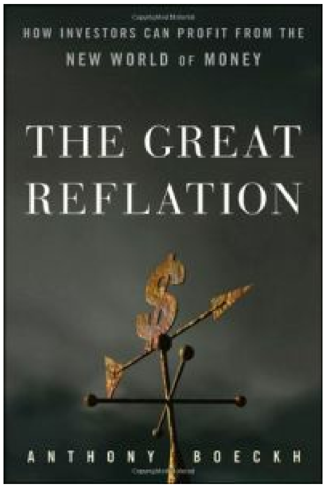

Book The Great Reflation

How Investors Can Profit From the New World of Money

Anthony Boeckh
Wiley, 2010
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Recommendation

You don't expect to find snippets of Goethe's poetry or Taoist philosophy in a book on personal investing. Financial editor Anthony Boeckh brings his 40 years of market experience, as well as insights from the wisdom of the ages, to bear as he explains how to prepare for potential unprecedented economic shocks over the next several years. The billions the U.S. government is spending to prop up the economy will have consequences – intended or not – that will force investors to manage their portfolios more actively. Boeckh offers a historical perspective on current events. He identifies market and political signals to heed, discusses what they might portend and suggests ways to position your money appropriately. *BooksInShort* recommends his commonsense approach to investors who are trying to make sense of what the economic upheaval means for their fiscal futures. Seek the harmony of the Tao as you flow with the financial changes to come.

Take-Aways

- Imminent financial collapse led the U.S government to pump billions of dollars into the economy with bailouts, stimulus spending and tax credits.
- This "Great Reflation" halted the meltdown, but its long-term effects are unknown.
- The danger is that the Great Reflation will turn into a "Great Inflation."
- Too much credit and money create inflation, which leads to crises and crashes.
- Growing federal deficits resulted from the dollar's delinking from gold in 1971.
- The uncertainty over the Great Reflation means that you should manage your investments with a new perspective.
- Equities, particularly of small firms, should offer good returns in the next few years.
- Gold's perceived value as insurance against financial collapse makes it popular for hedging against inflation.
- While volatile, commodities are compelling in the short term due to the dollar's weakness, increasing demand and the diversity of available investments.
- From now on, your home will have value as your shelter, not as a cash machine.

Summary

"Financial Instability"

The U.S. government's unprecedented response to the Great Recession of 2008-2009 – putting hundreds of billions of dollars into bailouts, stimulus spending and tax credits – succeeded in averting another Great Depression. However, questions remain about the effects of such massive spending on the American economy's long-term prospects. All the money sloshing around in the system bodes ill, because it could create inflation and because it evokes the bubbles of the past few decades. Excess money led to the tech boom, the increase in home prices, the rise of derivatives and the growth in commodity costs.

"The U.S. government has thrown an avalanche of new money into the economy and the financial system. This is the Great Reflation."

Though America's government has proven that it can halt a self-reinforcing meltdown by throwing money at the problem, it hasn't been able to ensure a steady, progressive economy. Clearly, the "Great Reflation" means eventual instability, since huge public and private debt, a shaky world economy and a suspect dollar all point to possible disaster. Only wise and, perhaps, painful economic and political decisions in the next few years can place the U.S. on a more stable path. As an investor during and beyond this time horizon, you must closely monitor certain signals that can indicate investment decisions you should make to preserve your capital.

Inflation

In the modern era, whenever a nation delinked its currency from some measurable asset, usually gold, inflation inevitably followed. Having a backed currency prevents governments from freely printing money – a temptation no politician can resist – and, thus, curtails deficit spending and excess available credit. Throughout history, governments from time to time issued "fiat money" – money not tied to any standard – mostly to finance wars, only to return to anchored money when the wars ended. But when the nations that fought in World War I reverted to the gold standard, they erred by setting a price for gold that was too low to support postwar growth and stability. Central banks had to augment gold reserves with foreign currencies. Inflation, already in the system, blossomed into hyperinflation and into the bubbles that ended with the 1929 crash. By the '60s, the policy of tolerating some inflation to gain full employment led to rising gold prices and an eventually unsustainable dollar-gold peg. In 1971, the U.S. floated the dollar, now untethered to gold. For much of that decade, U.S. inflation raged. Since then, varying degrees of inflation have become a global economic fact of life.

"The Great Reflation, if left unchecked, will run into a brick wall in the next few years, and another credit implosion and deep recession will occur."

