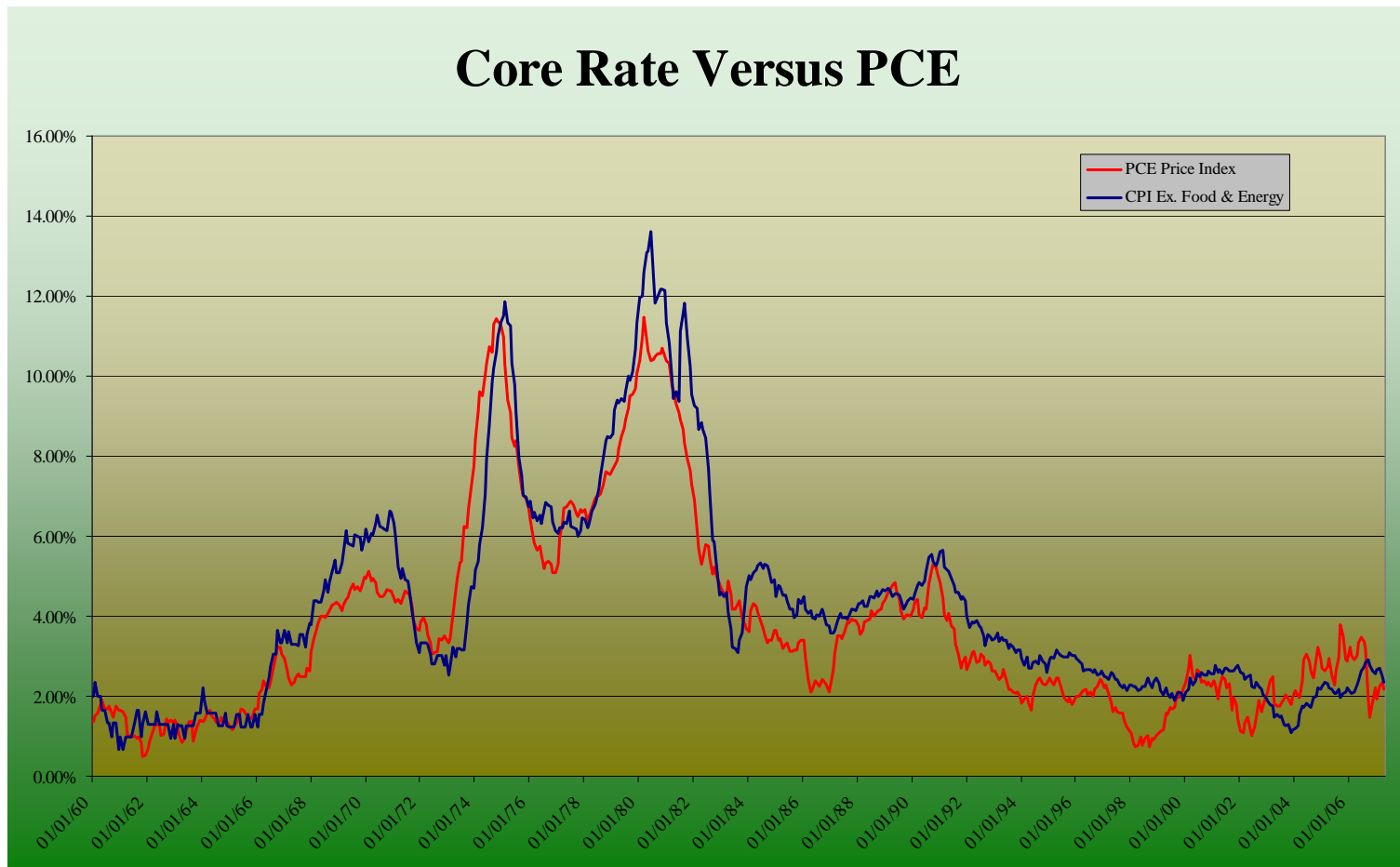
Corporate profits are a very high percentage of GDP (especially relative to past measures). Workers of the world, unite?

Inflation expectations



Our proprietary Price Pressure Index anticipates higher inflation based partially on this information.

Inflation expectations



But, traditional metrics do not seem to be capturing this, nor are they anticipating it given the TIPS spread of 2.36% (an expectations-based model for ten year inflation).

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Even though the earnings for the S & P 500 have been very strong, we are not experiencing a multiple expansion (higher PE ratios for the index). This, during a period of reasonably low inflation. Perhaps the market is estimating that inflation is higher than the reported numbers.

