

The Quarterly Report

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INSIDE STORY

Inflation



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They just don't make things the way they used to.

A few weeks ago my son, Charlie, came to me with a problem. He wanted to play with a kickball, but the ball had gone flat. I told him not to worry, we could go out to the garage and use the bicycle pump he had gotten for Christmas with his new bicycle (I'm cheap, but I wouldn't give my kid just a pump for Christmas, don't worry). So we went to the garage and I got the pump. Bicycle pumps have not changed much since I was a kid. I grew up in the 1970s, and as the youngest of five children I would guess that the pump we used was made in the early 1960s, about the time my eldest siblings would have been getting their first bicycles. All the parts were metal, including the nozzle. The nozzle had only one use and that was to blow up tires, mostly bicycle tires but it would have probably worked on a car tire as well. To blow up other items, like kick balls, you had to have a needle.



Based on my limited experience, in the last 40 years, there have been two

“improvements” to bicycle pumps: all that sturdy, last-forever metal has been replaced with break-if-you-look-at-it plastic, and the nozzle has a built-in needle, or at least it is built-in until you use it. I inserted the needle into the ball, pumped air into the ball, and pulled the nozzle away from the ball. Unfortunately, the needle stayed in the ball, which of course meant that all the recently pumped air quickly escaped while the pump had been rendered useless after one use.

The moral to this story is that it just isn't as easy to inflate things today as it was in the '70s.

Of course you wouldn't know that if you listen to financial news, or just visit the grocery store or local gas station. Prices

of commodities like oil, wheat and cotton have gone through the roof and inflation is on the lips of just about every financial pundit. Conventional wisdom is that inflation is on its way, if it isn't already here. But is it true?

Some of you will think I am crazy for even suggesting that inflation may not be the great threat of our society today, and I understand that. After all, few things impact our day-to-day spending more than fuel and food, and those prices have risen a great deal and inflicted real pain on most people's budgets. However, that is not inflation. A few months ago I had dinner with Dennis Lockhart, the president of the Atlanta branch of the Federal Reserve and one of the men who gets to vote on monetary policy. He used an analogy of tracking inflation being like tracking a swarm of bees: the Fed is trying to track the direction of the whole swarm, not just one or two bees. That is a good analogy. While the price of milk has been going up, the price of your house has been going down. As painful as today's milk prices are on a daily basis, in the grand scale of life you will spend more on your home.

Homes are not the only area where prices are dropping. The idea for this article

actually came to me when the firm upgraded the copier in our work room. One of my colleagues commented about how it seemed funny that we were getting a newer, faster copier for less than we had been spending on the

old copier. I informed my colleague that we did this every two to three years and that has always been the case. But you don't buy a copier every day.

You also don't buy a TV every day. Last summer my family finally got with it and purchased a modern flat-panel HDTV. We paid approximately \$700 for a 47-inch LCD. Not knowing a lot about TVs, my wife asked the installer if he thought we got a good deal. He put it this way, “A few years ago this TV would have cost you more than \$4,000.”

I have friends who belong to the Apple cult. They waited in line to pay \$599 for the original iPhone in 2007. You can get one today for \$49 with a two-year contract from AT&T.

Inflation

Tracking that whole swarm of bees is not as simple as it may seem when you check out of the grocery store.

One of the problems with the inflation argument is that the loudest voices are coming from people who are selling commodity-related investments. They scare people with talk of inflation, tell them that the solution is to pile into commodities, and then when this speculation has caused the prices of commodities to rise, they say, 'Look, here is our evidence of inflation. Now you should buy more commodities.' Madoff is probably sitting in jail and wondering why he didn't think of that.

When the money supply grows too quickly, money simply loses its value...

Unfortunately, intelligent conversation of complicated subjects does not fit in with today's culture of texting and tweeting, and inflation is a complicated subject. As Lockhart was explaining with his swarm analogy, understanding what inflation is and what it is not is the first hurdle to that conversation. I will try to make this simple by using slightly different terminology.

Inflation happens when the general level of prices rise. For that to happen two things must occur. First, prices of a basket of goods must go up, and second, consumers of goods must continue to consume roughly the same basket of goods. If the price of one item, such as gasoline, goes up by itself people will either consume less gasoline, or consume less of other items in order to pay for the higher price of gas. This is what is occurring today. Inflation happens when one can pay the higher price and still consume the same basket of goods, and that can happen only if their supply of money has grown along with the rising price. Their supply of money can rise in only two ways: their income must increase and/or someone must loan them the money.

Inflation is what happens when the supply of money increases. A larger supply of money does not sound all bad, and it is not. Inflation is not like pregnancy – you can be just a little inflated and that is a good thing. Inflation comes from growth, so we want inflation. The alternative to inflation is deflation, which goes along with economic depressions, which we do not want. When people argue that the actions of the Fed are going to lead to inflation, what Ben Bernanke should say, or tweet, is simply, "Duh, that's the point." The Fed wants to see inflation at around two percent per year.

