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

Stagflation and the Fed

by John Mauldin
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How Do You Spell Stagflation?
Memo from the Fed: Inflation? What Inflation?
The Fed Will Cut and Cut Again
Damn the Inflation Torpedoes! Full Speed Ahead!
Apple, Sprint, AT&T, and Going to the Dark Side

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This week's topic was inspired by a discussion I had with George Friedman of Stratfor fame last night. He was suggesting the recession would be short and steep, and I of course think it is going to be shallow and with a long, protracted, and slow Muddle Through recovery. And it all hinges on how the Fed thinks about inflation.

There is considerable angst in the press about inflation and recession conspiring to bring us to a repeat of the 1970s woes of stagflation. And the economic data can certainly be interpreted as warranting such concern. This week we look at several different definitions of inflation. How can the Fed (in the form of both Fed

chairman Bernanke and governor Kohn giving quite dovish presentations) dismiss inflation? Aren't they supposed to make sure that prices are stable? Just look at their European counterparts who talk tough on inflation and then "walk their talk."

There are those who suggest the Fed should do the same. There is no easy answer, but I will try to lay out the conflicting concerns and explain why the Fed is going to cut and cut again, as I have been writing for months. Let's put on our thinking caps, gentle reader, as we delve into some arcane but very important lessons.

But first, and for the last time at the beginning of my letter, I want to remind you there is only a week left to register for my 5th annual Strategic Investment Conference, to be held in La Jolla April 10-12 (co-hosted by my partners at Altegris Investments). Speakers include Paul McCulley of Pimco, Don Coxe of BMO (two of my favorite economists anywhere, and simply brilliant speakers), Rob Arnott, data maven Greg Weldon, George Friedman of Stratfor, as well as your humble analyst and a dozen hedge fund managers who will show you how they navigate in these troubled waters.

Attendees at previous conferences generally rate them as the best conference they attend in any given year, and often the best conference they have ever been to. We do try to do it right. The conference is limited to those with a net worth of over \$2,000,000, due to regulatory requirements. I simply hate to put limits like that, but rules are rules. You can register and learn more by clicking on the following link. <https://hedge-fund-conference.com/invitation.aspx?ref=mauldin>. You can register at that link, and someone from Altegris will call you, as all attendees must have a conversation with a professional from Altegris. Again, those are the regulations you deal with when there are private offerings being discussed at a conference. And let me know if you have any problems.

How Do You Spell Stagflation?

The classic definition of stagflation is a period of high and rising inflation, which coincides with a recession or very slow growth. Let's look at 10 recent items which have come across my screen, which I think leave little doubt that we are in a recession. (It could just as easily have been 20, but I think 10 are enough to prove the point.) In no particular order:

1. After hovering above 50 in recent months, the Chicago ISM number dropped sharply to 44.5 in February, notching its lowest reading since December 2001 and coming in well below expectations. This brings this survey in line with the disastrous services survey of last month.
2. The University of Michigan Consumer Sentiment Survey for the United

States came in at 70.8. This is the lowest reading for the index in 16 years.

3. "The New York City Purchasing Manager's Survey fell for the second consecutive month to 427.7 in February. The current conditions index fell to 43.4, down from 47.9 in January. The six-month outlook index was below 50 for the second consecutive month for the first time in the survey's history; at 47.5 it was down from 70 in February of 2007. The worsening conditions reflect rising prices coupled with slower job growth and layoffs in financial services, as well as tightening credit conditions and higher unemployment." (economy.com)
4. The dollar hit an all-time low against the euro and fell this week against nearly every currency in the world, except Zimbabwe's. And with inflation running there at 100,000%, I think we will have at least one currency against which we will stay strong. As an aside, and as I wrote in my annual forecast, I think we are seeing a top forming on the dollar against the euro over the next few months, but the dollar will continue to fall against Asian currencies.
5. Oil is over \$101 a barrel, and rising energy prices act as a tax on consumers, who have less available to spend on other items. To add insult to injury, much of that money is sent to foreign countries that are hostile to the US. Of course, we should be grateful that some of the countries recycle those dollars back to the US, buying large positions in our major banks and keeping them from going bankrupt.
6. Home prices continue to fall and home construction is slowing dramatically, even while the available supply of new homes rises to all-time high. Foreclosures are running at record levels and rising everywhere. And everywhere there are "foreclosure tours" as real estate agents charter buses to take prospective buyers to homes which can be bought very cheaply. The number of vacant homes is now over 2,000,000. There is no sign of a bottom in the housing markets. The inventory of unsold homes continues to rise, and is now at almost a 10-month supply.
7. Commercial real estate construction has held up well, but there are clear signs this is about to come to an end, as lending for commercial real estate is becoming harder to get. Indexes which track commercial real estate are softening and commercial real estate credit default swap prices are soaring. Look at the next chart. It shows that prices for credit default swaps have almost tripled in the last four months for highly rated investment-grade commercial paper. I can't do the math quickly, but the back-of-my-napkin analysis of CDS rates for the lowest-quality commercial paper (junk bond levels) suggests default rates approaching 50%. Only in a major depression of biblical proportions could we expect to see something like that. But it means the securitization market for commercial mortgages is drying up, which means available capital for new

construction is going to be much harder to find. This is going to be a drag on growth in the coming quarters.

