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MARKET OBSERVER

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"Gentle Ben" Bernanke showed his inflation-fighting fangs in the second quarter of 2006. Like the amiable bear of the television series, the Chair of the U.S. Federal Reserve spent the early part of his tenure ambling about, saying soothing things to investors, politicians and the financial markets.

Upsetting even a gentle bear is usually not the best policy. The spate of hot economic news and high inflation numbers over the spring caused Ben to introduce some growl to his inflation fighting act. The Chair and other Federal Reserve governors made a point of upping their anti-inflation rhetoric in the quarter. Their finale was the publication of the Open Market Committee minutes for June. Not only did it look like short-term interest rates would continue the steady 0.25% increases initiated by Alan Greenspan, the minutes indicated that inflation was worrisome enough that committee members had discussed a 0.5% increase.

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The thought that former Professor Bernanke was tough enough to consider this option was enough to destroy the "one and done" market consensus on future Fed rate increases. The financial markets were under pressure from rising short-term interest rates over the quarter, with both bonds and stocks negative over the period.

In August, however, the gentler side of Mr. Bernanke's nature asserted itself and the Fed Open Market Committee decided to take the "pause that refreshes" and kept the Fed Fund rate at 5.25% with one dissenting vote. Signs of a slowing U.S. economy were taken by the Fed Governors as a portent that inflationary pressures would ease going forward. They admitted in their minutes, however, that inflation was worrisome and over their targeted level. We believe that the Fed and its Chair are wrong to risk a premature end to their tightening. This could lead to a more stringent program later in the cycle.

Greenspan's Legacy is Bernanke's Quandary

Alan Greenspan left Ben Bernanke with quite a monetary policy quandary. Greenspan's ultra-low interest rate policy caused a huge swell in credit creation and asset values. The price appreciation was concentrated in things financial but spilled over into the real world in 2004 when commodities began a sharp price rise. Given Mr. Greenspan's dislike of things chaotic and abrupt, his program of "measured" short-term interest rate increases was meant to keep inflationary pressures contained and to restore a semblance of order to the increasingly speculative financial markets.

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So far, the measured program of monetary tightening has not been effective in slowing the economy and stamping out excess in asset prices. This does not surprise us. As our readers know, we have felt that the easing of monetary policy and lowering of interest rates that Alan Greenspan undertook in 2001 to 2004 was far beyond that necessary or advisable. We continue to believe that the monetary tightening that is required to mop up the excess liquidity and credit sloshing around the U.S. and the world is substantially more than investors and the financial markets currently conceive.

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The working consensus model of monetary policy in the new millennium, after the long and happy reign of Alan Greenspan, is that the monetary authorities fine-tune their control inputs to keep the economy growing, inflation free and the financial markets happy. Our problem with this view of all powerful and sage monetary authorities is that it stems from the unique set of circumstances which occurred in the 1990s, particularly the emergence of China as a modern manufacturer. This caused a deflationary shock in manufactured and finished good prices in the developed world which created benign inflation conditions for the developed world.

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Troubling China

What troubles us now is that China, the primary source of manufactured goods deflation, is now becoming a source of sustained commodity price inflation. While this is an old story, dating back to the last commodity boom in the mid-1990s, there is an important new twist. China now has huge U.S. dollar foreign exchange reserves which it has earned by exporting vast quantities of manufactured goods to the U.S. and maintaining its fixed peg to the U.S. dollar.

The ruling Communist Party in China is becoming more and more concerned with the political instability that its rapid growth and free market programs have created. The minority of successful entrepreneurs and economic insiders have profited immensely from the reforms while the vast majority of the population has seen little change or even deterioration in their living standards. Political and economic corruptions combine with the removal of state support programs to create a large alienated and volatile segment of the population.

As the National Post's Nicholas Kristof reports *"Wildcat protests, some violent and involving thousands of people, have been exploding around the country. By the Chinese government's own count, there are more than 200 protests a day, prompted by everything from layoffs to government seizures of land"* (*National Post, Wednesday July 5, 2006*).

Juxtapose this unrest with the recent purchase of the late Princess Margaret's tiara at auction in London by an unnamed Chinese woman who jetted around the world to buy it because she "just had to have it". It is clear the growing concentration of wealth in China has created significant social tension.

This means the Chinese government is loath to undertake any serious slowing of the Chinese economy that would result in an increase in unemployment or decreasing wages. It implies that China will increasingly use its foreign exchange reserves to improve the living conditions for its citizens by buying commodities and financing capital projects.

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Not So Benign Inflation

When the world economy slowed after the Asian and Long Term Capital financial crisis of 1998, we saw steep declines in commodity prices. Commodity prices should also decline this time around in the face of restrictive monetary policy and a slowing world economy, but the increasing demand from China and the other developing nations will offset some of the decline in demand from the developed economies. This will limit commodity price declines this time around.

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Given the prospect for a weaker U.S. dollar versus the Chinese yuan and other exporter currencies, we think the stage is set for a slower U.S. economy and potentially higher inflation.

Sticky Prices

We are also concerned at the "catch up" price increases from producers. Surveys are now showing that producers are raising their prices to reflect their rising input prices. Even a slowing economy does not guarantee moderating inflation. Prices tend to be "sticky" downwards as retailers and producers capture some of the falling input costs in improved profit margin. Given the prospect for a weaker U.S. dollar versus the Chinese yuan and other exporter currencies, we think the stage is set for a slower U.S. economy and potentially higher inflation.

This suggests that interest rates could go higher and stay there longer than most investors believe. The Fed paused its interest rate increases after its August meeting to "evaluate" the data and discern the effects of its earlier policy. We don't think that this will be the start of a downwards trend in rates. We point again to the experience of the U.K. and Australia which paused a year or two ago reacting to weakening data only to have to resume monetary tightening this year.

Financial markets are exposed to a major revaluation brought about by tighter monetary policy and higher interest rates. Real interest rates are still low historically and will rise as capital becomes dearer. Market inflation estimates and risk premiums will rise as it becomes evident that the longer term picture for inflation is not as rosy as once thought.

The Exotic and Nonsensical

We don't think that today's crop of risk-seeking portfolio and hedge fund managers are well prepared for a world of persistently higher interest rates. Plentiful capital has encouraged substantial borrowing based on financial asset prices and legitimized very speculative investment programs.

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The best is past for portfolios of exotic and nonsensical investment products that can only be described by complex mathematical jargon. The behaviour of these financial innovations in a financial crisis will be unstable at best and probably toxic to the net worth of holders. We look to the future with some trepidation, as we believe the level of speculation in today's financial markets has been encouraged by the naive belief that risk can always be laid off or hedged. A sense of invulnerability is as normal at the peak of a financial boom as sheer panic and fear will be at the bottom of the bust.

When capital seems plentiful and risk is in fashion, it is best to take some money off the table. We believe it is a time for caution and conservative investment portfolios.

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