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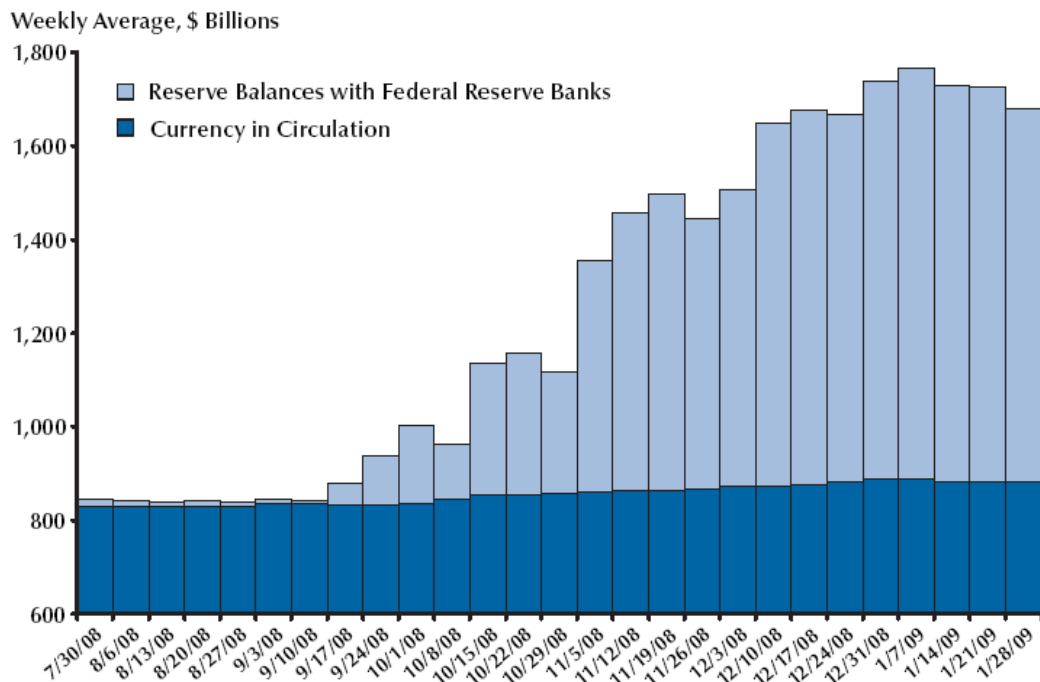
Is Inflation in Our Future?

Many of our clients are concerned by the recent actions taken by the Federal Reserve and Congress. The debt incurred by various “bailout” plans and the expansion of the Federal Reserve balance sheet are the biggest of these concerns. Many commentators have pointed to these two aspects of government action as clear evidence that the Federal Reserve is expanding the money supply so that high inflation or even hyperinflation is inevitable in the next few years. Let us look at these two aspects of policy separately and then compare the high inflation/hyperinflation scenario with what the markets and the economy are currently telling us today.

Expansion of the Federal Reserve Balance Sheet

Many of you have probably seen a graph that may look like this:

