BLUE WATER'S Market Perspective

January/February – 2011

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We welcome back all of our long-term readers, and in addition we extend a warm welcome to those who are new readers. We will present our usual review of the economy (authored by Wilson), market trends (authored by Sivalingam), and a segment on financial planning (authored by Pfahl), followed, once again, by a brief discussion of a special topic (authored by Wilson). This time the special topic for discussion will be "Inflation and the Price of Eggs." We hope that this issue's offering will prove useful to a wide range of investors and will help explain more completely our opinions on what should be done under current market and economic conditions. For new readers, please note that each issue going forward will feature a special topic for more detailed examination, plus a bi-monthly economic and market review. There will only be room for a brief discussion of each topic, so even the busiest reader ought to be able to glean something from this report with a minor time commitment. Please feel free to send us an e-mail or call with questions, comments or suggestions.

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Economic Summary: Recovery to Weaken

By Kevin M. Wilson

Overview: Food and Energy Inflation Raise Risk of Global Slowdown

Back in late June last year I wrote about my fear that we might be facing another recession in the U.S. within a year. At that time leading economic indicators were strongly negative and evidence was growing that a slowdown was on the way. But several of the leading indicators apparently gave a false warning, at least in terms of the severity of the slowdown, and the recovery has seemingly strengthened into the late fall and early winter. However, it is important to note that one reliable indicator, the 3-month moving average for the Federal Reserve's Chicago National Activity Index (NAI), has remained stubbornly negative for eight months.[1] If the 3-month moving average for NAI falls to a reading of -0.70, a recession will be imminent, but currently the reading is only -0.10. About the same time as leading indicators started improving last fall, the Federal Reserve's direct intervention in the bond markets caused a huge stock rally from September to late February. This resulted in strengthening consumer confidence and support for increased household spending in the U.S.

The global recovery appeared to be on track late in 2010 and early in 2011, although it was still weak in many developed countries, and weaker than it had been in many emerging countries. U.S. GDP growth came in at a revised 2.8% for 4Q-10, which was good but not as strong as had been predicted, and certainly not as strong as in a typical recovery. This relatively slow growth is probably due to high unemployment, falling home prices, and reduced spending by state and local governments in recent months. Now however, yet another challenge to the global recovery has arisen: the recent widespread trend toward higher food and oil prices. **There are concerns that soaring inflation is causing a slowdown in China, India, Korea, Indonesia and other emerging economies as governments tighten monetary policy in response.[2] In fact, in late February the Chinese government announced a reduced annual growth target of 7% for GDP in the next five-year plan, according to Bloomberg Research.** Bad weather and increasing global demand have combined with easy monetary policies to drive global food prices substantially higher in the past year, causing hardship in many emerging economies, and discomfort in many developed economies. This may be a contributing factor in the recent civil unrest in Algeria, Tunisia, Libya, Egypt, Jordan, Bahrain, Saudi Arabia, Oman, Yemen, Iraq, Iran and Syria.

One result of this unrest (and in Libya's case, civil war) has been a very rapid increase in oil prices to around $95-$119/BO in late February. The price in real dollar terms broke above $40/BO for only the third time since 1975 (the other two instances were November 1979 and October 2007). This is unsettling to global stock markets, raising fears of a double-dip recession.[3] It is not hard to see why

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Recovery to Weaken (Continued)

these fears have surfaced, since **the major recessions starting in 1974, 1980, 1991 and 2007 were all associated with very large price spikes for oil (see charts on page 5).**[4] A supply shock caused by the sudden withdrawal of several percent of daily production is a real possibility, and would have dire consequences for the global economy within a short period of time, as it did in both 1973 and 1979. However, oil prices have already increased so much due to the secular trend of increasing emerging market demand that an economic slowdown of some type may now be built in, assuming food inflation in Asia also continues at a high pace. Whether it becomes a serious slowdown (i.e., recession) would depend on many variables. Timing is everything though, and it might help the recovery to stay on track if food and energy prices fall substantially in the next few months. Right now that outcome seems unlikely, but that could change. **Certainly in the U.S., the high unemployment, falling housing prices and low industrial capacity utilization seem like they should be deterrents to higher inflation. Nevertheless, high inflation and rising oil prices persisted right through the 1974-75 and 80-82 recessions, so it is important not to be too complacent.**

