The Cure for High Prices
Let's Rewind the Inflation Tape
A Shocking Development
Another Important European Election
Home Again, a "Sports" Injury, and My Conference

By John Mauldin
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Today we once again think about the inflation/deflation debate, turn our eyes to Europe and the very interesting election happening there this Sunday, and speculate a little about what could derail the US economy.

But first, a quick note to Conversations subscribers. We have just posted a new conversation I did with Rich Karlgaard (Forbes publisher) and Andy Kessler. A found it fascinating to talk with two rational optimists who live in Silicon Valley and have watched the scene there for a very long time. I will soon be doing two more Conversations, the first with Neil Howe *(The Fourth Turning,* and one of the most astute experts on demographics) and the second with Albert Edwards and Dylan Grice of the Global Economics desk at Societe Generale and two of my all-time favorite thinkers.

For new readers, Conversations with John Mauldin is a subscription service where I sit down and talk with interesting people and let you listen in. You can learn more at http://www.johnmauldin.com/conversations/. If you want to subscribe or renew, use the code **conv** and get a 25% discount, plus access to all the previous conversations, plus a recent piece with George Friedman of Stratfor. Now, let's jump into today's letter.

The Cure for High Prices

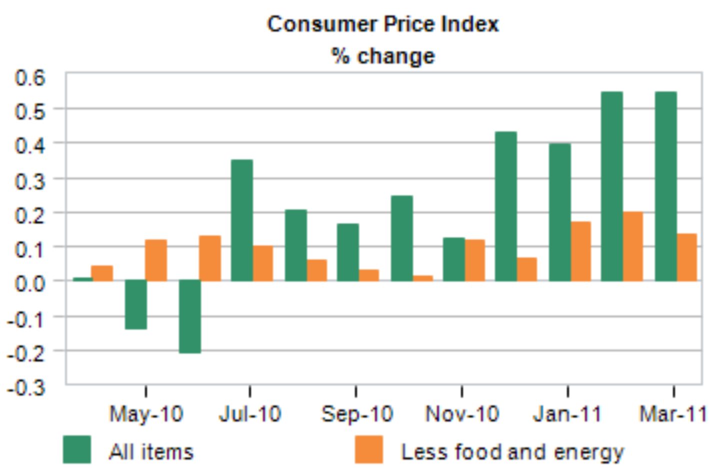
The old line is that the cure for high prices is high prices. When prices rise, businesses tend to respond by producing more. If the price of something gets too high, then people buy less, which then leads to too much supply, which lowers prices. Rinse and repeat.

Last week I wrote about what I think is the potential for inflation in the US to rise to uncomfortable levels, in the 4-5% range. I got questions from readers asking if that meant I no longer thought deflation was an issue. The quick answer is no. Deflation, or at least low inflation, should be the normal trend. Prices should go down as we become more productive. But there is never a one-way street. Prices fluctuate. We got the Consumer Price Index numbers today, and we will use them as a "teaching" moment to think about the whole drift, the yin and yang, if you will, of inflation.