Monetary Base



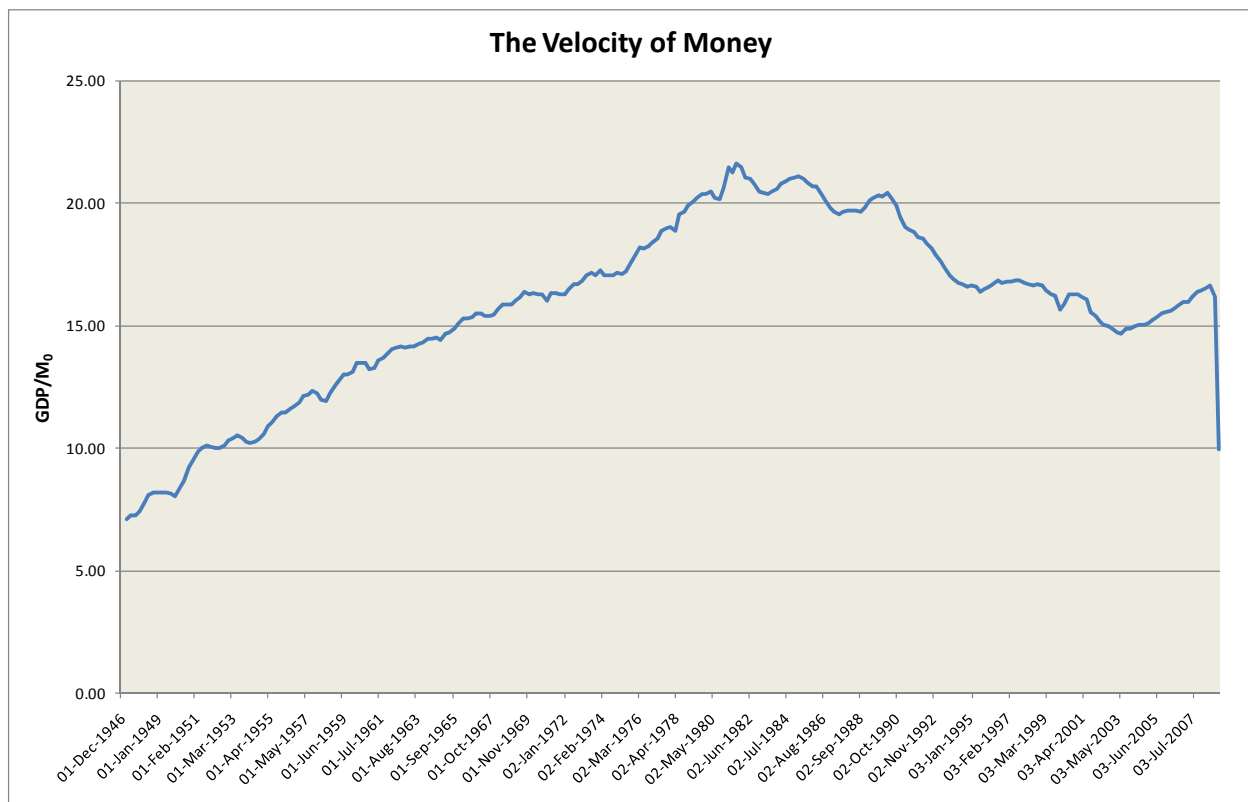
Source: Federal Reserve of St. Louis



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Without some context, the graph on the previous page looks very ominous. What it indicates is that the Federal Reserve is buying assets beyond the short-term Treasuries that it normally uses to control monetary policy and thereby influence interest rates. In other words, the Federal Reserve is injecting huge amounts of cash into the financial system. Under normal conditions, such an injection of cash would be quickly loaned out by banks, thus creating easy credit that would drive up asset and consumer prices resulting in inflation. **But we are not in a normal environment.** Most of the money that the Federal Reserve has injected into the system is not going anywhere or is offsetting the loss of credit in the money market and other capital markets. In fact, the chart below highlights that today's problem is one of deflation, not inflation.



Source: Factset

The Velocity of Money chart plots the velocity of money from 1946 through the end of 2008. The velocity of money is defined as the gross domestic product (GDP) divided by the size of the monetary base (in this case we are using the M₀—called “M-zero”—to measure this base). **The velocity of**



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money shows the rate at which the monetary base (e.g. money supply) is turned over in the course of a year. It indirectly measures the degree to which borrowers are willing to borrow and/or lenders are willing to lend. As you can see by looking at the chart, recent events have caused a severe drop in the willingness of creditors to lend money. This is why the Federal Reserve is increasing its balance sheet. The total credit available in the economy depends on both the size of the monetary base and the degree of velocity. Because velocity has dropped nearly 40%, the economy is in danger of being starved of the credit that is required for growth. To compensate for this, the Federal Reserve is expanding the monetary base to offset the decline in velocity. This should begin to limit the damage of the credit crisis and ultimately spur an economic recovery.

More specifically, the Federal Reserve is expanding its balance sheet to offset a precipitous decline in credit. In doing so, the Federal Reserve is now lending money in place of the institutions formerly known as investment banks, as well as in place of an impaired banking system. Without credit, the economy would contract sharply and potentially severe *deflation* would result. The Treasury's recently announced "bailout" program is an attempt to repair the banks so they can start lending and take the onus off of the Federal Reserve.

What happens if velocity increases suddenly? This *would* be inflationary. But there are several reasons why this is not likely to happen today. First, many banks are in poor shape. Whatever cash they receive they simply keep as reserves against losses that they are experiencing or that they could experience if asset prices continue to fall. Second, banks do not want to have any more losses than they have already absorbed, so they are raising their credit standards. Third, even qualified buyers may not want to borrow for several reasons: (1) they fear job loss, or (2) they want to wait to see if prices will go lower before they borrow.

