

J. Anthony Boeckh on the Great Reflation

By Robert Huebscher

May 18, 2010

From 1968 to 2002, J. Anthony (Tony) Boeckh was chairman, chief executive and editor-in-chief of Montreal-based BCA Research (previously known as BCA Publications), which publishes, among others, the highly regarded Bank Credit Analyst, a monthly big-picture analysis of the U.S. economy and financial markets. BCA Research is now owned by Euromoney PLC. Boeckh recently authored *The Great Reflation: How Investors Can Profit from the New World of Money*, published by John Wiley & Sons in 2010, which is available via the link above.



We interviewed Boeckh on May 14, 2010.

Can you discuss the primary theme of your book, the “Great Reflation,” and where you believe the US is now in this process?

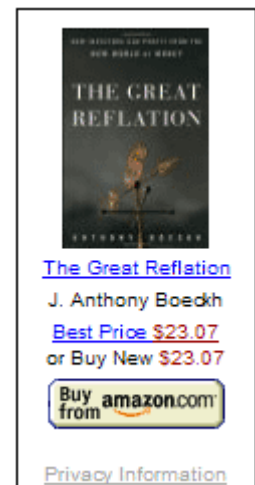
The Great Reflation has to do with the massive fiscal spending, bail-outs, huge deficits, and free money from the Federal Reserve that drove interest rates down to zero, doubling their balance sheet and pumping massive reserves into the banking system.

I really wanted to title my book the “Great Reflation Experiment,” but the publishers didn’t like the word ‘experiment.’ To me, this is an experiment. We’ve never been here before. We’ve never seen anything of this magnitude in peacetime. It was required because, without it, we would have had a full-blown Depression like we had in the 1930s.

In the 1930s they took the old-fashioned way and let the fire burn itself out. It took 10 years and 25% unemployment, but the fire did burn itself out.

This time they learned something from Keynes. When you get into these kinds of liquidity crises, you’ve got to supply liquidity. You’ve got to fill the hole created by the public, who have suddenly stopped spending and started saving, and you’ve got to prevent a complete debt collapse, which would have clearly been a catastrophe.

But there are consequences from all this reflation. There is no way that all this reflation is going to make us whole again. We got into this trouble because of a massive increase in private debt over the last 25 years, which we call the Private Debt Super-





cycle. Essentially, what we are doing is replacing private debt with public debt. There are limits to that, as Greece has demonstrated.

You describe a tug-of-war between asset inflation and price inflation. How do you see that playing out over the next several years? At what point will we face inflation?

You have raised a key point, which I deal with in the book. It goes back to an understanding of what is inflation. A lot of people are confused about inflation because they think of it as an increase in the consumer price index (CPI) – the things people buy on a day-to-day basis. Inflation really has to do with an excess creation of money and credit.

Rising prices are the symptom of that monetary inflation. Sometimes it shows up in the CPI, like in the 1970s. Other times it shows up in asset prices, which is what we saw in the 1980s, 1990s and in the first part of this decade.

Asset inflation is a far more dangerous type of inflation, because there is far more borrowed money that lies behind it. When asset prices get pushed way beyond equilibrium levels, and it is driven by debt, then when the asset prices come down and the debt is fixed in the short term you're left with a dramatic decline in the collateral value behind the debt. People can't pay their debt back and it feeds on itself, because people are forced to liquidate assets. It gets into a vicious cycle.

To go back to your question – how is it going to play out? It's a matter of time horizons. In the short term, the world is very deflationary and it's going to stay that way. All this money that has been created has to go somewhere. It's going to go into assets. We are already seeing this. The stock market is up 60% or 70% since its lows, and there are rising stock markets all over the world.

We've got a housing price bubble in China. Commodity and gold prices are all up. The money is going somewhere, but it's not going into consumer prices in any sort of general way. The impact on prices from the coming fiscal restraint we are going to see will further compound the general deflation of prices. That will force the central bankers to keep money easy and cheap. I expect to see more bubbles in asset prices.

When you say fiscal restraints, what specifically to you mean?

There won't be another stimulus package. We will see huge cuts in government expenditures, curtailment of entitlements and increases in taxes.

