

Thoughts From The Frontline John Mauldin's Weekly E-Letter

The Slow Motion Recession Re-visited

by John Mauldin

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"We appear to be entering a period of serious stagflation with sharply rising expected and actual inflation combined with large downside risks to growth and employment."

"I would argue that what we are seeing is an acceleration of expected consumer price inflation in the context of a sharp expansion in global liquidity. It is hardly surprising that the prices of those commodities, such as oil, for which the short-run price elasticities of supply and demand are low move upwards strongly when there is a rise in expected general inflation. The oil market is a very convenient vehicle to speculate on expectations of higher levels of general price inflation. Hence my view is that the 40% jump in oil prices that has occurred over the past few months - roughly the period during which financial conditions have been loosened sharply - is a reflection of the expectation of either an acceleration of global inflation, or a depreciation of the US dollar, or some combination of the two."

- Malcolm D Knight, General Manager, Bank for International Settlements

It was only five years ago that the central bankers of the world, and especially the Fed, was worried about deflation. Ben Bernanke was introduced to the world at large with his famous helicopter speech about how the Fed could deal with a deflationary environment. Who would have thought that what passed as humor to a group of economists would be taken so seriously by the rest of the world?

Today the worry on the mind of investors and central bankers is inflation. It is causing havoc with the markets. In this week's letter, we look at whether we should be worried about inflation, take a mid-year check on the economy, muse on the malaise in the stock market and offer a very contrarian possibility for a positive shock to the world. It should make for a thought-provoking letter.

But first, a very quick three paragraph commercial. In the current market environment, there are managers who have not done well and then there are money managers who have

done very well. My partners would be happy to show you some of the managers they have on their platforms that we think are appropriate for the current environment. If you are an accredited investor (basically a net worth over \$1.5 million) and would like to look at hedge fund and other alternative fund managers (like commodity traders) I suggest you go to www.accreditedinvestor.ws and sign up and someone from Altegris Investments in La Jolla will call you if you are a US citizen, or from Absolute Return Partners in London if you are in Europe. If you are in South Africa then someone from Plexus Asset Management will call. And for my long-suffering readers who are patiently waiting for another accredited investor letter, there is one in the works. If you sign up today, you will get it. (In this regard, I am president and a registered representative of Millennium Wave Securities, LLC, member FINRA.)

If you are not an accredited investor, I work with CMG in Philadelphia. We have created a platform of money managers who specialize in the alternative management space. By this I mean they do not need a bull or bear market in order to have the potential for a profit. (Past performance is not indicative of future results.) You can go to http://www.cmgfunds.net/public/mauldin_questionnaire.asp and quickly read about the recent past performance of a manager we recently added to the platform and sign up to get more information.

If you are an investment advisor, all of my partners will work with you to assist you in providing your clients exposure to alternative style investments and managers. Obviously, if your clients are high net worth clients, then you will want to work with Altegris or ARP, and if your clients need lower minimums, then you should work with CMG. And if you have any feedback or comments, feel free to write me. And now, back to our regular letter.

Inflation, Deflation and Stagflation

The quote at the beginning of this letter is from the managing director of the Bank of International Settlements, or the central banker to the central bankers of the world. (Thanks to Simon Hunt for the quote.)

Stagflation is a strong word to use, but Knight is surveying a world that is increasingly looking like it is in trouble. A Morgan Stanley study suggests that 50 countries around the globe have inflation running at 10% or more, and that this represents over 3 billion people.

Almost all of those countries have negative real interest rates, or interest rates that are below inflation (as here in the US). Central bankers around the world are slowly raising rates and tapping on the brakes, but they are going to be under increasing pressure to do so. Thus, Knight suggests that global growth is due to slow down even as inflation is rising.

A quick sidebar. I am often asked what I think about the inflation numbers produced by John Williams of Shadow Government Statistics. His number, using the methodology to figure inflation that existed in the late 70s and early 80s suggest that inflation in the US is over 11%. That certainly corresponds to what many of us feel like as we see food and energy prices rise. If you are bearish, a high inflation number makes your case easier.

But let me make a few of you mad. I think what Williams' number actually do is show that the government did not know how to calculate inflation back then. If inflation were actually 11.8%, then that would mean that GDP was a negative 6% today, and that the US would have been in a recession for several years. That is obviously not the case. You can simply

look at corporate profits and tax receipts to see the economy has been growing the past five years.

The recovery after 2003 was in fact robust, and corporate earnings were solid, and tax collections went through the roof after the Bush tax cuts. That is not something that would happen in a high inflation environment.