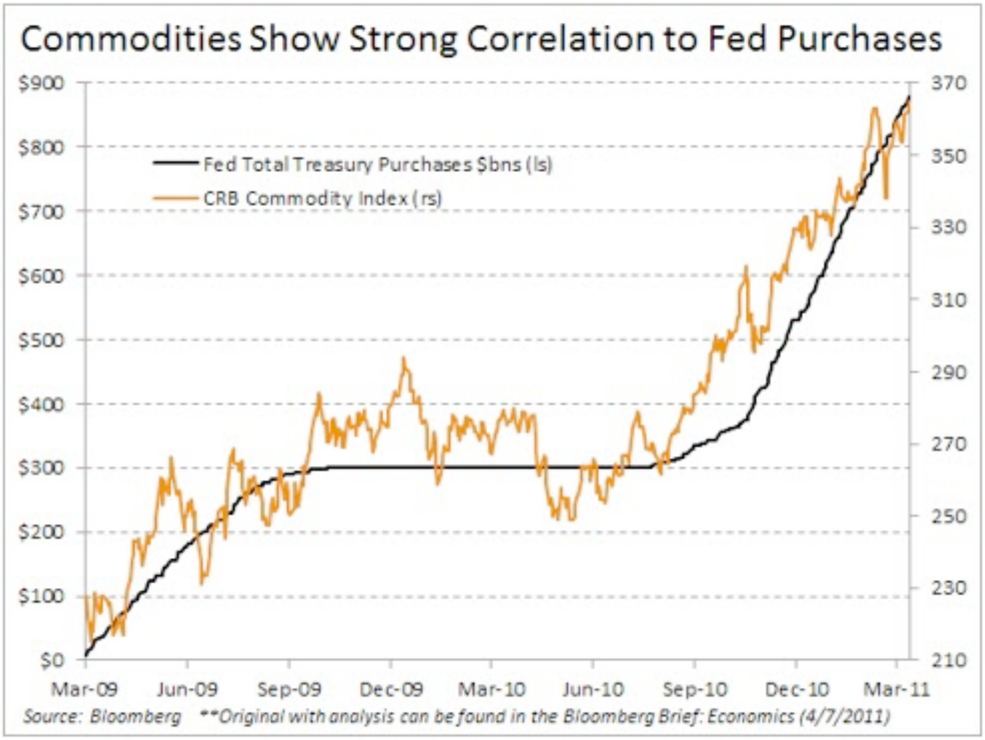
As a review, if the analysts at rent.com are right, rental prices for housing should rise 10% or so by the end of 2012. Homeowner's Equivalent Rent is 23% of total inflation and 40% of "core" inflation (inflation without food and energy in the index). The Fed prefers to look at core inflation, as it is less volatile. They think that price movements in food and energy overstate inflation at some times and understate it at others. You can make a case either way, but for now let's just accept that core inflation is what the Fed uses.

IF (a big if) rent prices rise by 10%, that will add 4% over the next 18 months to core inflation, which is a rather large move, but will also be something the Fed in theory should not ignore, all other things being equal. That could lead core inflation to be more than 3% and overall inflation back up over 5%. That will have the inflation hawks hyperventilating. It may force the Fed to raise rates sooner than they would like, or at least make them think a long time before diving into QE3.

Let's look at the data that came out today. Core inflation was tame, but overall inflation is still running at over a 5% annualized rate (and above 6% over the last three months!). Let's look at a graph from economy.com.



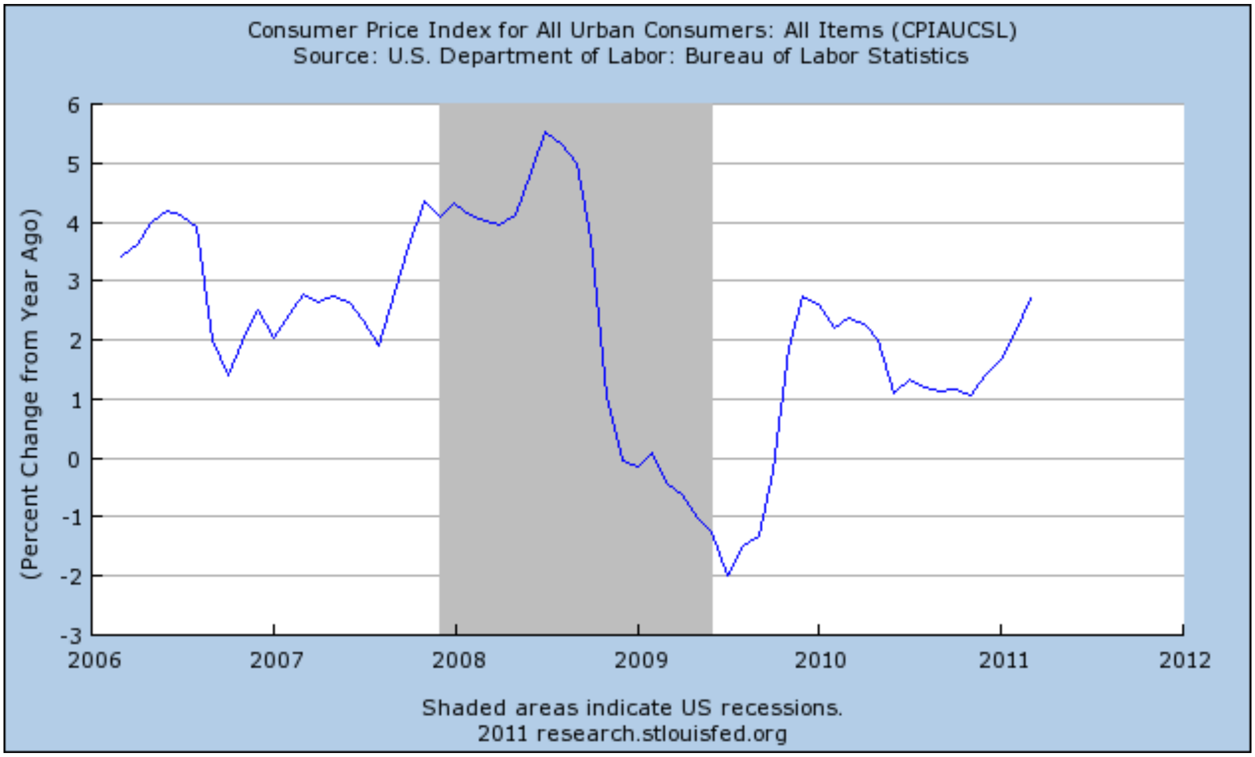
Core inflation remains tame, but the recent trend in overall inflation is still up. And given that we live in a world where we buy food and energy, it understandably annoys people to think that the people in charge are looking at core inflation when gas is $3.80 (or more!) a gallon. And as I outlined last week, there are reasons to think there is a transmission mechanism from QE2 to commodity price increases (www.johnmauldin.com and click on Thoughts from the Frontline, April 8, 2011 issue). And while correlation is not causation, the following graph from Russ Winter, at my friends from www.Minyanville.com, does make your eyebrows go up.



