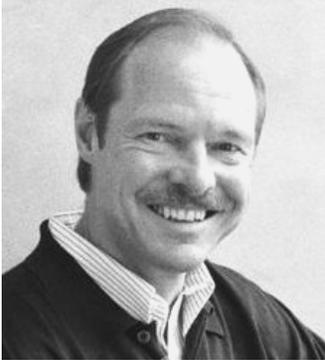


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Perspectives



The Fed's Monetary Torrent: Sowing the Seeds for Inflation

The scientists at Geneva-based CERN, the world's biggest particle physics laboratory, are busy preparing for the completion by 2005 of the Large Hadron Collider, which will send protons and ions from hydrogen nuclei racing through a 17-mile circular tunnel laid out at the border between Switzerland and France. The particles will move at a speed of up to 52.2 million miles an hour and eventually collide head-on.

CERN, whose scientists have earned no less than nine Nobel prizes and claim countless inventions, including the internet, doesn't know what exactly will happen when the super-accelerated particles meet their violent end. But the organization hopes to gain insights into the mysteries of the subatomic universe and the big bang.

What's happening in the world economy is less weighty than coming to terms with the birth of the universe, but there are a number of intriguing parallels. What the Federal Reserve is in the process of completing has also never been done before. And how the monetary torrent unleashed by the Fed will affect our day-to-day lives is equally unknown. And, finally, 2005 is not only a crucial year for CERN, it's also likely to be the year when the seeds the Fed is currently sowing will start to be reaped.

Deflationary collapse or inflationary super-cycle?

The seeds I'm referring to are money and its facilitator, credit—money in the form of printed paper certificates backed by nothing but your faith in the government of the United States and credit, the false mirror that distorts affordability and, by doing so, allows us to live well above our means. What the harvest will be is entirely uncertain. It could be anything from a deflationary collapse to the launch of an inflationary super-cycle coupled with a dramatic meltdown in the dollar.

The deflationary script becomes a serious risk if rising interest rates cause the housing market to crack. Housing, it should be noted, has been the only element in the consumer's universe that's done well and kept Main Street's balance sheet from imploding. An inflationary outcome will be virtually guaranteed if the Federal Reserve, true to its word, does everything it takes to keep interest rates low. Or it could be anyone of a dozen possibilities in between; after all, the majority of analysts still believe that we can get by without plunging into an extreme scenario.

"The Fed is walking closer to the edge than ever," my Geneva-based friend, money manager Dominique Dziurzynski told me recently, "but it can probably pull it off." Then he added, "In Europe this kind of thing would never work." I thought about his comment a lot and concluded that it made sense. After all, Americans--forever consuming more than they produce--are used to walking a tightrope. On the one hand, that makes them the global engine of economic demand and thus earns them universal respect for their "can-do" attitude. On the other hand, they're forever in debt, both individually and as a nation. There's recklessness at play here and the reckless, in most cultures, are both admired and resented. Predictably, America's boundless daring periodically gets the nation as a whole into trouble, which is why the Federal Reserve is in the spot it's in now.

In a way, a central bank is invariably a reflection of the national character, not an entity that can for any length of time steer an independent course. Just as America's bold ways caused the Fed to end up in a muddle from which boldness offers the only way out, the overly cautious Europeans have got the continental economy stuck in rut from which the European Central Bank seems unable to escape--primarily because it emulates that caution. If Europe's central bank did what the Fed is doing, its constituents would turn ever more cautious, rather than respond, because caution is etched into their character. It's an interesting thought, but it doesn't answer the most pressing question of the moment: what will the Fed's all-out monetary torrent lead to?

Inflation Threat Growing

Only a couple of months ago, I thought we were clearly careening towards a deflationary disaster. The Fed's actions and rhetoric (and those by many other key central banks) have since convinced me that the outcome is far more likely to be inflationary. Many of the world economy's problems (such as chronic overcapacity and huge debt burdens) mandate a continuous bailout of such scope that the rebirth of the inflation monster appears assured. And, come to think of it—is it not true that the Fed's (or any other central bank's) final mandate is to keep the system from collapse, no matter what it takes? And if it has to choose between various negative outcomes, doesn't it stand to reason that it will choose the one that allows for more time? By doing so, at least it leaves open the possibility that a positive surprise may, in the end, avert disaster.

A year or so ago, I started cautioning that the bond market was approaching its apex and that the two-decade long decline in inflation and interest rates was nearing its end. The Iraq war and the inability of the world economy to make a decent showing prolonged the turnaround, but this summer the party finally ended with a spectacular crash.

What will be next? Bond prices may stage a "dead-cat-bounce", but in my opinion the bear market in fixed income instruments has only just begun. The thing to do now is to prepare for inflation. It won't be visible for a while, just as the crop that's been sown takes a while to become visible. But by 2005, the time when the folks at CERN plan to crank up their Large Hadron Collider, inflation will start to show. □