Federal Reserve Watch

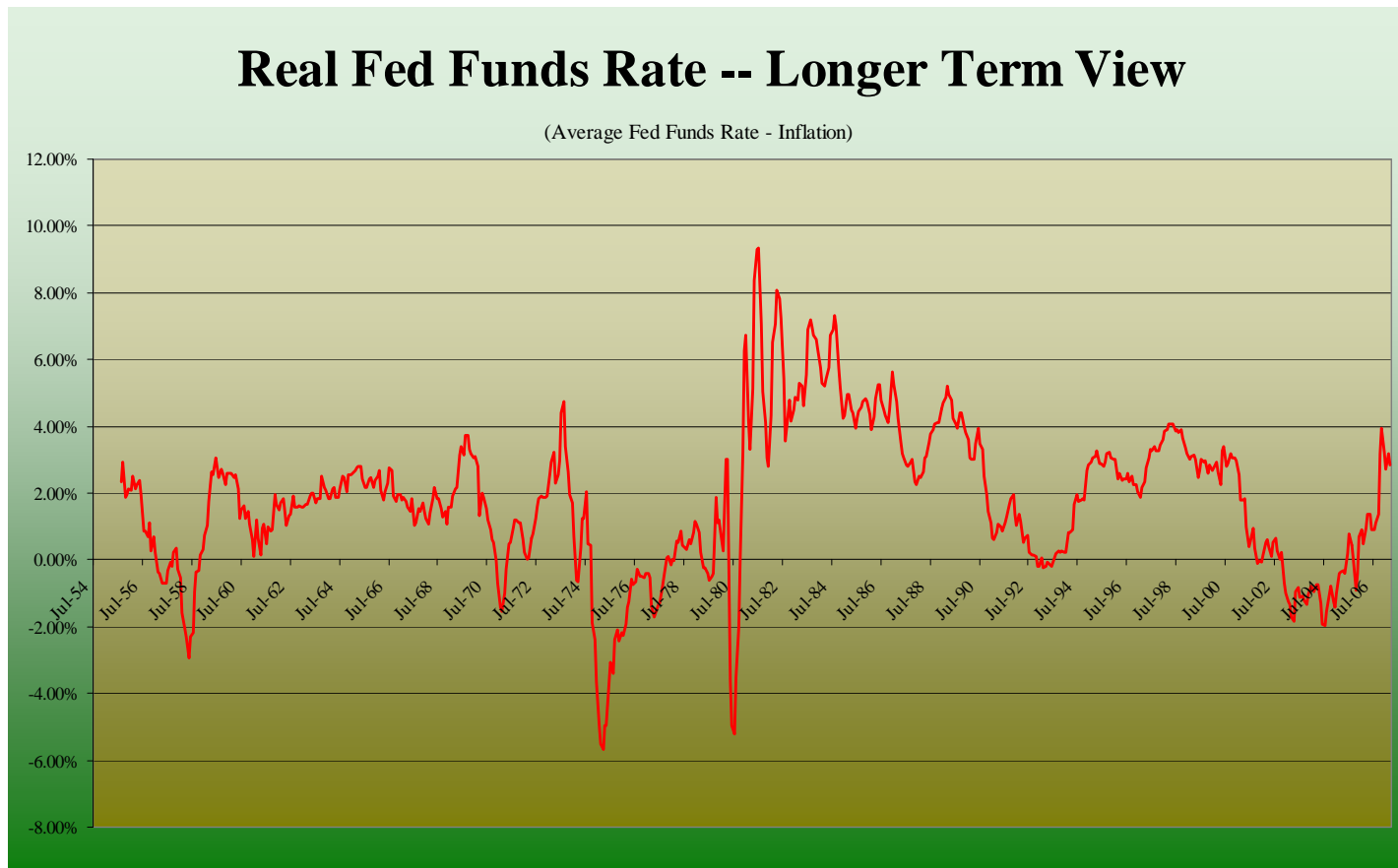
If our theory is true about inflation being higher than the numbers presented, then there is not as much real yield in interest rates as indicated.

But, that isn't the reason that our trading partners continue to buy the US government's debt... it's because they need for us to continue consuming their goods. By purchasing our debt, they keep our interest rates low enough so that we continue to buy their goods. How this ends could be ugly for everyone...

The near-term growth in the money supply seems inconsistent with what we had believed was a prudent approach to reducing the amount of liquidity in our economy.

