So Where's All the Inflation? -

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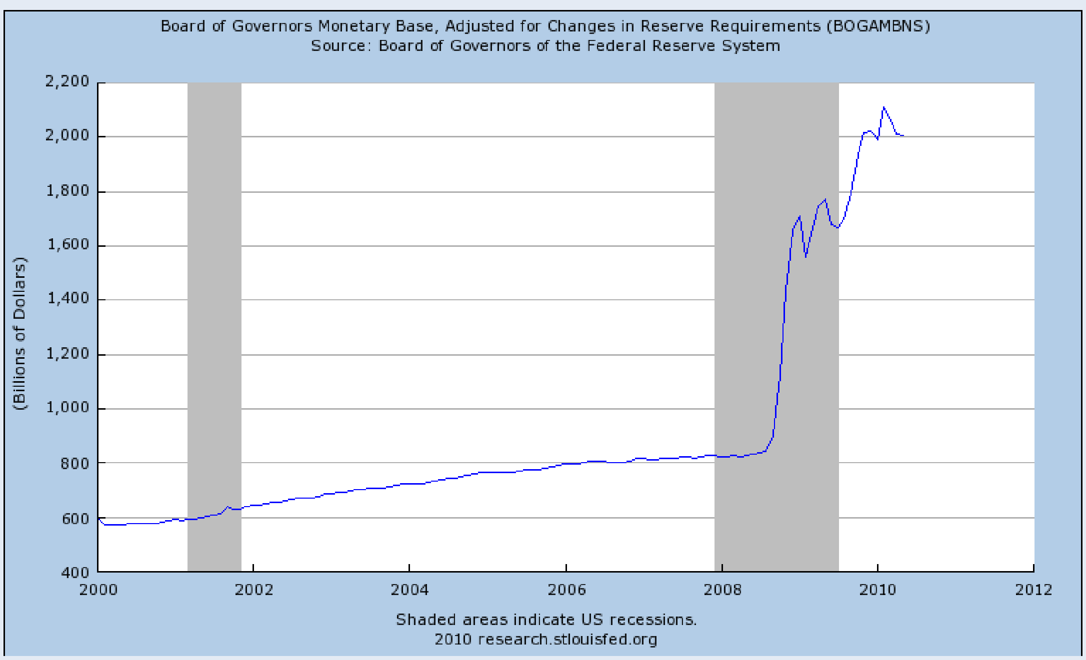
July, 2010 - A front page Wall Street Journal article recently announced that "U.S. inflation slid [in April] to its lowest levels in 44 years."[1] This is contrary to the usual reaction to easy monetary policy, which always creates inflationary pressures, eventually.

A closer scrutiny of Fed policy reveals that even as the monetary base has more than doubled since 2009, the actual M1 factor, defined as currency in circulation, has not increased likewise. This is because monetary easing has been directed almost solely to the mortgage industry. In short, the Fed's policy has been to simply buy bad mortgages from the banks when no one else wanted to, or could afford to.

The reason inflation is not yet apparent is simple. The following charts tell the story.

Step 1, Graph 1, the Fed creates money.



This is called the "Monetary Base," which, "in economics, is a term relating to (but not being equivalent to) the money supply, the amount of money in the economy. The monetary base is