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8. Personal income for the average US consumer rose by the same amount as inflation, around 0.4%, and with rising energy and food costs (which we will look at later) it is no wonder that retail sales are down and falling. The savings rate is still negative, which means consumers are using savings to maintain their consumption.
9. Jobless claims continue to climb toward recessionary levels. Remember that unemployment is a lagging indicator. Jobs are one of the last things to fall in a recession, as employers are reluctant to cut back but then begin to do so more rapidly as it becomes clear we are in a recession and not just a temporary slowdown.

10. The index of Leading Economic Indicators continues to plunge, and is not far away from levels last seen in 2001. Such a drop by the LEI has always been accompanied by a recession.

And finally, let's read a quick note from über-bull and friend Louis Navellier that just hit my inbox: "At the beginning of the week we hoped the market would stage a fundamentally-led, broad-based rally after the monoline insurance companies, namely Ambac and MBIA, were able to keep their triple-A ratings. Unfortunately, a healthy rally did not unfold. Instead, the markets rallied briefly, but with junk leading the way. It was basically another short-covering rally that evaporated later in the week. The problems affecting this market are running deeper than expected. Credit-related losses are still unraveling, the housing market is still free-falling, consumer spending has stalled, commodity prices are hitting new highs, manufacturing appears to be contracting, and overall GDP growth is skidding."

Even Art Laffer says we are in recession. Amazing. Only Bernanke and Bush think we are simply in a slowing economy. And for political reasons they clearly cannot use the "R" word.

Enough already. I think that should establish that if we are not in a recession, it certainly looks and feel like one. Now let's look at the other condition for stagflation: inflation.

Memo from the Fed: Inflation? What Inflation?

The inflation numbers for January were high. I reproduce a table from www.economy.com, which is one of my favorite sources for all sorts of data. The Consumer Price Index (CPI) rose 0.4% in January, which means a rise of 4.4% over the last 12 months. If you annualize the 3-month trend, it is 6.8%. By the way, that 3-month average is a useful tool for discerning trends, so the trend in inflation is not good.

Just last August, annual inflation was 1.9%, including food and energy. Notice the rise since then. Also notice the rise in core inflation (2.5%) and the 3-month trend of 3.1%. This is clearly above the Fed's comfort zone of 2%, although good friend Paul McCulley makes a good case that the comfort zone should be higher.

Consumer Price Index								
	Jan 08	Dec 07	Nov 07	Oct 07	Sep 07	Aug 07	Jul 07	Jun 07
CPI	212.5	211.7	210.9	209.1	208.5	207.7	207.7	207.2
% chg mo. ago	0.4	0.4	0.9	0.3	0.4	0.0	0.2	0.3
% chg yr. ago	4.4	4.1	4.4	3.5	2.8	1.9	2.4	2.6
% chg 3 mo. annualized	6.8	6.2	6.3	2.6	2.5	2.0	3.9	4.3
Core CPI	213.8	213.1	212.6	212.1	211.7	211.3	210.9	210.4
% chg mo. ago	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
% chg yr. ago	2.5	2.4	2.4	2.2	2.1	2.1	2.2	2.2
% chg 3 mo. annualized	3.1	2.6	2.6	2.3	2.5	2.5	2.5	2.3

We all know about energy prices. My assistant fills up my car about once a week, and yesterday she came in and said, "We just set a record for the amount of money spent on filling your tank: \$75." I don't have that long a commute, but it is clear that a two-car commuting family making a combined \$50,000 could easily be spending 10% of their net income on gas.

"Oil prices reached a new record high this week and traded consistently above the \$100 per barrel mark. The price of West Texas Intermediate closed at \$102.6 per barrel on Thursday, a new nominal high. Brent crude--used as a benchmark in Europe and Asia--reached \$101.3 per barrel on the same day. Adjusted for inflation, oil has still not matched the high set in April 1980. A price of \$104 per barrel for WTI would break the 1980 inflation-adjusted record. This could happen soon, given the bullish trend of the last few days." (Dismal Scientist)

If prices stay at current levels through April, gasoline will be approaching \$4 a gallon and it will cost \$100 to fill my gas tank. Ouch. You can bet that will make the current downturn much worse.