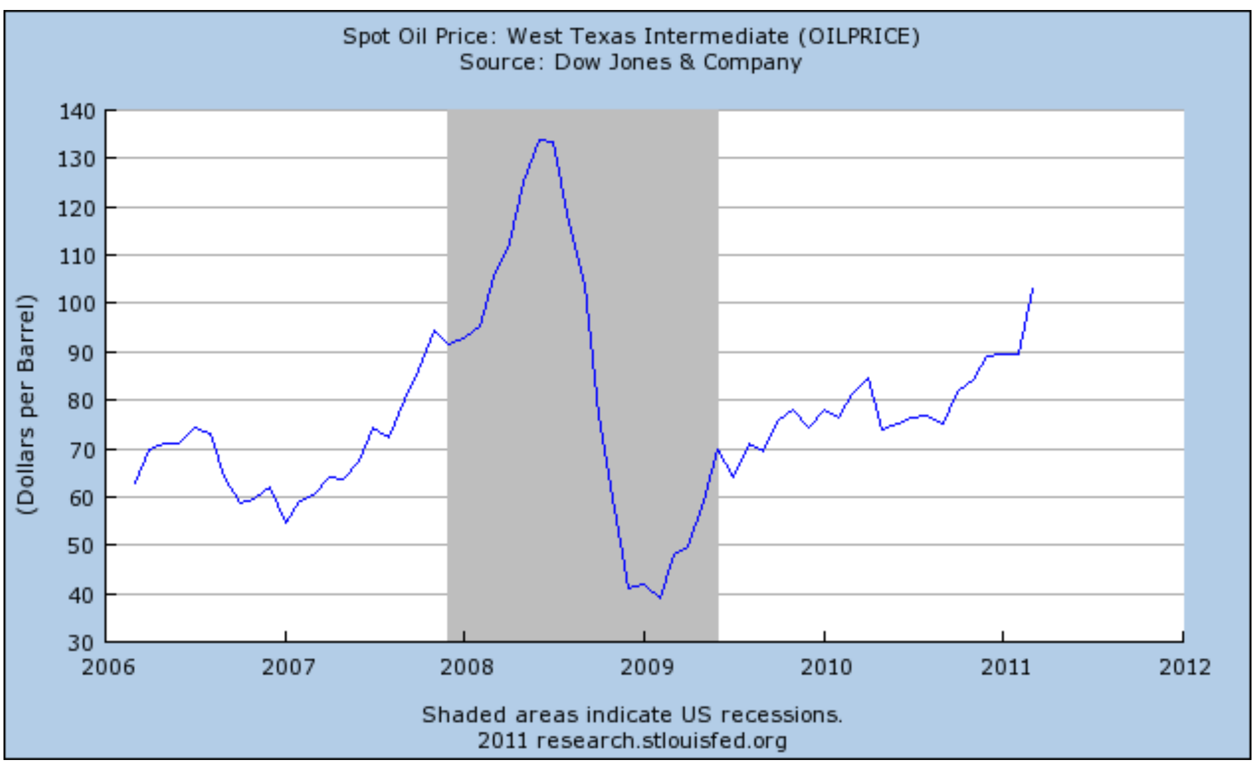
The subcomponents in the inflation index that have exposure to commodities are all up and show rising trends. The NFIB survey suggests that businesses are planning to pass on the price increases they are getting, although that is not in evidence yet.