Any system run by fiat money is inherently flawed, but in a delicate environment, any move to change that system would be disastrous. The Great Reflation's goal is to encourage asset prices to increase, thus improving corporate and personal balance sheets. However, rising prices must not spiral out of control, because that would lead to significant inflation. Evidence of creeping asset inflation, like higher gold and commodity prices, is mounting. The Federal Reserve, a vigilant inflation fighter, must balance between tightening interest rates too early, which would derail any ongoing recovery, against not tightening soon enough, which would be inflationary.

"Experience with markets over a long period teaches humility."

Easy access to credit has left Americans with a debt hangover. Now they are trying to pay down their debts and reduce their spending, but the government, with its stimulus plans and tax credits, is trying to get people to borrow and spend again. Investors should note this tension: If consumers continue to hoard savings, the U.S. could live through a period of stagnation much like Japan's in the past 20 years. If, instead, U.S. consumers resume borrowing and spending, the stage is set for inflationary forces and, perhaps, even another series of bubbles in credit and asset prices.

"Investors can never hope to be successful without an understanding of what has happened before and why."

In effect, the U.S is converting private debt into public debt. This "balance sheet recession" has great implications for continued fiscal deficits. In such a recession, says economist Richard Koo, debtors use any liquidity they have to pay off debts, and creditors stop lending. As a result, the government must step in to keep the economy from gridlock, thus swelling deficits. Once such a crisis passes, opposition leaders historically use growing public fears about deficit spending to force policy makers to pull back before consumers totally deleverage themselves and undermine any incipient recovery. This occurred in the U.S. in 1937 and in Japan in 1997 and 2001.

"Taoist philosophy and markets are all about change, and the key to successful investing is the accurate anticipation of change."

The numbers are frightening. In 2009, the U.S. budget deficit was 10% of gross domestic product (GDP), up from the previous postwar high of 6.5% in 1975. Adding private debt, state and local government debt, and contingent liabilities (entitlements such as Social Security and Medicare, and guarantees to bailed-out industries and to such entities as Fannie Mae and Freddie Mac) debt could overtake GDP in a decade, nearing post-WWII levels of 115%-120%, although the NPV of all the entitlements are three times GDP. The government's ability to tax citizens has allowed it to make funding promises it cannot keep. Trust in the dollar could dissipate quickly, with repercussions that extend beyond U.S. borders. Additionally, growing deficit financing could siphon off capital ordinarily used to finance private ventures. Such "crowding out" would inhibit growth in private investment. The argument no longer holds that due to the dollar's reserve-currency status the U.S. can afford "deficits without tears."

"Preparing for the New Investment Environment"

No one can predict the fiscal future, but one thing seems sure: As the Great Reflation experiment plays out, change will become the new norm. Over the next few years, your chief goal as an investor should be "wealth preservation," which will require planning, judgment, persistence and caution. Resist following the crowd; the money the Great Reflation has injected into the system will spur booms in certain asset classes, but they are likely to be short and, thus, perilous.

"The irony of central banks buying gold and inflation hedges while creating lots of paper money...has not been lost on sharp-eyed observers of the financial scene."

Your investment planning challenges are to identify your financial goals, determine how much risk you are willing to tolerate and gauge how long an investing horizon you have. Liquidity is particularly vital for those who are investing for a shorter term. Make three judgments:

1. **"Which assets to hold"** – The basic categories of equities, bonds, currencies, gold, commodities and real estate each hold myriad possibilities for investment.
2. **"In what proportions"** – Your risk tolerance and time horizon will dictate how much of any type of asset you should hold.
3. **"When to change those proportions"** – Watch for signs, like changes in interest rates, that can indicate when the time has come to amend your strategy.

"Will America recover? The answer certainly is yes. The uncertainty is over how well, how quickly and how durable the recovery might be."

The discipline of proper asset allocation will be crucial in helping you select and protect your investments. Diversification is still a pivotal investing principle. Understand the possible correlations among your holdings. You don't want "all your eggs in one basket."

Equities

Almost every portfolio benefits from some exposure to good quality stocks. Properly selected equities will generate returns through value increases and dividends. Over 10-year spans, the stock market offers greater returns than bonds, at less risk. During the past 174 years, bear markets have averaged a 37% decrease, but bull markets have shown a 114% average increase. Use four tools to decide when and how to increase or decrease your exposure to equities:

1. **"Money, credit and liquidity"** – Focus on four leading, not lagging, market indicators: the yield curve, bank liquidity, corporate lending and bond rate differentials.
2. **"Valuation"** – A company's value comes from the money it makes, discounted to the present worth at an interest rate adjusted for risk.
3. **"Psychology"** – Behavioral finance posits that successful investors buck the crowd. Look for signs of an overheated market in the levels of margin debt that investors take on, how much cash they hold and how often the media report on the markets.
4. **"Statistical (technical) analysis"** – Statistical data about the market, such as the moving average of stock prices, can help you refine your decisions about timing buys and sells.