We still wouldn't look for interest rate cuts anytime soon...

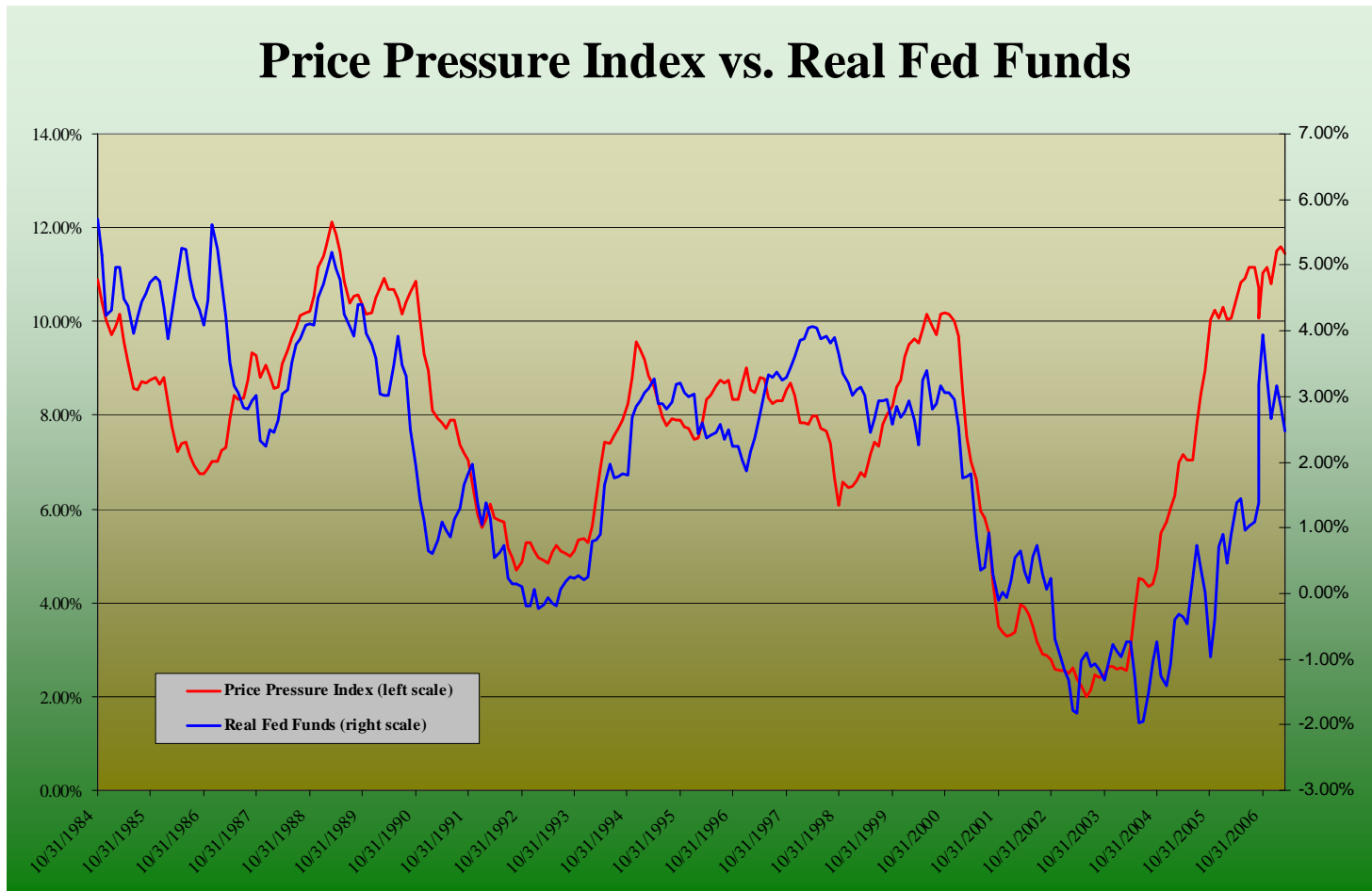
Federal Reserve Watch



Sure, there's yield in short-term rates now. But, if there is a "stealth" inflation not counted by the official numbers, is there as much yield as there appears to be?

