# LEITH WHEELER INVESTMENT OUTLOOK

Fourth Quarter 2009

## Revisiting the 70's: Bell Bottoms, Disco and Inflation?

For many of us, the 1970's stir up some fond memories, but there are a number of fads from that era that we hope don't return to see the light of day. While bell bottom pants and disco are high on that list, our biggest hope is that inflation remains as extinct as a "disco duck."

History tells us that persistently high inflation is associated with a host of problems as incomes and profit margins are eroded by ever increasing costs, rising interest rates, and government deficits growing larger. As a result, central banks have worked to keep inflation in check at low levels. But it took a long time to reach these levels. The key question going forward is: Will there be a sustained rise in inflation that cannot or will not be reversed? We believe the answer is no.

Leith Wheeler is proud to once again be a corporate partner with the Playhouse Theatre Company. Our sponsorship of the production of "The Miracle Worker" kicks off the 09/10 season on October 10, 2009. www.vancouverplayhouse.com

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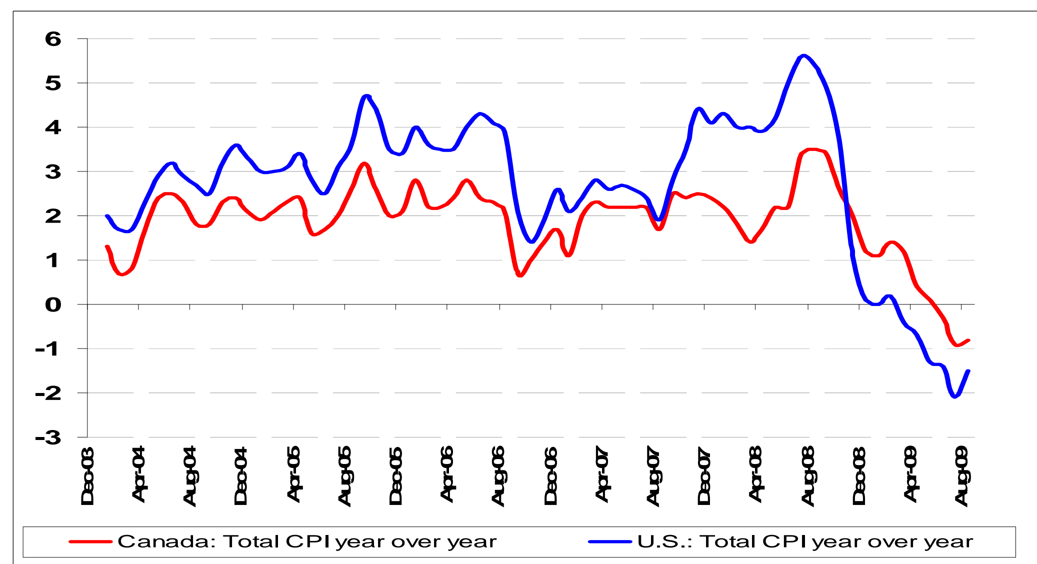
### Deflation (not Grease) is the word

Presently, the market is fixated on inflation risk. This may seem counter-intuitive since prices in Canada and the U.S. have been deflating on a year over year basis for a number of months as shown by the following chart.




In 2009 central banks have been telling us to heed the dangers of deflation. Deflation means declines in prices. Deflation is dangerous because it undermines debt financed assets. It can drive up the "real" cost of debt as the notional amount owed remains the same but the value of the equity in the asset declines. This makes it difficult for consumers to reduce their debt loads (or de-lever) and can result in panic sales of assets. Deflation is also a problem because it weakens the power of the central banks - when interest rates are near zero, central banks cannot use their strongest weapon (monetary policy) to stimulate the economy by cutting interest rates further as interest rates cannot be negative.

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There are a number of reasons why deflation remains a risk over the next year. Central banks chose to take dramatic action to avoid a sharp, painful deflation, so this may have spread the risk out over time. There is a large amount of unused capacity in the industrial sector and in the labour market. This means we have a lot of room to grow before an increase in demand for resources and labour results in higher prices and rising wages. In addition, consumer deleveraging will likely keep spending and demand for credit low.

Central bankers, while aware of these risks, have limited experience reversing deflation. We think the U.S. Federal Reserve will leave easy monetary conditions (i.e. low interest rates) in place long enough to avoid deflation.

## Inflation is likely "Stayin' Alive"

Media pundits are not focused on deflation but are in agreement that inflation will return. Massive increases in the money supply, programs to inject liquidity into banks, large government deficits, global trade protectionism, and a sharp economic recovery could, if not handled correctly, result in increasing inflation.

If inflation does rise, can central banks effectively manage it? Central banks have had success dealing with inflation in the past. As the worst of the economic and financial crisis moves behind us central banks have been communicating their exit strategies from the most stimulative financial conditions (i.e. lowest interest rates) in decades. So far the massive increase in the U.S. money supply has been offset by a dramatic fall in the velocity of money (how fast money circulates through the economy). If this changes, the Federal Reserve has been clear that they can take the punchbowl away quickly as most of the quantitative easing programs have preset expiry dates and there are tools in place to rapidly drain excess liquidity.

It is unlikely that Canada or the U.S. will "Do the Hustle" by inflating their way out of higher debts given the lessons learned from other countries that have tried it. First, this strategy usually results in a country's debt to GDP ratio rising due to ever increasing interest payments on its debt. Second, bond market vigilantes have reacted swiftly (read higher interest rates) when they saw a central bank waiting too long to remove easy monetary policy (i.e. increase interest rates) or when a fiscal situation was out of control. Finally, when a central bank has lost its inflation-fighting credibility this has increased the risk of a government's debt, keeping long term interest rates high for a long time.

## Should we dust off our platform shoes? Are the 70's back?

Are monetary conditions easing (i.e. low interest rates) in a way that should be a cause for concern? We don't believe that the central banks will easily give up their hard earned inflation fighting credentials. We are less confident that politicians will easily reverse their fiscal largesse, but are sure that the market will pressure them to keep things under control. Although inflation will reappear down the road, it is unlikely to be as high or as prolonged as it was back in the 70's.

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