Eventually, the velocity of money will recover. We believe that this will be a slow process as there is too much bad debt that must be worked off. This deleveraging process will take time, probably several years. As this happens, the Federal Reserve will gradually sell its assets (e.g. exchanging paper for cash) to reduce the monetary base. Even without action, most of these assets will naturally "roll off" the balance sheet as they reach maturity (in fact, this is why the monetary base fell during January when commercial paper matured). During the economic recovery, there is the potential for some inflation because the Federal Reserve would rather deal with some inflation than deal with deflation. However, a hyperinflation scenario, as far as we can see, is only a small possibility at this point.



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It is important to understand that what the Federal Reserve is currently doing is extending credit and not literally printing money. While people refer to quantitative easing and printing money synonymously, what is actually happening today is that the Federal Reserve is primarily extending credit into the banking system, where it in-turn is lent out to investors and borrowers, which in-turn increases the monetary base (e.g. money supply).

We live in an economy where trade is conducted with credit, and only a small fraction of business transactions are conducted with currency. Companies borrow against future revenues to purchase inventory, pay salaries, and pay utilities, as well as use longer term borrowing to fund expansion. Unlike the German hyperinflation of the 1920's, where the physical currency was literally printed, the credit that the Federal Reserve is creating today can be withdrawn at anytime. **When currency is literally printed, it is nearly impossible to withdraw from the system; therefore, hyperinflation would be inevitable. In our current system, the Federal Reserve is not literally printing money; it is extending credit which can eventually be withdrawn. However, if at some point the Federal Reserve does not reduce the money supply (e.g. reduce credit / raise interest rates) higher inflation would be the result.**

Some clients are concerned that Ben Bernanke is an inflationist that will live up to his name as "Helicopter Ben" (a name derived from a 2002 speech in which Chairman Bernanke referred to a statement by Milton Friedman that dollars could be thrown from a helicopter to induce consumer spending). We generally support Chairman Bernanke's actions thus far. There are few economists that have a stronger understanding of the dangers of deflation than he does. He has studied the Great Depression academically and has practical experience as a Fed governor prior to ascending to the Chairman position. We believe that he has properly diagnosed the deflationary forces that beset the economy today and has taken bold and appropriate actions while being forthright in explaining the reason for each action.

The Federal Budget Deficit

The second concern is the immense Federal deficit that has been created by various "bailout" plans. First, it is important to understand that deficits—in and of themselves—do not create inflation. We have experienced many periods in history where we ran huge deficits and still experienced mild inflation (like in the mid to late 1980's) and even deflation (like the 1930's). Deficits create price inflation if the debt is used to create inefficiencies in the economy, but they can be beneficial if used to increase the productivity of the economy.



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So what will be the effect of the current deficit on the productivity of the economy? Unfortunately, this is hard to say because the financial bailouts and stimulus packages are a mix of different types of spending. Money that is being used to buy assets, and which can be resold into the market at future prices, will not likely be inflationary. An example of this would be the government's purchase of "toxic assets" and investments in financial institutions. However, spending that tends to increase the cost of doing business or to lower the productivity of capital can be inflationary. Given the tendency of Congress to generate unintended consequences in its spending, this deficit spending has the potential to be inflationary over the long-term. The extent of the inflation depends on how much the Federal Reserve is willing to "monetize" the debt by continuing to expand the money supply as the economy recovers.

The alternative is that the Federal Reserve will not monetize the debt, thus raising interest rates. We believe this is the most likely outcome, as the Fed does not wish to ignite excessive inflation. However, some of the debt may be bought by foreign buyers (like China and the Middle East kingdoms) because the dollar is the world's reserve currency and is without credible alternatives. Foreign purchases of US debt will tend to push down interest rates, and possibly create further asset bubbles (foreign purchases of US assets are not inflationary because they strengthen the value of the US dollar). If the Federal Reserve continues to manage multiple asset classes in addition to short-term US Treasuries, they will begin to regain control over the yield curve and have the power to prevent major asset bubbles from emerging into the future.

It is important to note that the US Government debt was at a fairly reasonable level before this economic crisis began and was considerably lower than the level of debt experienced by many industrialized economies. For example, according to the US Treasury Department, in 2007 the US debt to GDP was 63%, whereas Japan's debt to GDP was 170%. Also worth noting is that after World War II (1945) the US debt to GDP was 113%, almost double today's level. Given that the costs of servicing the debt are currently very low (though likely to rise in the future), a temporary expansion of debt is not likely to have an onerous impact on future economic growth. If, however, a large deficit continues indefinitely, then the economic result will be higher interest rates accompanied by higher unemployment, higher taxes, inflation and/or stagnant economic growth (e.g. stagflation).