> "As the old saying goes, 'don't confuse a bull market with brains'."

Also evaluate the following assets:

- **Bonds –** If the Great Reflation turns into a "Great Inflation," bondholders will need to be very careful. Even though 30-year bonds lost more than "70% of their value" in the 1960s and 1970s, prudently chosen bonds can add solid income to your portfolio. Consider two factors before buying bonds. First, assess the bond's "tenor," that is, the length of time to its maturity. Second, look at the credit quality of the bond's issuer. Treasury securities provide risk-free, albeit low, returns; corporate and municipal bonds' returns depend on their risk ratings. Bond investors should monitor interest rate trends to determine if inflation is on the horizon. Treasury inflation-protected securities (TIPS) can, in some instances, provide a hedge against inflation.
- **The U.S. dollar** – Since its detachment from gold, the dollar has lost 80% of its "internal purchasing power," 97% of its value against gold and 75% of its value "against a basket of commodities." Debts that could approach 100% of GDP send shivers throughout the global economy, because the U.S. dollar is different from other currencies. Most internationally traded goods are priced in dollars, the globe's central banks maintain their reserves in dollars, and U.S. markets are large, liquid and reliably governed under the rule of law. The dollar is still the planet's reserve currency, and no contender is waiting in the wings to replace it. Pressure on the dollar will continue, but given that the U.S.'s currency is "too big to fail," the world will likely continue buying and holding dollars.
- **Gold** – Talk of inflation always circles back to gold, the ultimate inflation hedge; indeed, the price of gold reached $1,000 an ounce in late 2009. You can invest in gold via futures contracts, exchange-traded funds (ETFs) or mutual funds. Gold is a "hybrid" investment: Aside from its market price, it's portable, beautiful and eternal, and it is used in jewelry, industry and art. People trust in its inherent value, but for an investment, you'd do better with Treasuries. However, if you fear financial catastrophe, gold is as good as, well, gold.
- **Commodities** – Investors like these physical (not financial) assets because they tend to be negatively correlated to stocks and bonds. People consume commodities, such as oil, coffee, copper and pork bellies, so they must be replenished. In a world where the demand for resources is growing, the appeal of commodities investing is apparent. Index contracts, funds and ETFs let you share in the market without having to hold the physical product. Commodities, while volatile, present a compelling short-term case because of the dollar's weakness, increasing demand from developing nations and the sheer diversity of available commodities.
- **Real estate** – The adage is true: Most people's biggest investment is their home. At the height of the market in 2006, Americans owned $22 trillion in real estate, but only $9.5 trillion in stocks. That didn't last long. From 2006 to 2009, home prices dropped 32%. With many houses on the market, and the prospect that numerous aging people will have to sell their homes to pay for retirement, supply will grossly exceed demand for the foreseeable future. The only benefit of owning a home will be the roof over your head.

"Declining America"

Modern economic upheavals lifted the veil off the U.S.'s financial and political failures. While the Great Reflation short-circuited the immediate threat of financial meltdown, future trends don't look promising. Burgeoning public debt reduces the flexibility the U.S. has to address its problems. The aging population means that by 2050 workers will be taxed to support almost twice as many retirees as those in the system in 2009 (from 19% of the population to 35%). Manufacturing is now only 12% of the economy, just shy of half of its '60s role. America's renewal will lie in its ability to restructure its economy by focusing on the short term; investing in leading industries, such as technology and energy; and reducing its debt through judicious cost cutting and tax increases that do not inhibit growth. Amid this change, investors should consider equities, particularly of firms in commodity producing nations: Canada, Australia, New Zealand, Norway, Columbia and Brazil. In the U.S., small companies are likely to offer the best returns, particularly those working with cutting-edge alternative technologies.

About the Author

For 35 years, **Anthony Boeckh** chaired BCA Publications and edited "The Bank Credit Analyst." He co-manages Boeckh Investments, co-authors "The Boeckh Investment Letter" and co-wrote *The Stock Market and Inflation.*