[1] The Wall Street Journal, *Inflation at 44-Year Low*, May 20, 2010

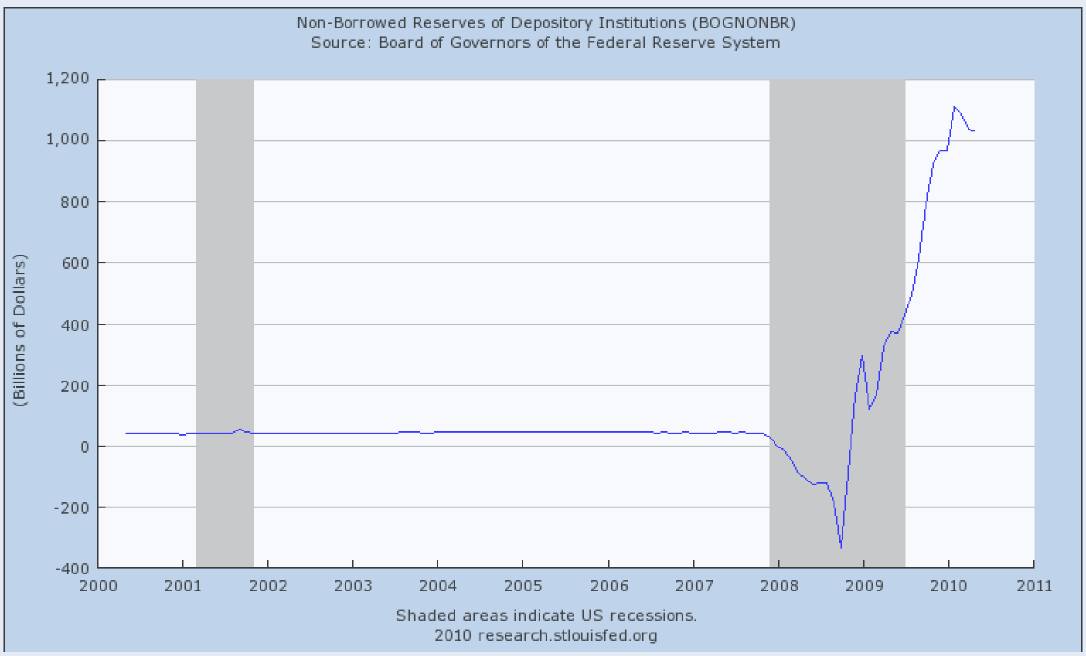
highly liquid money that consists of coins, paper money (both as bank vault cash and as currency circulating in the public), and commercial banks' reserves with the central bank."[2]

You can see from the above chart a nice gradual increase until late 2008, when the monetary base went from just over $800 Billion to eventually $2.1 trillion—an increase of over 250%. Where did that money come from? The answer: The Fed created it—electronically.

Such a substantial increase in the monetary base is significant because it represents the base amount which *can* then be multiplied many times as banks loan out money. This is called the money multiplier, or more notoriously, the Mandrake Mechanism.[3] Currently, banks can loan out 90 cents of every dollar they hold in reserves.[4]

As many would-be homebuyers can attest, however, banks do not seem to be loaning much money out. Rather, they are holding vast reserves as the following chart indicates.

Step 2, Graph 2, the Fed injects money into the banking system via reserves to commercial banks.



You can see from the chart above that "normal" bank reserves look to be less than $50 Billion; and then 2008 happened. Bank reserves went negative by almost $400 Billion, and then the Fed injected well over $1 trillion.

By the beginning of 2010, the monetary base had expanded to over $2 trillion, and bank reserve holdings to over $1 trillion. I would like to reiterate that a trillion dollars is a vast, vast sum—unfathomable to most people—1000 Billion dollars.

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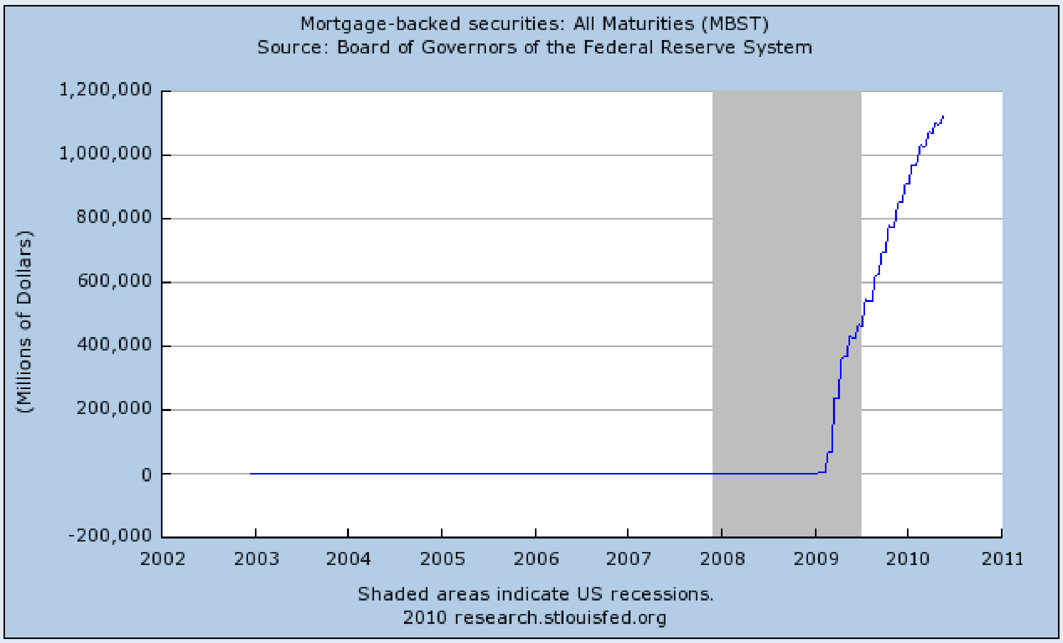
[2] Wikipedia® is a registered trademark of the Wikimedia Foundation, Inc., a non-profit organization.
[3] For a better understanding of the Mandrake Mechanism and the significance of fractional reserve banking, I strongly encourage you to read "The Creature from Jekyll Island" by G. Edward Griffin.
[4] Federal Reserve Bank of New York, *Fed Points, Reserve Requirements*, June 2010.