Going back to Greece for a second: Greece is a fantastically good example for the rest of the world. Of course, it's a disaster for the Greeks. But it has demonstrated for the whole world what happens when government debt goes beyond a sustainable level.



We are seeing this already in the UK. As soon as the new government took office, they slashed government expenditures and are going to be raising taxes. We're going to see this in every major country in the world. The real test is going to be whether it damages the social fabric, as in Greece, and you get riots in the streets and the government backs away.

If that's the case, then we are going to get into another 1970s scenario with consumer price inflation, and the central banks will have no alternative but to monetize all this government debt.

For many people, that is their worst fear – that we could see a replay of the inflation of the 1970s, or even worse. Conventional wisdom seems to be that a worst case outcome – hyperinflation – requires a political or policy decision to head down that path. Do you agree with that, or could we have that outcome despite the best efforts of our policy makers?

Absolutely, it's a possibility. But because the fears of that are so widespread, it's forcing the government into fiscal restraint. The test is going to be whether that fiscal restraint works and the social fabric holds. If the politicians find that they can get elected based on fiscal austerity instead of on entitlement spending, then I think there is a good chance we can avoid that.

If that doesn't happen, and if governments think they cannot politically survive fiscal austerity, then there is no alternative. That's where you get into the policy decision arena.

Governments don't inflate because they want to. They do it because it is the least bad alternative.

The risk of this is years away. Too many people are really getting carried away with inflation and looking around too many corners. Right now they should be focusing on deflation.

When you say years away, do you have a forecast for when that might be?

I don't really know. These things are really hard to pin down. My guess is that it could be at least two or three years away, and it could be a lot longer.

It's really hard to inflate. Look at the case of Japan. Despite all the deficits and zero interest rates for almost 20 years, they still have deflation.

Getting back to the US situation – the average term to maturity on US debt is about four years. They can't fool the bondholders for very long, or interest rates will go



through the roof. People have learned that lesson from the 1970s. It's still pretty much on their minds.

You forecast a weak dollar. Yet, over the very recent past, that has not been the case, at least with respect to the euro. Could the troubles in the rest of the world cause a continued flight to the safety of the US dollar, which would help strengthen the dollar and reduce our current account deficit?

The US dollar is a fundamentally flawed and weak currency, but so are most of the others. The dollar is the best looking horse in the glue factory.

Who wants to own the euro, yen or the pound sterling? So people have gone into the currencies of commodity-producing countries, like Canada, Australia and Norway. Norway has no debt. Canada is in pretty good shape. If there is an inflationary resolution to this, Canada is going to be a beneficiary.

The US dollar has been relatively stable against all the other big currencies. As long as that is the case, it is good for the US. It means the Federal Reserve can keep interest rates very low without having to worry about people dumping US dollars. It is a precarious situation, because foreign central banks hold approximately \$4 trillion of US dollars, and if they lose confidence in the dollar, the dollar could lose value very quickly.

Could that be a trigger to much higher inflation?

Absolutely. We've been telling people to watch the dollar and US Treasury yields. As long as they are both stable, then that day can be postponed.

You discuss several indicators of valuation in the equity market, and you cite two of them – the yield curve and bank liquidity – as having been reliable guides of future performance. Based on what you are seeing now, what is your forecast for US equities over the longer term?

One of the points I make in the book is that there is no long term anymore. Nobody knows how this experiment is going to play out.

There are lots of publications which sell precise forecasts. Most of them are not worth the paper they are printed on. My approach is to watch what's going on in the system. Follow the liquidity flows. As long as they continue like they have in the last 15 months, the equity market is going to work its way higher. It's going to be a good environment for US stocks.

There are lots of debates over valuation. Some say it is cheap, based on different metrics. I personally don't think valuation is very helpful in trying to gauge where the markets are going. Liquidity flows are really what drives the market. Right now they



are very positive. Price inflation is low. The money has got to go somewhere, and a good chunk of it is going to go into US stocks.

As long as the dollar is stable and interest rates are stable, then the stock market is going to work its way higher.

But if you're asking me where the market is going to be in three or five years, I haven't a clue.

