

## The Grand Scheme of Things

I'm not a paranoid type of guy despite what you might be thinking: you and all of those other people that is. I believe the world is energized by self-interest and that when objectives coincide, then families, companies, and countries are conceived with a common bond. But self-interest dominates, stirs the pot, makes it next to impossible for conspiracies à la John Le Carré to exist other than on the pages of spy novels. Not that there aren't spies out there and that some of them aren't watching me right now. They're just not part of an organized plot. It's the coordination that's the hard part, you see. Too many pieces to juggle behind closed doors. Still I believe in uncoordinated schemes and even uncoordinated grand schemes because self-interests, like the planets, sometimes fall into alignment. Now is one of those times. Now is the time for a global grand scheme.

The economic world's disparate interests are currently aligned because it has a common enemy: deflation. Born and bred out of the bowels of (1) globalization, (2) excessive buildup of "good times" debt, and (3) a demand-stifling demographic imbalance, the world is now threatened by deflation and its 21<sup>st</sup> century poster boy – China.

And so the times are changing – not via a back room, cigar smoke laden plot, but step-by-step, month-by-month, policy-by-policy. The pieces are beginning to form a coherent whole but there is no giant, behind the scenes, puzzle maker – only individual countries trying to survive and, if possible, thrive during these darker deflationary days.

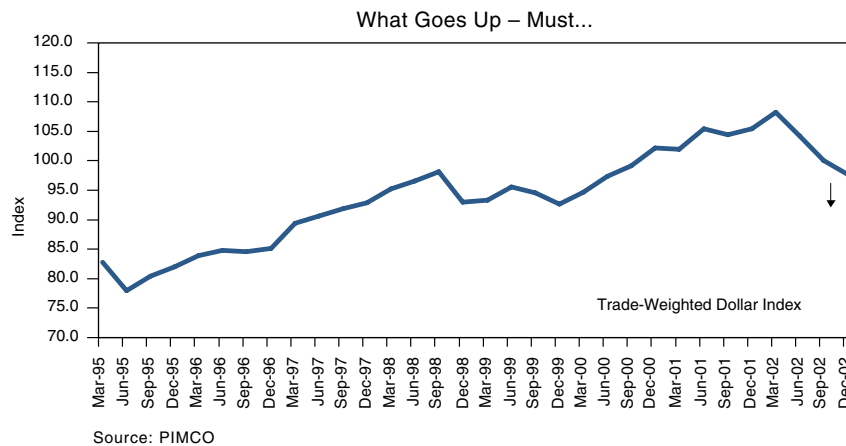
As proof I submit a chronology of disparate, certainly unsyncopated policy changes that began several years ago when the original cauldron of deflation – Japan – cut its interest rates to near absolute zero. Japan was followed in January of 2001 by Alan Greenspan and the U.S. Fed, reducing short-term yields from 6½ to 1¼ % in just short of two years time. The ECB reluctantly joined the anti-deflation party at about the same time, but at their own pace, bringing their yields down to a still high 2¾%. On the fiscal front Euroland, the U.S., and Japan all proceeded individually but with common alignment in the direction of large budget deficits – all the better to fight deflation. In addition, in the aftermath of 9/11, the U.S. selected a list of "evil doer" nations and targeted (not surprisingly) the one with the large oil reserves, not the most imminent

nuclear capability, as enemy number one. A future attack would/will not only stimulate the domestic economy via military spending, but presumably assure us of cheaper oil to fight the deflationary menace and stimulate economic growth. These disparate events form no giant global conspiracy – they arise from individual countries deciding that its interests are best served by policy reversals. The policies however have a common element – eliminating the deflationary menace from their own economic homeground. It is, to be sure, a grand scheme.

In recent months we have been informed of additional measures which would hopefully eliminate the D word from our current economic lexicon: Bush's Republicans are convinced that the election gave them free rein to cut a myriad of taxes when in fact it was a homeland security referendum. We will, however, have lower taxes in addition to internal security. Japan is about to appoint a new central bank governor who may more aggressively reflate via

inflation targeting. Europe is getting serious on structural reforms, as well as considering further interest rate cuts. And of course Fed Governor Bernanke has delivered the coup de grâce of anti-deflationary policies by threatening the use of seldom if ever used maneuvers such as buying Treasury and corporate bonds to keep the good times rolling. While in last month's *Investment Outlook* I shouted that I "believe them," it's still not clear if ultimately they or any other government will succeed. Japan is proof that deflation once it takes hold is a behemoth to be reckoned with.