That being said, let me make two observations. Inflation for much of America is much more than the headline CPI of 4%. If you make \$40-60,000 for a family of four, the cost of food, gas, medicine, insurance, etc. is causing the inflation you personally experience to be much more than 5%. The CPI reflects the inflation of all items, but your personal inflation rate depends on what you actually buy. And it seems like a lot of the necessities are running well north of 4% inflation.

Secondly, there are some of the statistical methods used to measure inflation which I think are quite suspect, like hedonic measurements. Just because the computer I buy today is twice as powerful as the one I bought three years ago does not mean that the price of a computer dropped in half. I seem to still spend about the same amount on my new computers or cars. It is still the same percentage of my budget.

If we used the same methodology as Europe (for instance), US inflation would be somewhat higher. And that is a number I would find useful for comparison's sake. But let's get back to main thought.

Louis Gave recently wrote a very interesting essay on inflation. He makes the point I have made often, that the Fed is not really increasing the money supply. If you look at the growth in adjusted monetary base, which is the only measure that the Fed actually can control, it has not been all that much over the past four years. But M2 and other measures of money supply have skyrocketed. What gives?

Two things. One is the extraordinary growth in credit offered by banks around the world. We saw a true inflation in financial assets of all types.

Secondly, and this is less intuitive, the US consumer has been a large supplier of money to the world by running a massive trade deficit. We have seen trillions of dollars flow into the world markets which has to find a home. Those dollars have been part of the growth in the supply of dollars around the world.

Now, let me offer a hypothetical series of events which could alter the current environment and maybe even bring back the specter of deflation.

The US trade deficit is roughly where it has been for four years, running in the neighborhood of 6% of GDP. Only a few years ago, less than 30% of that was for oil. Now, that has changed. Roughly 60% of our trade deficit is spent on oil, much of it sadly going to countries that are not necessarily our friends.

The US consumer has cut his spending on non-oil items by almost 40% in terms of GDP over the past few years, and the trend is clearly down every quarter.

Financial assets are clearly deflating. Banks are cutting leverage as aggressively as they once expanded their balance sheets. Even though the data shows that bank assets (lending)

are increasing, it is because they are being forced to take assets that have been off the balance sheet and put them on the balance sheet. That trend in the data is going to reverse, and with a vengeance.

We are also watching home values decline, not just here but in the United Kingdom and soon to be so in a lot of Europe, which will put European banks under even more pressure. That is serious wealth deflation.

I have been pounding the table for over a year that financial stocks are going to continue to show losses for at least through the end of this year. Dividends will be cut. More shares will be sold and further dilution will be a fact for many banks both in the US and in Europe. Trying to pick the bottom in the financial stocks is like catching a falling anvil.

And their distress is going to translate into distress for businesses and individuals who need to borrow money. All of this is deflationary. It is a strange world indeed in which we are in the middle of two bubbles bursting and for inflation to be the headline topic of every financial medium.

The source of the inflation is clear. One is rising food costs. World demand for grain is growing at 1.2% a year, yet yield increases are growing at 1.1% a year. The developed world, both the US and Europe, uses a lot of food for bio-fuels. The major areas where we could increase production are areas like Africa where the infrastructure and production methods are poor.

Everyone now believes that food costs are going to go up, energy will continue to rise and the dollar will continue to fall. And maybe all these trends continue. But let me offer a very contrarian thought or two.

Farmers around the world are going to respond to high food prices and by this time next year we could see a rise in supply that more meets the rise in demand. Prices might begin to actually fall.

Energy prices have risen so much that demand destruction is beginning to happen. US drivers are using less gas, and as Asia takes away its subsidies demand will fall as well. You could see oil prices drop over the next year.

And if oil prices drop, that means the US is shipping less of our dollars offshore, which slows the growth of available dollars, raises the price of the dollar which further lowers the cost of commodities.

In a world of decreased leverage, debt and housing deflation, coupled with lower food and energy costs and a higher dollar, it is possible that inflation drops below 2% by this time next year. Maybe more.

Far-fetched? Maybe. But it is a possibility that few are considering. In the inflationary commodity boom of the 70's, there was a 30% correction, which most don't remember. Everyone was convinced that commodity prices could only go one way. And we do not have the wage pressures and inflation that we did in the 70s.

The cure for high prices is high prices. High prices stimulate production and reduce demand. I see no reason that this could not happen again. Over time, I am along term commodity

bull. I think oil could indeed go to \$200 or more in the next decade, and as a developing world increases its need for commodities of all types, I see growing demand and prices. But that is then long term.

Stagflation on a world wide basis is going to have an effect on demand in the short term. I would be cautious about long only commodity funds. While I do not expect anything to change abruptly, I would be more vigilant and recognize that trends which look so good now can change. I am not suggesting that you get out, just pay attention to supply and demand figures coming out of the developing world.