Let's turn to the situation in Europe. What thoughts do you have about the events of the last two weeks? Does the eventual fate of the European periphery – the PIIGS – depend on the ability of those countries to successfully undertake fiscal tightening, or are there other more important forces at play?

Greece is in by far the worst situation, because not only do they have a very high debt to GDP ratio – about 120% – they also have no savings, and a huge amount of their debt is held by foreigners. They lie about their numbers. Nobody trusts them. People riot in the streets as soon as their government wants to cut back on their entitlements, which they really don't deserve.

Greece will default on its debt. It's an absolute certainty.

Even with the Draconian fiscal tightening that was imposed on them by the EU and the IMF, the Greeks' debt-to-GDP ratio is going to go to 150% in the next four years. No country can live with that and with the accompanying decline in living standards. They will default like Argentina. Their big problem is that they don't have their own central bank, so they can't devalue. They are locked into the euro. They have to deflate internally, like the 1930s under the gold standard and that can be disastrously painful.

The lesson for those peripheral countries is that they have to act now. But, it's hard to say whether they are going to pull it off. It's a high-risk situation. Those Mediterranean countries don't like austerity.

Spain has a huge unemployment problem and its housing crash was much worse than in the US. Ireland seems to have bitten the bullet and has really imposed Draconian policies. The UK has a horrible debt situation and they've imposed a lot of restraints in the last few days. I think there is a good chance the UK is going to work its way out of this.

It's going to be a country-by-country resolution. We are not going to have a global sovereign debt crisis in the short term – in the next year or two. It's really going to depend on whether the social fabric can withstand the austerity that is required. I don't think we are going to know the answer to that for a year or two.



Is it possible for a country to withdraw from the EU? If a country such as Spain withdraws from the EU, wouldn't its home mortgages, which are in euros, end up in default?

It's very hard for a country to withdraw from the euro. It's like California withdrawing from the US, creating its own currency and devaluing. It boggles the mind imagining how they would do that. I don't know how that would happen.

I doubt if the Greek central bank has printed up a whole bunch of Drachma, getting ready to create its own currency. If word of that ever got it, there would be chaos.

They are going to default on the debt. The homeowners, who have taken on debt in euros, will default too.

The ECB president Trichet has said that the ECB will "sterilize" its purchases of sovereign debt. How does that decision stand with respect to the current low inflation levels in Europe? What advice would you give to Trichet?

I would look for another job. He doesn't have many good options.

It's a real balancing act. Germany's worst nightmare has just come true, having to bail out these Club Med countries – these financial spendthrifts. The Germans have been kicking and screaming, but they really don't have a choice if they want to keep the euro and the EU together. They've got to do it.

There will be a combination of some default and the central bank buying some bad assets. They will have to bail out the banks a bit more too. European banks own approximately \$189bn of Greek bonds. American and European banks own about \$1.7 trillion of the debt of the so-called PIIGS. There could be a lot more bailouts required for banks, if they have to write off a chunk of that.

What are the key takeaways for investors in light of your forecasts? What do they do with this information, and what is going on in the world?

This is an experiment. Nobody knows how this is going to play out.

It's going to be tricky. We've been on a roller coaster ride in the financial system and the economy over the last 25 years. It's going to continue. Now, it's going to be a roller coaster on steroids. Things can go wrong on short notice, like it did last week in the US stock market.

I think people really need to understand a little bit about history, and how inflation, particularly price and asset inflation, can affect their investments.



People need tools to navigate through this. Buy-and-hold is gone as a basic investment philosophy. You have to watch the financial flows and take some money off the table when liquidity starts to go the other way.

Above all, people have to be the CEOs of their own portfolios. They have to take responsibility for their assets. Planners can do a terrific job educating and advising people, but ultimately people have to establish their own risk parameters.

For the future, you really need to think a lot more about wealth preservation in this kind of environment, even if it means giving up some return in bull markets. You have to have the liquidity and staying power to get through these big downturns. The big lesson from 2008 and 2009 was that so many people got caught without enough liquidity. They found out their assets were in illiquid vehicles and they couldn't sell them. Even though the market has come back a lot, when you are at the bottom of one of these crises, you don't know if or when it will.

You need liquidity to make sure you can withstand these downdrafts, which can be very severe.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>