

INVESTMENT POLICY MEMO

July 7, 2008

Between Scylla and Charybdis

Our previous three Memos, from last August through this January, each focused on the wide consensus about what had to be done to avoid another financial and economic disaster like the Great Depression. Each of them argued that since everyone, including the most powerful, had much to lose in an economic implosion, governments and central banks would act vigorously to prevent such a calamity. This view has been confirmed repeatedly by dramatic and imaginative interventions, most notably the salvaging of Bear Stearns by the Federal Reserve in March with the implicit promise that the same would be done again if necessary. As a result, the chance of repeating the Depression of the 1930's is now very low.

We cannot say there is no chance of a financial and economic collapse because each of the few previous examples of such events was different and each caught nearly everyone by surprise. Our current situation and the credit crisis we have been experiencing are once again unique in many aspects. Economists, investment analysts, even worried central bankers, have repeatedly underestimated the losses that would be realized because of debt defaults, as well as the amount of new capital that banks and other financial institutions would need to raise as a result. The consensus estimate now seems to have risen to the number contained in the title of a wonderful book finished just before the credit crisis began: The Trillion Dollar Meltdown, by Charles Morris. So far less than half this amount has been realized, and inside his book Morris concludes that a trillion is only the minimum dollar loss in the best outcome.

While we have navigated farther away from Charybdis, the monstrous debt-default whirlpool of deflation and depression, we -- the whole world really -- now find ourselves well within reach of Scylla, the people-devouring monster of inflation whose multiple heads have already appeared in the global markets for oil, food and most other commodities, not to mention countries. Ulysses' dilemma was that he could not safely avoid Charybdis without falling into Scylla's clutches, nor sail far enough from Scylla without being sucked under the sea by Charybdis. Central banks and governments face a similar dilemma in the sense that policies designed to avoid a severe depression risk increasing the momentum of inflation and vice-versa.

As a result, the Federal Reserve bank has stopped cutting interest rates and hints that the next move may be to raise them, although not too soon; and the European central bank has indicated that its recent increase in rates was probably the last for now. Each is hoping to sneak down the narrow lane between two disasters by ending further changes in policy while coasting through the twin crises. Since vast forces beyond government monetary and fiscal policies are generating inflation, and most developed countries appear to be drifting into recessions, which might be mild but could easily be as severe as those of the mid 1970's and early 1980's, this policy of paralysis is likely to prove temporary. As inflation and recession both spread, we

expect that central banks and governments will choose to raise interest rates and restrain economic activity in order to fight inflation.

As long as anything like the Great Depression can still be avoided, this is a rational choice, especially for the wealthy, who have the most influence on policy. Since the Great Depression all of the recessions in America have passed in a year or two. Often, as with the severe recessions in the early 1980's, economic declines have helped to reverse the direction of inflation by lowering demand and increasing fear and caution. In particular recessions are often effective in restraining wages and increasing profits as happened after 1982. Based on this most recent role of recession in slaying inflation, policy makers have reason to hope that a severe recession in developed countries and the consequent slowdown in developing countries would lower the prices of oil, food and other commodities as well as wages, an effect Fed Chairman Bernanke has often mentioned.

Inflation on the other hand tends to be self-perpetuating (and so is deflation as in the Great Depression and the dismal experience of Japan for the last 17 years). Moreover, inflation transfers wealth and income from lenders to borrowers, from those with money, bonds and stocks to those without, and more generally from the rich to the poor. Inflation is bad news for the entire economy with the worst impact on the wealthy. Recessions, as long as they stop short of deflation or declining prices, are also bad for everybody; but less long lasting, and most bad for the least well off. So the ultimate choice is likely to be higher interest rates, tepid government stimulus and a covert welcome of the recession that seems to be arriving anyway.

This inflation-fighting emphasis will make the recession deeper and longer than it might have been otherwise. At the same time, it is likely to be less effective against inflation than the connected recessions of 1980-1982. The current inflation has more diverse and stubborn causes than the inflation of the 1970's. Two primary trends that would be difficult to reverse are the increase in population and the increase in global prosperity.

