Deflation – When Worlds Collide

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With so much event risk in the short term, and so many policy measures in a state of flux, it's hard to keep a longer---term perspective.

As we are all aware, the credit crisis has spawned a myriad of unconventional policy measures from Central banks and Governments to stave off a global depression.

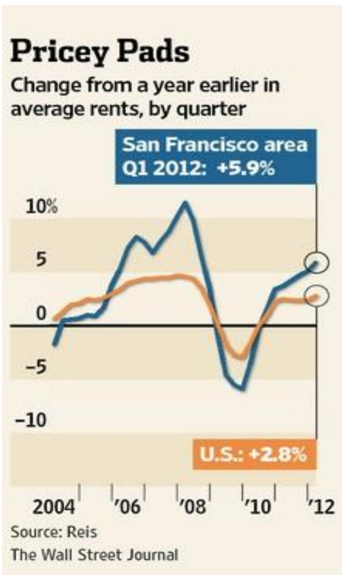
In terms of fiscal policy, Governments are fully stretched to the point where even their ability to honor Sovereign Debt is questioned. This applies to peripheral Sovereigns – but deep down the core Sovereigns i.e. Germany, the UK and the US are all closer than ever to hitting the fiscal wall where their ability pay is questioned. The former by contagion and the latter by their own direct prolificacy. The only saving grace for the UK and the US have is they have control over their own currency--- yes they can "print." Members of the common currency have no such luxury.

Recall 2008--- this was the "Great Global Margin Call." Every funded position was tested, and many didn't survive. Everything from Lehman Bros. to the AUD and Stocks was subject to this margin call. The rescue package came via Government bailouts, and of course the ramifications of this are ongoing and the process hotly contested by political and fiscal vigilantes along the way.

Now the debt transfer has gone from Private to Public--- there's no more margin call, right? Wrong. The Sovereign bond market – and the bellwether 10 yr. is where investors say, "No more!" So now we are left with the same excess debt problem but relocated and repackaged, but with vastly different possible outcomes, especially over the longer term. And it's the longer term that is really where the action will be.

In my view, the final leg of this great debt swap will be in the form of exchanging present value for future value Dollars/Euros/Pounds. Present values, net of debt haircuts to maintain balance sheet" quality" must be maintained, and to a large extent, they will. Do you remember the Greenspan equity put? Well now Draghi has given rise to a credit put in the EU. The phrase "whatever it takes" extends LTRO to include debt purchases and eventual mutualization of EU debt.

But the debtors, in particular the US, will then permit inflation to rise, even set targets (4%) and focus entirely on unemployment. This will depreciate future government capital prices and coupons. Bond holders, and in fact the general public, will see the future value of these non---inflation adjusted coupons, retirement savings and wages fall. For the sovereign issuers, the real value of debt will fall as a consequence, thus "repaying "the debt over the long run.



Short---term risks to purchasing power have already arrived. For example, the US has gone from a nation of homeowners to renters--- and rents, which account for 41% of the US CPI, are on the rise. The graph shows a US hot spot, to be sure, but the message is clear. Add to this energy price rises, increasing bank loans, more QE and the crop failure in the US all add up to a smorgasbord of risks.

Inflationary expectations must rise under this scenario. A bond selloff is thus now a clear and present danger, especially to holders of long dated Bonds in the UK and US and possibly Germany. UK inflation is already uncomfortably high, for example but the safety bubble is holding prices up.

The bottom line is this--- investors need to see the potentially damaging collision of inflation targeting, bailouts, and food and energy supply shocks. The epicenter is the long bond market, which is currently sitting in a safety bubble. Negative real return bond investments could possibly be the worst place to be over the next 6 to 12 months.

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