Of course when the commodity ETF-selling fear mongers use the word inflation, they never talk about specifics. They just make it sound scary, and make themselves out to be like Paul Revere riding to the rescue. "Inflation is coming! Inflation is coming! Buy my ETF and save

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Soft patch or hard landing? That is the question we are all asking about the economy. After encouraging signs late in 2010 growth has slowed and the progress on unemployment has reversed itself. The first quarter GDP growth slowed to 1.9%, after 3.1% in the 4th quarter of 2010, and we expect it to be in the 2% range for second quarter. We don't see a new recession on the immediate horizon, just more sluggish growth. Two steps forward and one step back.

After several months of improving job numbers and upward revisions we have hit a set back.

Unemployment is back over 9% at 9.2% and job creation has slowed to a trickle. There were only 18,000 jobs created in June while expectations were for as many as 150,000. High unemployment is going to be with us for a while. +

REVIEW of
ECONOMY

The S&P 500 was up 0.10% for the quarter but that is misleading. Two weeks before the end of the quarter the S&P was down almost 5% then rallied strong to the end. As we had predicted last quarter we had a mild correction. However, we expected that correction to be followed with a rotation into higher quality, better valued areas of the market, such as large cap technology, and away from speculative areas such as small caps, energy and materials.

This has not occurred, at least not yet.

Bonds rallied in the quarter along with renewed global worries about sovereign debt in

Europe, and unrest in the Middle-East. As bad as US treasuries look for the long-term, they remain the short-term shelter of choice for the "risk-on, risk-off" traders. The Barclays US Aggregate Bond Index was up 2.29% for the quarter.

International did well despite the renewed issues with Greece, with the MSCI EAFE up 1.83%. Europe's attractive valuations outweighed their economic concerns. Emerging markets continued to struggle finishing the quarter down 1.04% as measured by the MSCI Emerging Market index. Slowing growth due to monetary tightening remained the theme in the emerging world. +

REVIEW of
MARKET

MARKET *forecast*

Our outlook has not changed much. We believe corporate earnings will continue to grow and the growingly negative view, caused by the softening economy, will provide for some upside surprises. There is nothing we like more than low expectations. Our prediction for 2011 remains a 10% gain in the S&P 500. We are still anticipating a rotation towards large cap and towards some undervalued sectors such as technology.

The long-term emerging markets story remains in tact, but look for monetary tightening in the emerging economies to continue to mute growth in 2011.

Bonds remain our greatest concern and the one thing that could spoil the party for everyone. Rates have stayed low, but when they begin to rise it could get ugly. The most likely threat to our equity market prediction is if rates rise too quickly and start to spook equity investors. +

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yourself?" The fact is the environment we have been in for the last few years is stagnant to slightly deflationary. Have you felt good? If not, then you may welcome two percent inflation, or to put another way, a two percent growth in your money supply.

Inflation is not bad; runaway or hyper-inflation is bad, which is what we had in the '70s. When inflation gets beyond four percent or so, it starts to get out of control. If inflation gets up to the double digits, watch out. When the money supply grows too quickly, money simply loses its value, and that, of course, is a bad thing. Many believe this is going to happen because of the large deficits and the easy monetary policy, a recipe that has, in part, led to inflation in the past. There is just one problem: today these policies are not leading to growth in anything other than the national debt.

The money supply for the nation is nothing more than your money supply plus mine plus all the other people out there. Has your money supply grown? Has your salary increased, or is it easier for you to get a loan than it was a few years ago? Wages are not growing and banks are not really lending, and until that happens we will not see inflation. This does not mean that speculators, combined with some poor harvests and unrest in the Middle East, can't cause the price of commodities to rise. However, without growth in the money supply these price increases will simply cause consumers to cut back elsewhere and are more likely to cause a new recession than they are to cause inflation.

The same goes for our runaway deficits. Just ask the Japanese if government spending will bring about growth and inflation. It will not. Government spending tends to crowd out private spending, and empirical evidence suggests that private

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spending tends to deliver a greater multiplier effect than government spending does. In other words, millions of people making independent judgments with their own money will in aggregate spend more effectively for economic growth than will a small number of policy-makers spending other people's money.

Even loose monetary policy will not do the trick by itself. Low interest rates make it more affordable to take on debt and increase your supply of money, but it doesn't necessarily make people want to do it. Japan has had near-zero interest rates for as long as I can remember, but a dysfunctional banking system and a cultural bent towards saving has kept them from experiencing inflation.

My critics will say that we are different than Japan. They are correct, but as Mark Twain said, "History doesn't repeat itself, but it rhymes." There are no carbon copies, just common repeated themes. We are closer to looking like Japan of the 1990s than the U.S. of the 1970s. In the '70s we had wage inflation and quality metal nozzles on bicycle pumps, both of which made it a lot easier for inflation to take hold. Today we have neither – something one should consider when making investment decisions, or buying their child a bike.



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