Since the end of the 1970's the population of the world has increased by two billion, four hundred million people, or the entire population of the globe at the start of World War II. But, there is no more arable land on this earth, and even less oil and coal, copper and zinc or most anything else beside green house gasses and people. In the past decade most of the world has experienced strong growth of income and wealth. As a result the previously neglected emerging countries, most notably China, now are the primary sources of increased demand for meat, grains, energy and industrial raw materials. In the past year or two developed economies have decreased their consumption of petroleum products as the emerging economies have accounted for more than 100% of the world's increased use of petroleum. Meanwhile global production of oil has been essentially unchanged for three years.

As the emerging economies entered global trade ten to twenty-five years ago, the braking effects on inflation were huge. A new labor force of about two billion people, four times greater than the combined labor force in all developed countries, was available at significantly lower wages to produce less expensive goods for the global market. The immediate effect was to lower prices for many goods and to eliminate many jobs in Europe, America and Japan. Now that there are no large countries left to add to the global market place, continuing disinflation depends on the prices of emerging market exports continuing to fall or at worst to only rise slowly. Until recently this was consistently the case. Today we have quite the opposite situation. Inflation in

emerging economies is generally over 10% a year. Wages are rising at close to 20% a year. Emerging country currencies are strong against the dollar. As a result, prices of exports to the United States from China, India, Brazil and other emerging economies are now rising at 4% to 5% a year and thus *increasing* inflation in the developed world.

So to bring this long story to a brief conclusion, the growth of emerging economies continues to alleviate poverty in the world; but instead of continuing to restrain inflation, it is now the principal cause of an inflation that threatens the entire world. Emerging country growth accounts for more than all of the increase in oil consumption, nearly all of the increased pressure on agricultural supplies and more than all of the increase in demand for most other resources like iron ore or alumina.

Recession in America, Europe and possibly Japan will slow emerging economies by reducing demand for their exports. The tax that high oil and food prices impose on every other kind of spending will also slow growth in the Brazils and Chinas of the world. Most emerging market governments and central banks have long since turned their attention to raising interest rates, cutting government spending and investment and other measures designed to fight inflation by slowing their economies. If the developed world avoids a catastrophe, its economies will at most decline at a rate of one or two percent a year during a less severe recession. In the emerging countries high expectations and fears of unrest are likely to moderate the slowdown from recent economic expansion around 10% per year to something still positive, like 5%. This set of changes would be categorized as a very serious global recession, yet it would leave global demand for food, energy and commodities roughly unchanged and wages in emerging markets still increasing.

The investor's dilemma in these straits is just as acute as the choice faced by central bankers and treasury secretaries. The three things that are most deadly for stock prices: rising inflation, rising interest rates and declining profits, are all likely now. Still, the best protection against inflation is also to be found among stocks with direct exposure to energy, industrial commodities and agriculture. However, a portfolio of such stocks will perform poorly in a strong recession and worse still in another depression. A portfolio of long-term bonds would do best when the inflation-hedge stocks are worst and vice-versa. Inflation-protected bonds could benefit from higher inflation in the moderate recession cases and from higher pricing in the severe recession cases; but most of this is already reflected in their historically low yields and high prices. Cash is reasonably safe in every case but a collapsing dollar, but will also not make anybody's fortune.

For these reasons our clients' portfolios contain cash, equities and bonds, including inflation protected bonds when we can find attractive ones to buy. We prefer having more than half the stocks in any portfolio in overseas companies, especially in Emerging Markets, with exposure to the likely growth of consumption in those countries or likely to benefit from rising inflation. We have large positions in energy stocks, particularly renewable energy, and we hope to increase investments in agriculture and select commodities. It is our hope that this odd combination may keep our clients from losing money or from losing very much money no matter what happens. The price of this comfort is a diminished expectation of making very much money over the next year or two no matter what happens.