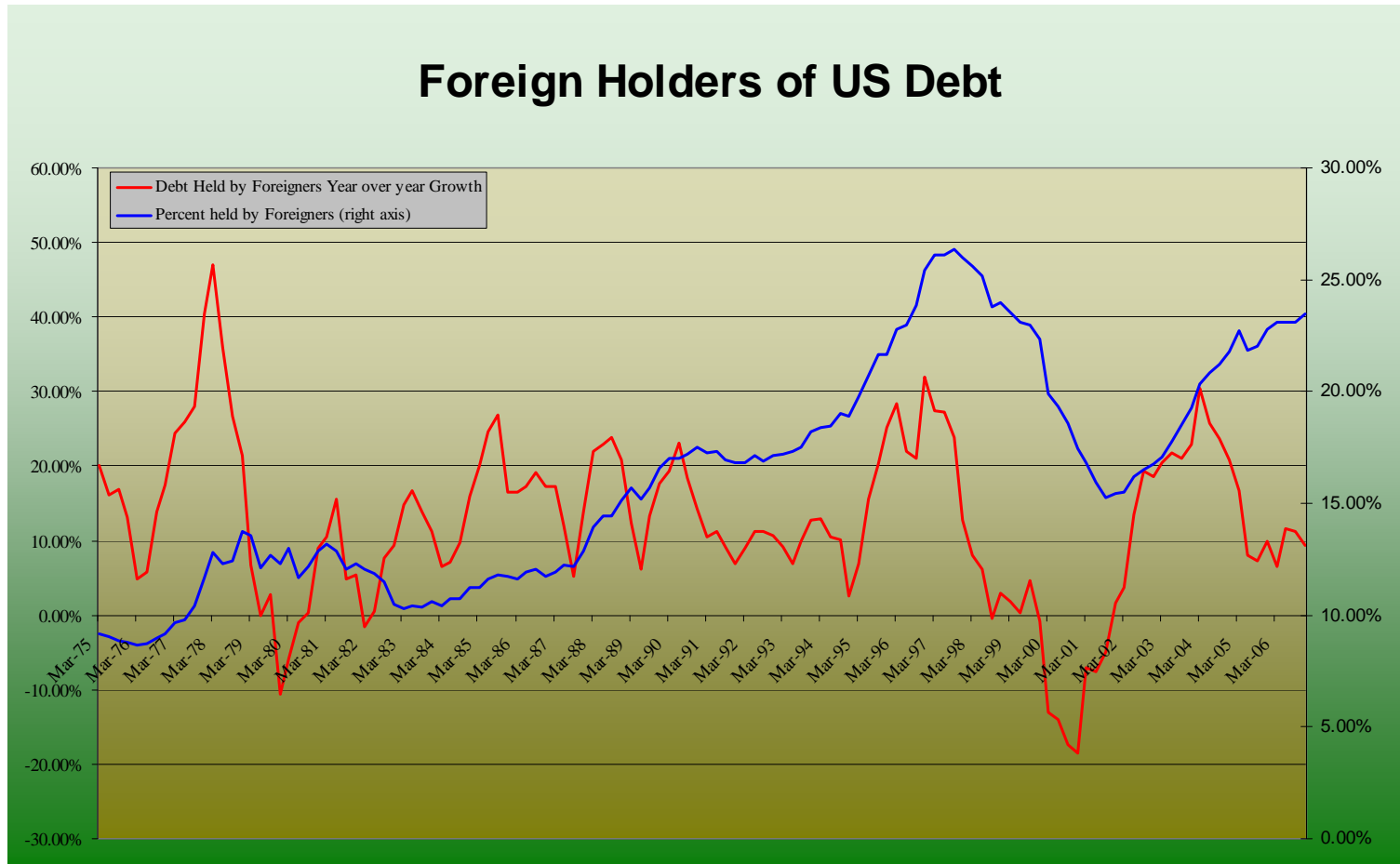
We've seen that purchasing power for assets has declined as their prices have increased. That may tell the real story...