Let's Rewind the Inflation Tape

Now let's look at inflation a few years back. Inflation was above 5% and I was writing that deflation was in our future – and got a few remarks from some corners about not being able to read a chart. And inflation was rising, but we were getting ready to go into a recession, and recessions are *by definition* deflationary. Predicting lower inflation was not all that hard. Let's look at a few charts from the St. Louis Fed. This first one is the CPI for the last five years. Notice that inflation was high going into the recession.



Where did the rise in overall inflation come from? Let's look back at what energy was doing back then. Here is a chart on the price of oil (West Texas Intermediate on a monthly basis). Notice that the correlation between inflation and rising oil is very high.



And as oil fell so did overall inflation, and with the rise in oil once again we have seen overall inflation begin to rise.

Now, let's do a thought experiment. What if oil stays where it is today for one year? Then the inflation component of energy would be flat. Oil prices would still be high (as we think of them today) but not contributing to inflation. The CPI measures the change in prices over a period of time, not the effect of prices. High energy costs would still be a drag on the consumer society, but not get reflected in the CPI.

This is why Fed types, among other reasons, tend to not focus on volatile energy prices (which will correct themselves over time) but on things like wages, which are "sticky." By that we mean, when you get a rise in wages, they don't tend to go back down (absent losing the job and the next person hired at lower wages). Wage inflation is something the Fed does pay attention to.

As I noted above, core inflation could begin to rise going into the end of the year, even as the economy could soften with the expiration of QE2, persistent high employment, and high energy prices. I think the economy will grow at less than 2% for the latter half of the year, at least looking at the data we have now. That means that by the end of 2012 we could see inflation coming back down as the rise year-over-year slows.

A Shocking Development

I gave a speech today and was asked what I thought about the US economy. I said that, absent some kind of shock, we should continue to grow, albeit slowly. Of course that begs the question, what shocks are out there? I see two main ones. The first is an oil price shock with a slow economy. Another crisis in the MENA area (or Nigeria) that disrupts oil supplies even further could quite easily send oil to $150, which would not be good for the world economy.

But, following that thought, that would mean another recession and probably a global one, which would reduce demand for oil, which would help lower the price of oil as the crisis (wherever it is) gets resolved. And once again we would start talking about deflation, which is really just year-over-year price movements. Remember, recessions are by definition deflationary, as they reduce demand and increase unemployment.

The correlation between oil shocks and recessions is high, especially if the economy is not robust. Thus my worry.

Another Important European Election

And the second shock I worry about is the sovereign debt crisis developing in Europe. I have written about how Irish voters rejected funding their banks and about the ongoing negotiations. But this week we got a vote from Iceland that gives us some insight into how things may go.

Last year the Icelandic voters turned out the old government and rejected backing their bank debt, which was mostly to Britain and the Netherlands. The new government then renegotiated the terms of the debt. They lowered the interest costs to 3.2% spread out over 30 years, and no payment until 2016. Not bad terms if you can get them. The debt was incurred when Britain and the Netherlands compensated their nationals who lost savings in online "Icesave" accounts owned by Landsbanki, one of three Icelandic banks that collapsed in late 2008.

The *Eurasia Review* noted:

“Attempts by creditors to persuade nations to bail out their banks at public expense thus is ultimately an exercise in public relations. Icelanders have seen how successful Argentina has been since it imposed a crew haircut on its creditors. They also have seen the economic and political disruption in Ireland and Greece resulting from trying to pay beyond their means.

