

“Bond Markets and Inflation Fears”

There is a surge of Government debt funding the various bailout and stimulus packages and, interestingly enough, many of the recipients of this Government money are issuing their own debt to get out of the grip of the Government bailout. Needless to say, sometimes following the pea as it is transferred between the shuffling cups can be a challenge.

The stock market has been confidently predicting that the worst is over and many positives are coming our way. The bond market, however, has been brooding over the piles of new debt and also signaling concern over how inflation will impact this recuperating economy. Clearly inflation is coming, but the media hype about hyperinflation (greater than 12%) or even high inflation (greater than 6%) is probably just that, hype.

Inflation, with its higher interest rates on bonds and money market funds may bring relief to investors looking for higher income, but is bad when you want to encourage economic growth and spending which do much better with low rates. Unfortunately, when anything is for sale, in this case Government debt, it tends to get cheaper when supplies are plentiful. The supply of debt is now very plentiful indeed. As debt gets cheap (the price to buy it goes down), the rate (or yield) goes up. Rising interest rates usually equate to rising prices on goods and services, and rising prices are the root of inflation. The possibility of such an inflation spiral will be paraded to all investors via the media pundits for many months to come, so prepare to be bombarded with the threat of this type of scenario.

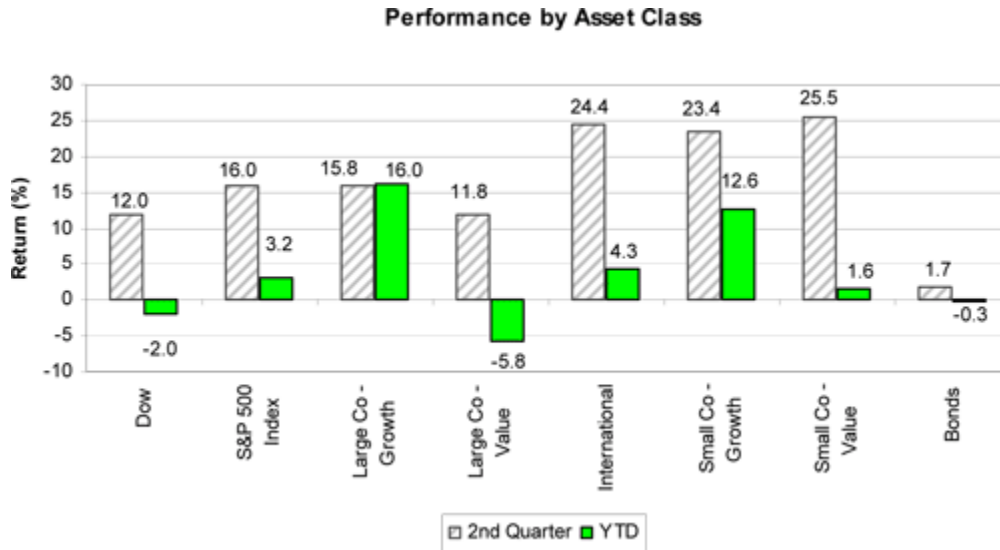
All this new debt by itself however is not nearly enough to drive inflation past 3-4% in a \$13 Trillion dollar US economy. Other factors are needed like wage pressure, limited production capacity, excessive consumer and corporate debt, and excessive consumer and corporate spending, all acting in concert to push prices up. We have none of these pressures with little likelihood of seeing any in the foreseeable future.

The US and world consumer is shaken and still retrenching. Most spending is focused on either paying bills, if possible, or simply saving. Homes are no longer easy ATM machines, US corporate debt outside of banks and financial service companies is at historic lows, US manufacturing capacity is underutilized and there is gigantic global capacity available. These factors all limit the impact of inflation.

The driving force behind any possible increase in inflation is most likely going to be the amount of outstanding Government debt and the capricious and volatile price of oil. Both of these can be controlled somewhat by the Government spending less in the future on stimulus and the consumer using less oil. Both of these factors are complex and will take some hard choices and positive action by both parties to resolve. We know this is not a new debate so we shall have to wait and see. The likelihood of uncontrollable or unforeseen inflation sneaking up on this economy as it has in the past

is remote, but we are concerned that the fear of it might bring more short term volatility into these fragile markets.

The chart below reflects the tremendous gains in the equity markets for the second quarter which helped bring the year-to-date gains for the most part into positive territory.



Market recoveries have unique features, but tend to wander down some of the same roads. The rebound from the March 9th low has followed this pattern. Markets may swing up and down for a few months longer, but eventually investor fear will subside and the abundant opportunities provided by this necessary restructuring will foster the creation of wealth.

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