So, to recap what has happened: Millions of Americans bought houses they could not afford at interest rates that were historically low, and worst of all, temporary. When rates rose, so did payments. High risk borrowers with no equity simply walked away. Banks foreclosed. Bank income plummeted. Bank reserves shrank. Real estate values dropped. More homeowners found themselves owing more than their home's value. Many of them walked away too; the so called "strategic foreclosure." The banks needed money—lots of it. So, the Fed created over $1 trillion and put it at the disposal of the banks, where it sits today.

Step 3, Graph 3, commercial banks dump their non-performing or barely performing mortgages on the Fed.



The above chart wasn't even needed until 2009, when the Fed—for the first and only time in history—bought up all those mortgages that the banks didn't want. So all those empty houses are owned by the Fed, bought with money that was created, that would surely cause inflation if it were liquid and in the system, but is left dormant. So far, so good.

So where's the inflation? Simple: It's locked up in those empty houses.[5]

The big question is, "what happens next?" Sooner or later, somebody will buy that empty house and the mortgage will become a performing asset again. As the Fed is paid back, and the mortgages come off the books, what will happen to that money? Will it be reabsorbed—destroyed—sent back to whence it came? Or will it be released into the economy?

Most likely, it will be a combination of both. Very recently, the Fed has switched from a policy of money creation to a policy of money destruction. (You can actually track this exciting action by going to www.usdebtclock.org. Look for the "Money Creation" section on the lower left side of the screen.)

[5] I use the term "empty" to mean simply "non-paying," knowing full well that someone may be living there.

In addition, if you look at the first two charts herein, you will see a reduction of about $100 Billion from the previous high. This is all good news and indicates the Fed's willingness (and prudence) in reducing the monetary base.

Unfortunately, I seriously doubt all of the created money will be destroyed. Instead, I expect more of the usual Fed policy of monetizing the Federal debt. "Debt monetization" sounds so innocuous. What does it really mean?

To put it simply, debt monetization is when the Fed creates money to buy treasuries, which are loans to the government. Loans? This is like those "loans" one makes to one's children. Call it what you want to, this is the quintessential cause of inflation. But why is inflation so bad?

According to former long-time Federal Reserve Board Member Henry C. Wallich, "Inflation is a means by which the strong can more effectively exploit the weak. The strategically positioned and well-organized can gain at the expense of the unorganized and aged. Like burglary, inflation is an extralegal form of redistribution."[6]

The worst hit are aging Americans who live on fixed pensions and social security. As they get older, healthcare expenses become more burdensome, and generally all costs associated with mere living rise at a quicker pace than the meager social security cost-of-living-increase, which last year Congress temporarily suspended.

In addition, inflation attacks savers. In volatile times like these, conservative savers who fear losses in the stock markets hold their savings in cash alternatives like money markets and CDs. While cash sits there earning next to nothing, the cost of basic living needs continues to rise.

With time, the value of saving a dollar can become much less than the original dollar saved. If you find that confusing, that's exactly what central bankers and print-and-spend politicians are hoping for—and that's the way they like it. Thus it would seem we are tied to this destiny since no one in Congress (except Ron Paul) has the courage to take action to correct it. Indeed, most fail to even see the problem.