Five years ago everyone was worried about deflation. A lot can happen in a short time. Ben Bernanke may be dusting off his helicopter speech in a few years, as deflation once again becomes the concern.

The Slow Motion Recession

Last October 5, I wrote a letter called The Slow Motion Recession. The basic premise then and in this space since then has been that we are either in recession or a lengthy period of very slow growth and that this slow growth will continue for some time. The cause of the lackluster growth is the bursting of the two bubbles of the housing market and the credit crisis. These are not problems that can respond quickly to the Fed cutting interest rates, but will need several years to correct. These deflating bubbles will put pressure on consumer spending and thus on corporate profits.

At the end of the day, it is earnings which drive the price of stocks. And if earnings are under pressure, we are going to see the stock market to continue to be under pressure. In a Slow Motion Recession, with growth depressed in the latter half of this year, it is going to be hard for the stock market to gain any real traction. As I have been writing for some time, in a recession the US stock market typically falls 30% or more. We are now down almost 20%. It would not be surprising to see the markets fall another 10%, at least from the perspective of history.

And inflation is not helping. Inflation is often more damaging to stock prices than a slow economy. Inflation, especially in a slow growth economy, eats into profits and can be hard to pass on to customers who are under spending pressure. And while inflation may slowly go away over the next year, it could be a factor for the remainder of the year.

While we should see some rallies in July and August, I think the trend is going to be lower, as the earnings projections are going to come down, and guidance is likely to be soft for many companies.

A Slow Motion Recession, a Muddle Through Economy, and inflationary pressures are not a prescription for a robust bull market. Further giving cause for concern, the recent rise in consumer spending is largely attributable to the stimulus checks being spent. This will be largely over by the middle of the next quarter. As gas and food prices eat into more and more of the average US consumer's ability to spend money on other discretionary items, there will be pressure on almost any company that has exposure to the US consumer.

An Update on Myanmar

My good friend Ed Artis and a team of workers are currently in Myanmar helping the victims of the recent hurricane. His stories are heart-wrenching. My readers have been very generous in helping provide relief. They are one of the few teams that have been able to get in and direct help to exactly where it is needed.

They are working to help re-establish an orphanage, help farmers, supply needed food and medicine to families. The need is overwhelming. He is going to stay a while longer and asked me to ask you, gentle reader, if you could send a donation to help purchase more supplies. The need for food for families is large.

One of the real needs is for more water buffalo. They cost about \$500, but allow a farmer to feed his family and more. And it is not as easy buying a buffalo as it looks. Ed tells me that many are in shock. Many of the ones that did not die will not work because they are scared silly. "I never considered that as a possible problem but it is BIG TIME," he writes. "Buffalo with Post Traumatic Stress Disorder just stand there and stare into space."

Donations made thru Pay Pal with a credit card are best as they get quicker access to funds. Go to www.kbi.org and scroll down till you find the donate button. Click on it and it takes you to Pay Pal. "We can also accept checks made out to Knightsbridge International, PO Box 4394, West Hills, CA 91308-4394, they just take longer to get funding to us here in the field."

These are the good guys. They are there on their own nickel. Not a penny goes to overhead or salaries. I cannot say too much about them. I can personally vouch for them. They are a small operation, but their efforts are very large. They get in where other groups just can't. Pony up some money for a buffalo.

New York

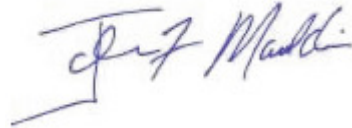
This next Tuesday Tiffani and I go to New York. I will be on the Larry Kudlow show that afternoon and then we will get to have dinner with Larry and Charles Gave, co-founder of GaveKal. The next morning we head out early to Philadelphia. My friend Thomas Fischer from Jyske Bank in Denmark is coming in and we will be going to see Steve Blumenthal and three of the managers on the platform that I mentioned above, and another two that evening back in New York. We will be at the Bull and Bear for Happy Hour so drop by.

I am really excited about the line-up that we have with all the partners. They (and I) all do a lot of work looking for managers on behalf of our clients and I think it is paying off. I am proud of the work they do.

As long time readers know, I have an office that is physically in the Ballpark in Arlington. You can watch the Texas Rangers game from balcony in right field. My lease is up on my office this time next year, and if we can get someone to take it before then we will move, as Tiffani and I could each save about 200 hours per year by not having to commute. But I will admit that tonight, with the Rangers playing Philadelphia outside while I write, I will miss it. And tonight, when the two hottest hitting teams in baseball are in the park, it is fun. Even better when we win 8-6. If we only had some pitching.

Have a great week.

Your ready for the Big Apple analyst,



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