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How Inflation Begins

> "I am a large volume importer of industrial hardware, mostly out of Asia. I just received my April ocean freight rate update. Container cost up 5% from March and up 21% from April 2009. For my products, the YOY increase represents a 3% increase to cost of goods. Cost of steel as we know is going up significantly and these price increases for us – contrary to what the popular spin may be – are effective immediately. Obviously, as we are replacing fast-turning inventory, we are passing on these increases immediately. About a year ago, I reported to you that our business was extremely slow and our inventories very high. Despite price increases going on offshore, I pointed out that in our world, these increases would take time to trickle through due to the high inventory levels that we and our competitors were sitting on. Our position was that if we had it in stock, we would sell at basically any price for cash flow reasons. Any new inventory would be sold based on actual current cost. Needless to say, the purchases we made through the year were very minimal as we (correctly) were not optimistic about business looking forward."
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> "Now, business is still terribly slow but inventories have been depleted to the point that shortages are occurring. These shortages are exasperated by the fact that no one is buying any significant volume of replacement inventory. Our statistics would show that our purchases in March (for delivery this summer) are up about 400% from any given month last year BUT are still only about 30% of our peak going back before all hell broke loose. Can you imagine how this data can be spun by focusing on the former and conveniently ignoring the latter? We feel that we have hit bottom and have reasonable expectations to survive this debacle simply because we have downsized to about 20-25% the company we once were. Our domestic competitors and vendors overseas basically report the same. . . . (The) bottom line is this: no one is (all that) busy but prices are literally skyrocketing. Smells like stagflation to me. Anyone who tells me that there is no inflation on the horizon is delusional and in for one hell of a shock."
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> . . . a post on Bill Fleckenstein's website *Ask Fleck*

Annualized inflation in India is running at about 15% and China is not all that far behind. In the Philippines, March's inflation figure was just reported at +4.4%, up from the previous month's 4.2%, with the cost of Philippine fuel/electricity/water up 14.6% over the trailing 12 months. In our country, since January 2009 the price of copper is up ~185%, crude oil is better by ~118%, and rubber is higher by ~167%. Moreover, from August of 2009 until now hog prices have rallied ~75%, while cattle prices have lifted ~19%. Such actions caused the Reuters CRB Commodity Index to travel above its 200-day moving average in June 2009 and stay there ever since (read: bullish and inflationary). Meanwhile, economists continue to insist there is no inflation because wage inflation is non-existent. That, however, may be changing given some of the recent "worker strike" announcements.

To us, inflation is assuredly returning, yet the degree of inflation is unknowable. Why are we so sure inflation will return? It is because for decades that has been the easiest political solution for the debt accumulation of our citizenry and our government. To wit, pay back the debt with "cheaper" dollars. Given the recent geometric rise of debt, we see only three ways out for our government: sovereign default (unimaginable); severe economic contraction (unlikely); or, currency debasement (read: inflation). We choose "door" number three as the most likely course. In past missives we have suggested that a 10% per year inflation rate, for the next five years, would go a long way in solving the nation's debt problems. As one savvy seer writes:

> "In 1979 the government ran a deficit of more than $40 billion – about $118 billion in today's money. The national debt stood at about $830 billion at year's end. But because of 13.3% inflation, that $830 billion was worth what only $732 billion would have been worth at the beginning of the year. In effect, the government ran up $40 billion in new debts but inflated away almost $100 billion and ended up with a national debt smaller in real terms than what it started with."

So yeah, we choose inflation. Recently, however, in addition to inflation, another "way out" has been proffered as the phrase Value Added Tax has emerged. Wikipedia defines VAT as "A Value Added Tax (VAT) avoids the cascade effect of sales tax by taxing only

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the *value added* at each stage of production. For this reason, VAT has been gaining favor over traditional sales taxes. In principle, VAT applies to all provisions of goods and services. VAT is assessed and collected on the value of goods or services that have been provided every time there is a transaction (sale/purchase). The seller charges VAT to the buyer and the seller pays this VAT to the government."

Hey "body politic," have you not learned ANYTHING about the folly of a VAT tax from the Europeans?! I think it was my beloved France that first introduced the VAT tax over 50 years ago; and, the implementation of that spurious tax spread quickly across the region. It is a politically *sly* tax because it is embedded into the price of everything you buy. Frighteningly, body politic can raise said tax at their collective will. Accordingly, the government controls the revenue stream, which permits government to do what it does best e-x-p-a-n-d! Hey America, are you listening? Such a tax only aids in lowering an economy's structural growth rate with a concurrent compression in corporate price earnings multiples. And if you don't believe me, the only state in this country to ever use a VAT tax has been my home state of Michigan – 'nuff said!

Speaking of increased government intrusion into the private sector, there was an interesting story in last Friday's *Wall Street Journal* titled "The Massachusetts Insurance Blackout." The gist of the article is that the state's Governor, for purely political reasons, rejected 90% of the non-profit insurers' requests for a price increase (think about that – not for profit organizations). As it turns out, those insurers lost $100 million last year, making it impossible for them to pay the anticipated cost of healthcare claims. As stated, "It may even threaten the near-term solvency of some companies. So until the matter is resolved, the insurers have simply stopped selling new policies" – 'nuff said.

Ladies and gentlemen, our government is running amok. As Dr. Ed Yardeni writes:

> "The wall of worry is higher now following the passage of ObamaCare. The coming tax hikes could depress consumer spending and increase the odds of a subpar recovery in employment. The new law is likely to raise healthcare costs and widen the federal deficit, which might explain why the 10-year Treasury bond is as high as 4%. This can't be good for consumer spending and profits. The Obama administration is likely to be emboldened to push congress to pass more of its liberal agendas, which is bad for business. Yet, I remain bullish until November 2, 2010. That's when our democratic political system will determine whether the liberal agenda will prevail, or will be reversed by a conservative backlash. Until then, I expect that better-than-expected earnings, along with near-zero money market rates, will continue to push stock prices higher. If the political backlash occurs, then a powerful year-end rally is likely. If the liberal agenda prevails, 2011 could be a very good year for the bears."

The call for this week: We are on the road this week and consequently these will likely be the only strategy comments for the week. That said, our short-term indicators have wrongly been counseling for caution since mid-March. But as Lowry's notes, "The probabilities have favored a relatively brief and shallow reaction. Investors can use such periods to upgrade portfolios by reviewing holdings to identify laggard issues to be sold, and use the proceeds to buy stocks with stronger Power Ratings within the strongest Sectors and Industry Groups." Plainly, we agree and since March we have mentioned more than 20 such stock names from the Raymond James universe of stocks.

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