To this mix of potential reflationary palliatives must be added one additional (and perhaps the one most dangerous) hole card for U.S. policymakers to play. I speak of the dollar and its potential depreciation, which – if done gradually and without causing investor flight – would correct a number of global imbalances that are holding down growth and inflation at the same time. That's a big "IF," however, and astute observers know it. Foreigners now hold



over \$7 trillion of U.S. assets and they will not take kindly to a devaluing of their investments. 13% of the U.S. stock market, 35% of the U.S. Treasury market, 23% of the U.S. corporate bond market, and 14% direct ownership in U.S. companies are now in the hands of foreign investors. It's a theater crowded with foreigners and if someone yells "Fire, Feuer, or Kaji" there could be a rather crushing stampede for the exits.

Still, there's little doubt in my mind that a lower dollar might help to break up several current policy logjams. Despite hope for future progress, both Japan and Euroland are dragging their heels on labor and bank related structural reforms, which if implemented could free up underutilized capacity and promote stronger growth. With both economies resting near the 0% growth line, a weaker dollar would make their exports even less competitive, applying a reform hammerlock that forces them to cry "Uncle" (Sam) much sooner. In addition, the ECB would be given that much more leeway to bring yields closer to U.S. levels since a depreciating dollar and an appreciating Euro reduce future inflationary pressures on the Continent. And a depreciating dollar of course raises prices for U.S. imports, adding a tint of inflation to the current mix and stemming deflationary momentum here in America.

A "strong" dollar policy, however, has been part of the U.S. economic mantra

ever since Robert Rubin first uttered the words in 1995 after succeeding Lloyd Bentsen as Treasury Secretary. His presumed (although never directly stated) belief was that a strong dollar would attract foreign investment and lift all market boats. Mr. Rubin succeeded beyond anyone's most bubblish dreams, but now with the trade deficit at 6% of GDP, and our need to attract nearly 80% of all the world's ongoing savings just to keep the dollar at current levels, an end to the party is clearly in sight. Future investment by foreigners in anything with a \$ sign attached is at risk. In addition, Rubin's policy succeeded so famously that our bonds and our stocks now have lower yields and much higher P/Es than most other alternative markets. Rubin and his successors have painted us into a corner from which either a falling dollar, depreciating financial markets, or both are nearly inevitable.

Despite these negative ramifications for the U.S. currency and its financial markets there is no doubt that this final, last-gasp hole card in Uncle Sam's hand would be played if deemed necessary. Incoming Treasury Secretary John Snow may continue to mouth the mantra of a U.S. strong dollar policy but at some point his lack of enthusiastic support or perceived silence on the topic may be enough to cause a run on the bank. Besides, astute investors and holders of dollar-denominated securities must know by now that public proclamation

of the strong dollar policy was always a ruse, that there was no necessity for a Wizard to hide within the palace of Oz whispering “strong dollar, strong dollar.” Our appreciating currency up until mid-2001 was a result of our role as the world’s lone superpower and our perceived superiority in generating productivity and ultimately capital gains. Now that Iraq, North Korea, and an anemic recovery are threatening that image on all fronts, the dollar is sinking with or without Rubin, Summers, O’Neill, and Snow as Wizard of Oz sound-alikes. If the dollar is to decline it will sink of its own weight, not from the pronouncements or lack thereof from Wizards on high. Still it would be a kick in the pants for others to speed things up, to reflate at an accelerated pace in order to avoid the Japanese malaise of the past decade. Europe and Japan would have to listen.

This final playing card, however, must be viewed as just one of a multitude in an anti-deflationary deck that can and has been dealt in recent months and years by rather independently minded global poker players. Japan, Europe, and the U.S. may be employing rather similar strategies at different times but they do so independently in order to defend their own economic interests.

Together, these disparate steps represent a grand scheme to defeat the deflationary Dragon now represented by China but created by globalization, high debt, and ongoing demographics tilted against consumption. Investment ramifications remain uncertain if only because the ultimate winner remains in doubt. What I think I do know however is that every weapon in the global arsenal will be fired at some future point to prevent declining prices and a concomitant economic collapse. With such resolve, and with U.S. Treasury yields already near rock bottom, the odds favor bear market Treasury trends if only because – as last month’s Genie observed – when yields can’t go down they must eventually go up. The Grand Scheme of Things points towards reflation over the next several years and higher Treasury rates but the Dragon will not go down easily.

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