Let's turn to food. Over the past year, the All Farm Products Index and the Food Commodities Index both increased 13%. And this is showing up in the grocery store. Much of the growth in Wal-Mart sales is actually from rising food prices.

The Fed Will Cut and Cut Again

Bernanke practically promised more rate cuts at this week's Congressional hearings. The market is pricing in at least another 1% lower Fed funds rate within six months. I think it will be sooner. This is not a Fed that will react to the crisis in the markets by going at a slow 25-basis-point cut per meeting. If there is only a 25-basis-point cut at the next meeting in March, the stock market will throw up.

But how can they cut if inflation is high and rising? Bernanke and Kohn made it clear that they think the #1 task right now is to fight the recession/slowdown in the economy. They are not going to let a little inflation keep them from that goal, nor are they worried about the dollar.

But won't that guarantee a repeat of the '70s and require a new Volker to come in and cause a deep recession to bring inflation back down? Are we trying to avoid a recession or only have a mild one today, just to have a major one forced on us in a few years?

I don't think so. To understand why not, we have to look at just what inflation is and how it works its way into the economy. There are significant differences from the 70's and today.

First, remember that Saint Milton Friedman taught us that inflation is anywhere and everywhere always a monetary phenomenon. Monetary inflation is different than rising prices. Monetary inflation can lead to price rises, but they are two different things.

Some will raise the point that the money supply is growing rapidly, by some measures, but I would counter that by other measures it is not. And please do not suggest, as some do, that the soon-to-be \$180 billion Term Auction Facility, by which the Fed provides liquidity to banks, is proof of monetary inflation. It is not. The Fed "sterilizes" the money they inject through the use of the TAF, so that while they inject money into banks, they take a similar amount from the economy as a whole. Over the last few years, we have had little growth in the base money supply, and certainly nothing to get worked up over.

But what if the Fed decided that inflation was a problem and decided to go ahead and raise rates and shove the economy into recession. Would that reduce oil prices? A little, as demand would weaken. But oil prices are not a result of monetary inflation or low interest rates. They are a result of rising demand for energy, particularly from Asia, and flat supply. The Fed has no control over oil prices.

Would food prices go down if they raised rates? No, as rising food prices are largely a result of our idiotic foray into turning food into ethanol. So much land is being planted with corn, that it creates a shortage of land available for other grains. This pushes prices up for food for cattle, hogs, poultry, etc., which means meat costs more.

If you want lower food prices, just tell your Senator to take away ethanol subsidies and stop using corn to make ethanol, when we can buy ethanol made from sugarcane from Brazil much cheaper than we can make it here. By the way, I am a big cheerleader for biomass ethanol. I have no way to check the math, but I read that there are enough wood chips in Georgia to make 2 billion gallons of ethanol a year. That day will come. But using corn in the meantime does not make sense unless you are a corn farmer.

Want to know why Senator McCain did not campaign in Iowa? Because he has voted against ethanol subsidies, which are a religion in Iowa. He would have lost big-time and ruined his chances to win the nomination.

Damn the Inflation Torpedoes! Full Speed Ahead!

So, let's look at why the Fed is not focusing on inflation, despite the numbers from last week. First, they truly think that inflation is going to come down on its own this year, and I agree.

As I have written for some time, it would be a very strange recession indeed, for

inflation to be persistent, particularly with two major bubbles slowly collapsing before our eyes. The housing bubble is only beginning to be felt. It is clearly going to have a negative effect on consumer spending, and that is not a climate for demand-led inflation. It is just the opposite.

Second, the credit crisis is going to make credit cost more and be harder to get. A major paper was just released today at 11 a.m. I have not had time to read all of it, but the gist of it is that banks are going to reduce lending by about \$2 trillion as a result of their losses. Almost half of that would have gone to consumers and Main Street businesses.

"The resulting withdrawal of credit could knock one to 1.5 percentage points off economic growth, significantly compounding the impact of collapsing home construction and softer consumer spending due to lower home wealth, said the study, presented at a joint academic-Wall Street forum in New York Friday."
(Barry Ritholtz)

The paper is titled "Leveraged Losses: Lessons from the Mortgage Market Meltdown," and was written by an all-star cast from Wall Street, the Chicago Fed, and academia. Basically, they show how subprime debt is connected to Main Street business and consumer spending and credit. It is quite worrisome. You can read it at:

http://www.brandeis.edu/global/rosenberg_institute/usmpf_2008.pdf.