Unfortunately, there are only two responses to print and spend inflation: Make more money or spend less money (or both). Assuming one would like to preserve one's lifestyle, the only option is to make more money, since we don't have the Fed's privilege of printing our own. Thus, for those who are already retired, or, like most, don't have the powers needed to simply "earn more," the only remaining option is to take on risk through investments. And that's where we find ourselves: forced to invest in stocks and other conduits so as to at least "keep up with inflation."

There is an interesting juxtaposition, however, between inflation and the price of stocks. Simply, stock prices are also subject to inflation. Thus, as inflation reduces the purchasing power of your dollars, you will find that the price of shares of stock increases as all other factors remain equal. The historical price of almost any stock you research—save those who have filed bankruptcy—is invariably higher today than it was twenty plus years ago.

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[6] Henry C. Wallich, *The Cost of Freedom, Conservatives and Modern Capitalism, The Case For A Free Economy*, 1960.

This fact may seem somewhat comforting in the long term if one can avoid making mistakes in the short term. Again and again, the whipsaw effect scares investors out of the market when stocks plummet, locking in a loss. These worried investors want to wait until the market has "calmed down" before reentering—meaning that they will reinvest only after stock prices have risen to a level with which they are comfortable, foregoing any rebound and setting themselves up for another loss when the cycle inevitably comes round again.

The inflation of stock prices is neither a real fix nor a permanent solution. Rather, it encourages, as Greenspan once remarked, "irrational exuberance" and misallocation of capital which eventually leads to another correction—another bust. Keynesian economists call this the "business cycle," but the Austrian School of Economics, to which I firmly subscribe, calls it the "boom-bust cycle."[7]

Thus, after a degree (large or small) of monetary easing and loose money, leveraging and expansion, the economy goes through a boom. Sometime thereafter, usually four to seven years later, a contraction begins as the smart money pulls out. Then, the bust occurs, and the common investor on the street is left holding the bag and wondering what just happened. We've seen this again and again without exception.

So why is inflation so bad? At least three reasons: It devalues the purchasing power of those with fixed incomes. It punishes conservative savers. It encourages poor investment choices and artificially inflates stock prices, which soon thereafter collapse along with the savings of the common investor.

So what can a common investor do? The answer is to be smart. Recognize it for what it is: a boom-bust cycle. Sell at the top of the boom, and buy at the bottom of the bust. Sounds easy, but it is nearly impossible to call the top or the bottom. A more realistic approach is to become ever more conservative as the boom continues, and more aggressive as the bust continues (within reason, of course).

You may note that this is exactly the opposite of what most investors do. Even now, with the average stock market more than 40% off its high, more than $2.8 trillion is sitting on the sidelines in the form of money market funds.[8] Apparently, these worried investors are waiting for the markets to "settle down" again—which is to say they will buy in after prices have sufficiently risen.

Another world wide market crash is, of course, possible, but the fundamental cyclical nature of the boom-bust cycle—or business cycle—will ultimately recur until there is at long last a complete loss of confidence in and abandonment of central banking as we know it. Are we there yet? I would venture to say "not yet," but we are drawing ever nearer. Already the Fed and other central banks around the world have set their rates as low as possible to address the crisis—the equivalent of firing all your bullets—and yet as I write this the Dow Jones Industrial Average is under 10,000.

The lesson one must take from this is twofold: When investing during a boom cycle, take a balanced approach. When investing during a bust cycle, stay invested. Higher prices suggest

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[7] The Austrian School of Economics is represented here in the United States by the Ludwig von Mises Institute, located, of all places, in Auburn, Alabama. See www.Mises.org for more information.
[8] Associated Press. *Money fund assets rose to $2.817T in latest week*. June 29, 2010

that the price will move lower; lower prices suggest the movement will be higher. As basic as this sounds, it's a useful rule of thumb.

In the interim—as I have been saying for three years now—expect more volatility and uncertainty. As I outlined in my last letter, we have not seen the end of this European debt crisis nor have we begun to deal with the Iranian situation in any serious way. These are coming, so don't be surprised to hear more bad news. As usual, bad news sells better.

We also are well aware that unemployment is a serious problem, but it is a lagging indicator and as such will be one of the last problems corrected. Initial, leading indicators send mixed messages but overall indicate an expanding economy. In addition, government intervention, myriad new regulations and an encompassing air of uncertainty have done us no favors.

About J. Kevin Meaders

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through ING Financial Partners (member SIPC).

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