Federal Reserve Watch



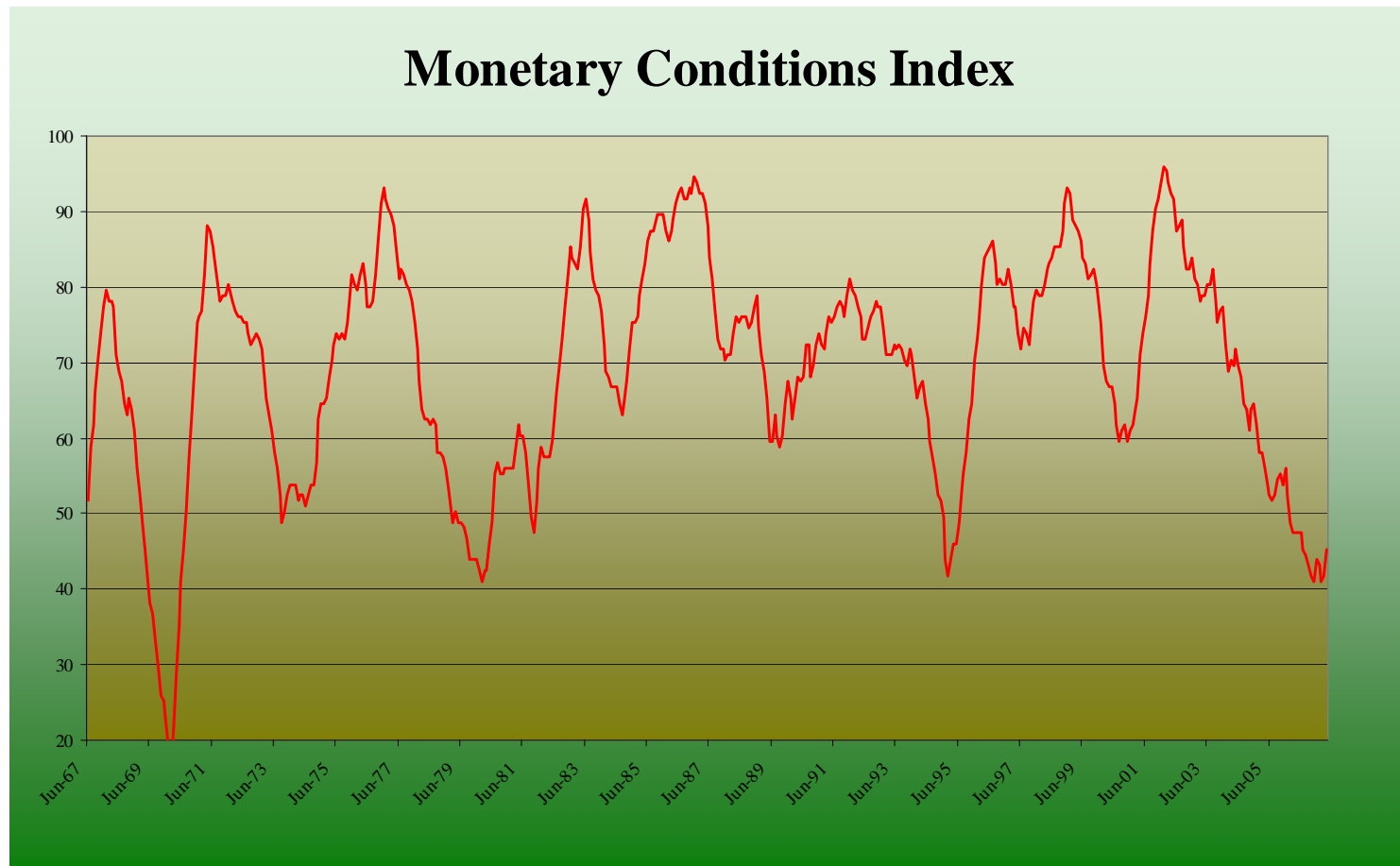
The increase in interest rates and real Fed funds has brought this relationship back into parity.

