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Remember those investment strategists from a couple of years ago who claimed that higher energy and gasoline prices would be deflationary? At the time, we thought that this was one of the most absurd investment conjectures that we had ever heard. Driving down any Canadian highway today at the posted speed limit of 100 kph, there is obvious evidence of the error of yesterday's sage investment prophecy. Even with gas prices over $1 a litre, cars fly by at 140 kph with fuel economy being crunched under their drivers' heavy accelerator feet. So much for higher gasoline prices emptying the pockets of drivers and hurting consumer spending!

As we pointed out at the time, the logic of these strategists was that higher gasoline prices would divert money away from other expenditures, causing a fall in demand for other goods which might lead to a recession. They assumed that the money supply was reasonably fixed and that consumers could not avail themselves of extra money or credit to continue their gas guzzling ways. This wasn't the case, as there has been ample money and credit available for consumers to drive merrily forward, which they are now doing at very high and illegal speeds.

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Alan Greenspan's personal quest to defeat his bogeyman of deflation with ultra low interest rates and copious amounts of U.S. dollars has put enough liquidity in the U.S. economy since 2000 to last for some time. Unfortunately for those in the deflation camp and holders of fixed income securities, not only was enough money and credit available for high speed automotive pursuits, there was also more than enough available for strong consumer spending and a wild credit orgy in the financial markets.

The Inflation Speedometer is Vibrating

The crescendo of Greenspan's acclaimed and lauded monetary opus might not be viewed as heroically in the future. His "pedal to the metal" approach to monetary policy has sped up wages and spending to the point where the needle of the U.S. inflation speedometer is now in the red zone and vibrating. The problem for his successor as Fed Chair, Ben Bernanke, is that all that liquidity and easy money is very popular and has a huge embedded constituency of voters, politicians and financial market participants. Does anyone really want zero inflation any more?

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The sources of the acceleration in inflation are not only domestic to the United States. We have commented for some time on the well known demand for commodities from the developing nations, particularly China. The seemingly insatiable Chinese demand for commodities is causing raw material price inflation to be passed through to the developed countries, including the U.S. This is the new millenium's offset to the deflation in manufactured goods created by the unleashing of cheap Chinese capacity in the 1990s. There are also some global economic, political and social trends that have the potential to lessen the deflationary forces that have shaped global monetary policy over the last fifteen years. These bear watching, as they will shape the climate for interest rates and inflation for some time to come.

Raising the Minimum Wage is "In"

One notable development is the move away from unbridled free enterprise to a more "socially responsible" economic agenda. This can be seen in the move to

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raise minimum wages across most of the developed world. "OUT" is the right wing rhetoric of high minimum wages destroying jobs and "IN" is the idea of letting the disadvantaged in on the economic boom. The corporate titans who are clipping huge salaries and the wealthy are not in a position to complain. A plug of greed has largely stopped the "trickle down" effect of wealth generation. Globalization, asset appreciation and investor friendly tax reform have benefited the financially astute and the professional class. The current share of corporate profits in the United States is at a record high and the concentration of income among the wealthiest is at the highest level since the 1920s.

Politicians in a democracy seek to get elected. That means that populist economic measures will be increasing. The recent minimum wage legislation by the new Democratic controlled congress has been supported by some Republicans and even the White House. This groundswell is growing. CNN commentator Lou Dobbs has been waging a campaign for some time against perceived economic injustices. The title of his recent book speaks for itself: *"War on the Middle Class: How the Government, Big Business, and Special Interest Groups Are Waging War on the American Dream and How to Fight Back".* The rapid political rise of Barak Obama as a contender for the Democratic Party's presidential candidate also reflects this new reality of populist economic politics.

Power Beats Right Wing Ideology

This trend is not restricted to the United States. The recent Conservative Canadian federal budget was characterized as liberal and free spending by the same right wing lobby group, The National Citizen's Coalition, which Prime Minister Harper used to head. Demonstrating further that practical politics overwhelms ideology, the 27 year NCC staffer who made the blog comments was fired soon afterwards. Even in France, where the schism between right and left is pronounced, the right wing candidate for President, Nicolas Sarkozy, has been ruing the results of globalization and European Community policies on French society. As Jacob Arfwedson reported in the The Wall Street Journal:

"His (Sarkozy's) campaign speeches have become diatribes against capitalism and global free trade, and his constant calls for interventionism bode ill for France should he reach the ultimate pinnacle. In a March 6 speech in the Parisian suburb of Cormeilles, for instance, he used the word "state" more than 70 times and the verb "protect" more than 40 times in outlining his economic program. When he did talk about issues such as capitalism, innovation or entrepeneurship, it was only in dismissive or disparaging terms." WSJ.com "The Status Quo Radical" March 27, 2007"

This protectionist economic trend also affects the prospects for inflation. The outsourcing of manufacturing to low cost China and other developing countries is the real source of the Greenspan era's low inflation. Domestic capacity in the developed world was augmented and eventually supplanted by the massive industrialization by China and other developing countries. The resulting deflation in the finished goods markets meant that Greenspan's monetary stimulus fed into financial asset and housing prices rather than the general price level.