“Creditors did not give accurate advice when they told Ireland that it could pay for its bank failures without plunging the economy into depression. Ireland’s experience stands as a warning to other countries about trusting overly optimistic forecasts by central bankers. In Iceland’s case, in November 2008 the IMF staff projected yearend-2009 gross external public and private debt at 160% of GDP – but observed that an exchange rate depreciation of 30% would push the ratio to 240% of GDP, which would be ‘clearly unsustainable.’ But the most recent IMF staff report (January 14, 2011) shows end-2009 gross external debt at 308% of GDP, and estimates end-2010 gross external debt at 333% – even before taking the Icesave and other debts into account!”

Basically, the voters of Iceland were being asked to take on a huge debt based on foreign currencies over which they have no control. Voting no meant that acceptance into the euro club would not be likely (though that is not a club you might wish to join today!) There are other threatened measures. But absent the British or Dutch sending in troops, there is not much you can do to force that debt collection. Iceland’s voters sent the referendum a resounding 60% no vote.

Now let’s fast forward to Sunday and the elections in Finland. Yes, Finland, that bastion of euro correctness.

It turns out that some of the nation’s voters don’t see why they should “donate” to a fund that will bail out Greece, Ireland, and Portugal (for openers – forget about Spain!). There is a party, called (in translation) the True Finns party. It is a very nationalistic party and generally does not get more than 4% of the vote. But recent polls show their level of support has more than tripled and is approaching that of the three biggest parties: Center, National Coalition, and Social Democrats, which each have about 20 percent. It is very possible that the True Finns could get a sizeable vote. If the polls are right.

Why? Because they are the only way Finnish voters can say no to using their money to bail out other countries. Some 60% of 2,400 respondents in an April 8 survey by Think If

Laboratories said they opposed bailouts, while 31 percent approved. The margin of error was 3 percentage points. *(Canadian Press)*

The True Finns note that no one rushed to their aid when they had their own crisis in the '90s. The country has since gone on the "straight and narrow."

60%! Wow! The True Finns have made it clear they will not go into coalition with any government that votes for more bailout funds. Think that same sentiment is not rising in Germany? Most people are concerned about the debtor nations rejecting the terms of the deal. Finland may show us on Sunday that the no vote works both ways!

As I understand the treaty, even the debtor nations must "guarantee" the debt that is used to bail out other countries, even as they accept bailouts. It is all for one and one for all. But what if Finland says no? Does that mean the end of the debt bailouts? Will the rest go on without Finland? Will other voters in countries with little deficits also decide that enough is enough? Can Angela Merkel keep her coalition together in Germany? The possibility of a crisis is high and rising. Stay tuned.

Home Again, a "Sports" Injury, and My Conference

I am back home for 13 days and ready to be in my own bed without obeying an alarm clock. These last trips, while fun, have been tiring. It was especially pleasurable to see my old friends Ed (of Crestmont Research) and Kelli Easterling in Oregon. He has built a fabulous retreat in the middle of their tree farm, under old-growth trees, very close to Corvallis. I like the city, but a few days of woodland retreat would be nice. And Tony Arnerich was a great host at his conference, with some fabulous Oregon wines and dinners with fascinating people.

I (literally) limped home. My left heel has been getting worse and worse and the pain sometimes is pretty intense. I went to the podiatrist this morning. He came in and posted the x-rays and I said, "That doesn't look right, does it?" Turns out my right heel is quite inflamed. He confirmed what Dr. Mike Roizen told me Wednesday night at Mehmet Oz's fundraiser. Moving my foot, which seems to help the pain, actually makes it worse. Kind of like bursitis, but in my heel. He wondered what I did to bring on the injury. "What have you done to change things in the last three months?"

"Well, I did start working out with a new trainer, doing lower weights, higher reps."

"She has you doing lots of lunges, doesn't she?" "Yes."

"You didn't do many before, did you? You just exacerbated the heel, creating an inflammation. Let's call it a sports injury," he said with a smile.

So now, for the next 4-8 weeks, I will be wearing this large brace to immobilize my foot. It looks like I broke my ankle skiing. I can take it off for speeches, but the more I wear it the faster I will heal. Oh well.

I will go to La Jolla in about 13 days, and wear it there most of the time. I guess I will get used to it. The conference has again sold out, and this one looks to be even more fabulous than the last seven. And I am working on a new speech on a new topic. Lots of fun research, and nice to be home to do it.

Time to hit the send button. Dinner with friends beckons. Have a great week!

Your feeling kind of silly in a brace analyst,

John Mauldin