Again, this is not an inflationary force. It is just the opposite. As I have argued for over a year, the subprime crisis will not be contained. It is going to spread. Notice that AIG announced today they are writing down \$11.1 billion on investments related to the subprime markets. This is just the first in what will be a long line of insurance companies that are going to announce large losses. The paper I mentioned above says that 23% of reported exposure to subprime problems is in insurance companies, which is the same as the exposure of US commercial and investment banks. We have seen almost \$120 billion in writedowns from them, but a small fraction of that amount from insurance companies. The shoe will drop. Count on it. (I wonder how my Chinese translator deals with US slang like "the shoe will drop.")

Further, if you look at core goods prices, that is everything but food and energy, inflation is 0.2% over the last year. Yes, I know that we have to eat and buy gas, but in the '70s everything was going up.

And that included wages. Today, there is little inflationary pressure coming from wage growth. Until that happens, I doubt the Fed will worry too much about inflation getting away from them. That is not to say that it couldn't happen, but we would have to see wages and goods prices rise to convince the Fed inflation is an issue.

And one last point. Notice in the table above that inflation started picking up in August as food and energy costs rose. In six months, the year over year comparisons will be from a much higher base. Unless you think oil is going to \$150 a barrel by the end of the year, energy inflation will be much lower. That does not mean prices will come down, though they may. In fact, I expect them to in the short run.

But if oil is \$100 a year from now, then that will mean there was zero inflation in gasoline over the preceding 12 months. Remember, we measure inflation in annual terms.

The same with food. We are having massive dislocations in food availability due to using land to grow corn to make ethanol. These things will sort themselves out, and I expect that food prices will be flat to down from here for the next 12 months.

So, taking the longer view, we have two very serious deflationary forces at work in the economy that could lead to a serious recession if not dealt with, and the likelihood that the inflation numbers that are causing heartburn today will moderate by the end of the year.

At least, that is the bet at the Fed. As I wrote last week, they are very concerned about the credit crisis. They are going to bring rates down, and I think it likely they will go below 2%. They may stay there longer than we now think if I am right about a protracted and slow Muddle Through recovery. I would not be surprised if I am writing about deflation by the end of the year.

Stay tuned.

Apple, Sprint, AT&T, and Going to the Dark Side

I have been a Sprint customer for at least ten years, I think. They are losing customers at a very serious rate. Some two million are expected to leave this quarter. I am one of them.

My new Treo phone stopped working. It is only a few months old. I gave it to my assistant to take to Sprint and get it exchanged, as I have insurance on it, which I pay \$5 a month for. Also, Sprint has the worst customer service. It can take hours to get through the lines at their nearest store, and you can be on hold for a long time on the phone, so I let my assistant deal with them. After waiting forever in line, she got to the desk and explained the problem. They took the phone and came back and said they would not replace it as I must have dropped it in some water, since it was corroded on the inside. They are not responsible if I drop it in the water. She had to get out of line and call me.

I told her I had not dropped it in the water and I wanted a new one like the contract said. I spend almost \$5,000 a year with Sprint, and I wanted them to

honor that contract. She once again had to get in line, waiting for an hour to get to another clerk, who told her he could not do anything, but we could call customer service. After she endured yet another conversation and waited another hour, I told her to come on back to the office.

I called my friend who is an expert in the cell phone business, and he said AT&T was the best. I got in the car with my daughter, we drove five minutes to an AT&T store, and in an hour I had a new iPhone from Apple, at a lot less per month than Sprint. No waiting in line. Very friendly and knowledgeable service.

Tiffani has bought a new Apple Macbook Air. It is amazingly thin and light, with a full keyboard and lots of cool features. She loves it. I liked the look, but did not want to spend the time learning a new system. I have always teased people who use Macs as being members of a cult.

Then I started using the iPhone. I am simply blown away. I love this thing. Yes, there are some features I wish they had, but not major ones, and I bet the next versions will have them in a year or so.

So, I let Tiffani persuade me to go to the Apple store near my home. We actually set up a private 30-minute appointment online with a sales representative. When we met, he carried a sign that said we were in a private meeting. I was blown away by the MacBook Air. I am going to get one before my next trip. It will reduce my carry-on weight by 4 pounds or so.

And for \$99, they will let me come in one hour a week for a whole year for one-on-one personalized tutoring on any program or aspect of anything Apple makes. Any question I want.

It is likely that when we move next, we are going to convert the office to Apple. I can run my Microsoft software but not have to deal with viruses and garbage.

I wonder how many people like me are going to get an iPhone and start to think about other Apple products. And love the service?

Memo to Sprint board: steal someone from Apple to come run customer service. Or watch your customer base continue to erode.

I have kids at home waiting for me to take them out, so I am going to hit the send button. Have a great week, and remember, it is only a recession. We will get through this and back to solid growth, just as we always have. That is what free markets do.

Your still thinking we have just begun a bear market analyst,

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