Federal Reserve Watch



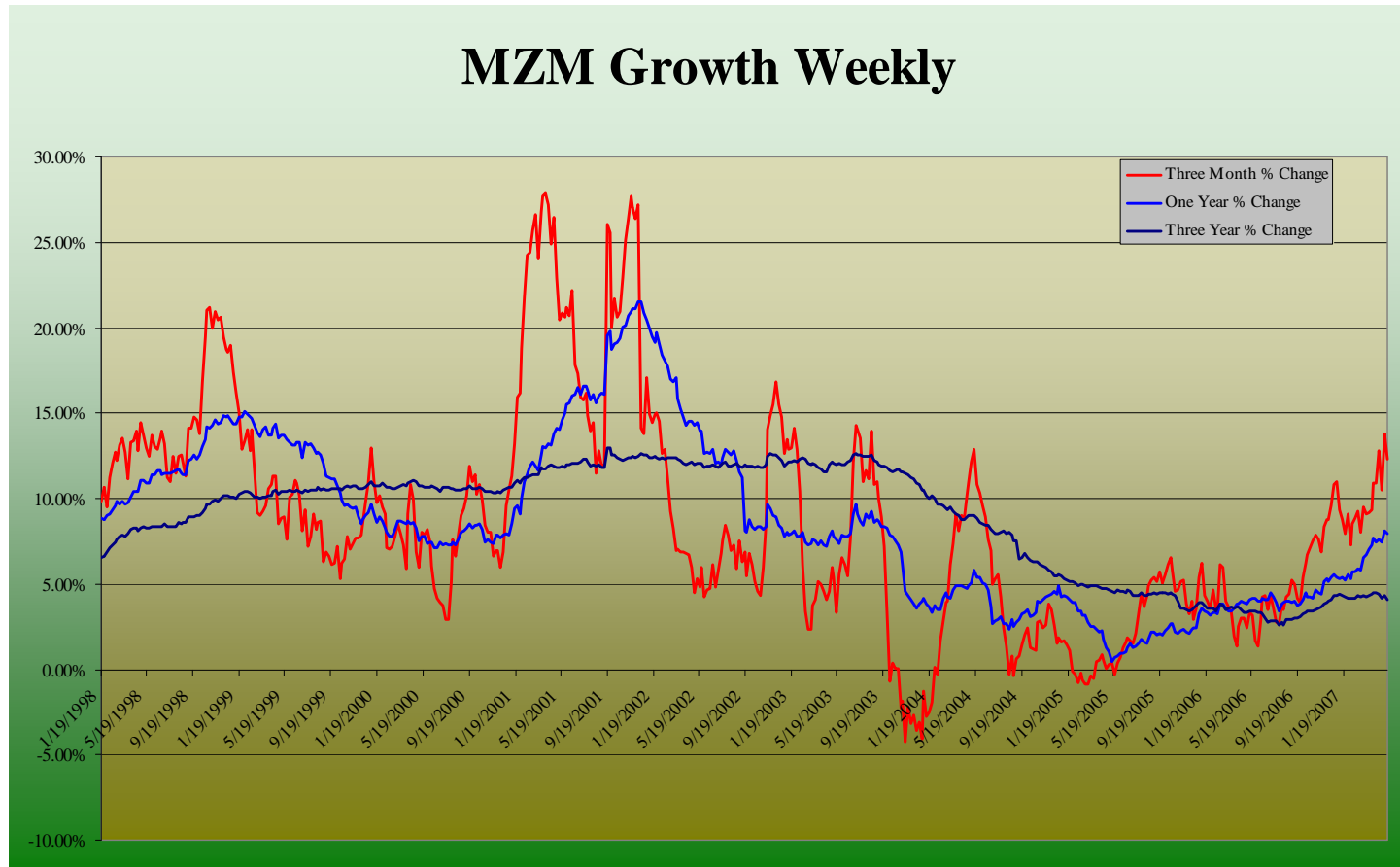
There is a symbiotic relationship between the US and the nations who produce the goods we consume. That means China can't choose to not buy US Treasuries without inflicting harm upon themselves. But, I would prefer longer-term rates being low through another means.

Federal Reserve Watch



Has this measure bottomed? The decline in the monetary conditions index was one of the primary reasons we thought the excess liquidity was being removed.

Federal Reserve Watch



Why the short-term growth? It seemed as though the Fed was working through excess liquidity not too long ago; now, they're creating it?

Outlook & Forecast

(as of 5/31/07)

Index	Current	Forecast	Range	Time Frame	Comments
S&P 500	1530.62	Trading range	1400 -1500	9 Months	About 10% over-valued?
Ten Year Treasury	4.75%	Trading range	4.6 – 4.85%	10-12 Months	An unanticipated shock here could be damaging, but is not outside possibility.
Inflation (all Urban)	2.59%	2.75%	2.35 – 2.95%	10-12 months	We don't think these accurately reflect costs.
Fed Funds	5.25%	No change	5.25%	12 months	Don't look for lower rates.
S&P 500 Earnings	\$80.46	\$85	\$83. 50 - \$92.50	End of 2007	Not forecasting an earnings decline, but earnings growth will slow.

We are not anticipating a tremendous amount of upside in US markets in the coming three years. The trend for the past period has been gently positive with minimal downside risk. Given some of the economic clouds we see on the horizon, that isn't sustainable.

Our client portfolios are positioned accordingly with an emphasis on non-dollar assets and away from asset classes with out-sized three to five year returns.