Current Market and Economic Conditions

What are the markets and the economy telling us today? They are telling us we are not facing high inflation or hyperinflation anytime soon. Here are some of the key indicators that support this statement:



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- **The stock market responded to the announcement of the latest Treasury and Federal Reserve actions by staging a strong rally.** If high inflation or hyperinflation was anticipated, the market would have plunged because high inflation is the worst possible thing for stocks.
- **Commodities prices are—in general—still below long-term trend lines.** Despite the aggressive expansion of the Federal Reserve's balance sheet, gold and other commodities remain below their peak levels of March 2008. This indicates that despite the expansion of the money supply, the demand for money has kept prices in check. Gold appreciation is often cited as clear evidence of future inflation, but gold prices have actually been a poor predictor of this. When fundamental demand is excluded, gold is a better barometer of investor fear and panic (often a harbinger of stock rallies) than of inflation.
- **House prices continue to decline.** The decline of housing prices is deflationary, not inflationary, as it impairs mortgages and cripples lending.
- **Inflation causes individuals and businesses to increase their debt load and unload cash.** The reverse is happening today as individuals and businesses try to raise cash and reduce debt.
- **Demand for most products and services is declining.** Without an increase in demand, most businesses do not have the ability to raise prices. Furthermore, those that are healthy are seeing a drop in many of their input costs while many of their weaker competitors may be going bankrupt. Therefore, they have no need to raise prices. In fact, companies may have to lower prices to spark demand or to match discounts offered by unprofitable businesses that are selling at low prices to generate cash flow.
- **Workers are in a poor bargaining position.** Many unions have made huge wage and benefit concessions to prop up companies that are facing possible bankruptcy. Non-union labor can be outsourced at lower wages, so labor costs are unlikely to rise soon and may even drop. Workers overall are reluctant to demand higher wages while unemployment is increasing.
- **Globalization is still a factor in prices.** Producers of goods can still move production offshore to lower costs and increase profits—without raising prices. As exporting countries suffer from the drop in US demand, they are more likely to continue to produce goods to maintain employment, as well as drop prices to generate as much cash flow as possible.



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- **Capacity utilization has dropped to 70.9% in February.** Some industries are operating at only 20-30% of capacity. Levels of utilization are now at the lowest level since the 1930's. Manufacturers are under pressure to lower prices to fuel demand and keep plants operating. In this environment, raising prices is nearly impossible. Historically, inflation has not been a problem until capacity utilization exceeds 83%.
- **Rally in the US dollar.** According to the Federal Reserve, the US dollar has rallied from its lows in early 2008 and is now up approximately 24% versus other major currencies. More specifically, from the 2008 lows, the dollar has increased approximately 18% against the euro, 43% against the British pound, and 15% versus the Japanese yen. Since currencies tend to decline in value when future inflation is expected, this suggests currency traders do not see significant inflation in the near-term.
- **Overall, an uptick in inflation would require an economic recovery.** Although there is the possibility of above-average inflation as this recovery progresses, it is unlikely that it will create an upward price spiral. The Fed could drive up rates to reduce inflation (or raise bank reserve requirements) so that a 1970's inflation scenario is avoidable.

While predicting the future in these uncertain times is challenging, we believe that the most probable outcome is an uptick of inflation as the economy recovers, which will moderate as the Federal Reserve unwinds its balance sheet. We believe, however, that economic growth will be sluggish (after a possible bounce resulting from depleted inventory levels being rebuilt) and that unemployment will be stubbornly high. We believe that the likelihood of high inflation (greater than 10% price increases) is low, though dependent on Federal Reserve behavior. We also believe that there is a chance of a “double-dip” recession if the Federal Reserve moves too quickly to unwind its balance sheet.

While we do not see any problems with inflation over the next several years, we will continue to monitor the factors we believe will signal future inflation. In addition, we have already begun analyzing industries and companies that would be the beneficiaries of inflation should the Federal Reserve not reduce the money supply as the economy recovers.



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Below are some of the sign posts we are monitoring that will alert us to future inflation.

Changes in:

1. The value of the U.S. dollar
2. Bond yields
3. The velocity of money
4. Factory utilization
5. Protectionism
6. Unemployment (the higher the rate the lower the rate of inflation)
7. Commodity prices (especially oil)
8. Real estate prices (both residential and commercial)

At the present time, none of these factors are signaling any signs of inflationary pressure. Rather, today's battle is with deflation. Therefore, while there are many concerns about the economy today, inflation is not going to be a problem in the foreseeable future.

Sincerely,

The Century Management Team



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