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The "Non-Market" Capitalists

The recent move of the U.S. Commerce Department to allow trade actions against subsidized Chinese goods is an important portent for inflation. Previously, China was viewed as a "non-market" and communist economy under U.S. trade law and domestic producers could not initiate trade actions based on government subsidies as they could for a market economy. This recent decision recog-

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nizes that China is now a market economy and coated paper imports from China were assessed 20-30 % duties because of government subsidies to paper producers.

China intends to appeal to the WTO but its chances of succeeding in its efforts to be confirmed as a "non-market economy" are not good. A China that is trumpeting its capitalist economic prowess, competing for global energy resources, destroying satellites in orbit and putting taikonauts into space is not likely to be viewed as a communist basket case unable to compete effectively with developed world industries.

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Death by a Thousand Chain Saw Cuts

The Canadian experience in the softwood lumber dispute with the U.S. doesn't auger well for Chinese manufacturers. American producers have been fighting a running battle to keep Canadian lumber out for years, claiming government subsidies of stumpage rates. Each time Canada won a case in a U.S. court or before an international tribunal, the U.S. lumber lobby finds another way to claim that it is being injured by another perfidious and socialist Canadian government subsidy. Canada reacted to this "death by a thousand chainsaw cuts" and recently agreed to voluntarily restrict its lumber exports to try to recoup some of the huge duties that had been levied. The U.S. lumber producers are now complaining again and are said to be gearing up for another trade action.

Since all Chinese banks are state controlled and lending practices are far from commercial, the U.S. industry trade lawyers are going to have a field day with claims of subsidy. They also have the option of claiming non-enforcement of environmental regulations and even compliant unions are indirect state subsidies. Since China still publishes economic plans from the central government to foster selected industries, abundant evidence will be available for trade actions. The bad news is that these trade actions are only the "low yield" protectionist measures that can be deployed. The hydrogen bomb of trade actions would be the "currency manipulator" designation which would allow a 30% tariff to be levied on any Chinese good or service.

Slow Growth and Faster Inflation

The Bernanke Fed has now held short-term interest rates at 5.25% since June of 2006. The economy has slowed, but strong employment and wage growth has kept core inflation above 2%. Recent wage reports in the United States show a year over increase over 4%. As we have said many times in past reports, wages and inflation are intricately and inextricably linked together. This high current level of wage growth does not bode well for future inflation.

It is not extraordinary for the economy to slow with higher levels of inflation. It is normal for growth to slow cyclically as capacity utilization runs at high levels and the labour markets tighten. Incremental increases in production are marginally expensive and producers must devote more resources to capital expansion which drives up the demand for credit. The problem is that the onslaught of cheap Chinese production in the 1990s that coincided with Greenspan's triumphal monetary reign has created an expectation that a slowing economy means a drop in interest rates and inflation.

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Say Goodbye to Glorious Deflation

The glory days of manufactured goods deflation is passing. The growing protectionist trend is not a good portent for inflation prospects. Now that the developed world has basically outsourced its light manufacturing to China, higher duties and tariffs will only lead to higher consumer prices and further pressure upwards on wages in tight developed country labour markets.

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The potential for stubbornly higher levels of inflation is not something the bond market wants to hear. We have believed for some time that the U.S. economy will slow but that inflation would stay higher than the financial market expects. We believed the huge monetary stimulus provided by the Greenspan Fed and other world central banks from 2000 to 2005 would overwhelm their recent and modest efforts to reverse the monetary tide. In particular, we pointed to the examples of the U.K., Australia and New Zealand, all modern credit based economies, where monetary policy has been tightening for some time. These central banks have seen their tightening efforts defeated by continuing strong growth in wages and higher levels of price inflation.

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Equities are Nominally Protected

Although rising inflation will chill a bond investor's soul, we think the prospects for the equity markets are reasonable, as nominal cash flows will continue to increase, albeit at a slower rate. Even a 2% "real" growth rate is 5% nominal growth in a 3% inflation world. As long as interest rates continue to lag inflation on the upside, we do not see a huge downside to the equity markets, absent a recession.

The problem for equity investors will be the slowing in corporate profits that inevitably happens at the end of an economic cycle. Unit costs fall early in the economic cycle as expanding sales are spread over contained fixed costs. Now businesses are finding it increasingly difficult to meet orders with existing plant and labour making incremental sales much more expensive. We see this in the current debate over the falling productivity statistics in most developed economies. If slowing profit growth combines with an increasing discount rate due to Fed tightening, the equity markets could be in for some turmoil.

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