It has been observed over the years that an oil price spike in excess of 120% over a two year period is very destructive to economic growth; note that the oil price surge since February 2009 has been at least 120%.[5] (There is also an "oil price rule" for stocks, mentioned in the market discussion below). Many economists believe that each 10% rise in the oil price above trend cuts about 0.5% from global GDP; thus, if the recent trend line was at $80/BO, the current price increase would cut about 1% from global GDP this year. This is important but not yet critical. However, the effects of rising oil prices take time to have an impact, and the lost GDP growth tends to increase from -0.5% to more than -1.0% (for each 10% price rise) two years into it, if prices stay high. Thus, although higher oil prices must already be producing a moderate drag on global economic growth, they will have increasingly negative effects as time goes on. Yet unless the situation in the Middle East and North Africa is very quickly normalized, oil prices will remain elevated and therefore will probably cause at least a slowdown, if not a recession by late in the year. A potential oil price spike far above current levels, combined with the Asian slowdown already occurring, could bring the global recovery to a complete standstill. At this juncture it seems unlikely that the situation in all of these politically unstable countries will be normalizing anytime soon. However, some leaders have obviously reacted to their respective problems more effectively than others. It is not out of the realm of possibility that the threat level stays high for many months even if there is no sudden supply shock, since the situation is fluid and highly unpredictable.

Alternative Crisis Scenarios

Some alternative scenarios are potentially much more benign, even if seemingly unlikely. On the inflation front, one such scenario would involve sustained higher inflation rates in rapidly growing economies like that of China, but with no wage-price spiral as in the 1970s. Domestic Chinese consumption would increase based on higher wages and an appreciating local currency, and trade imbalances would improve, causing the negative tendencies in globalization to fade a bit.[6] Obviously, oil prices would still have to fall in order to avoid a slowdown, but there are reasons to think that this could happen under certain (perhaps somewhat remote) circumstances. First, some of the countries facing unrest do not have significant oil production, such as Yemen, Syria and Jordan. So a revolution in one or all of these countries would cause a very temporary increase in oil prices, but not necessarily a long-lasting surge. Second, if certain Middle Eastern and North African leaders were to learn from the mistakes made by Egypt's Mubarak, Libya's Gaddafi, and others, it is possible that gradual reform would win out over revolution. This may sound naïve, but Bahrain's government has pivoted nearly 180 degrees since its trouble began, giving its demonstrators the right of assembly and allowing time for negotiations. Countries that could go this way might include (in addition to Bahrain) Jordan, Saudi Arabia, and Iraq.

Third, some countries might successfully, if brutally, suppress their uprisings. Candidates for this outcome might include Iran, Algeria, Syria, Oman and Yemen. The survival of any of these regimes would likely not be a good thing, but it is not a given that all of their revolutionary opponents would be any better. In any case their survival would have the effect of stabilizing the situation somewhat (status quo ante), at least for a while. This combination of factors might act to stabilize an otherwise catastrophic situation in the region. Yet another possibility, somewhat more likely, is that the new governments installed following successful revolts will want oil revenues as soon as they can get them, and so they will protect oil assets and get them on line again rapidly. Finally, Saudi Arabia is promising to increase production unilaterally, which they have done before, in order to stabilize oil prices. It is important to note though that much of Saudi Arabia's spare capacity is heavy, sour crude, which is difficult to refine and much less effective as a source for light fuels. The Libyan oil now out of production is light, sweet crude that is much preferred to the Saudi heavy crudes. The International Energy Agency (IEA) has also promised to open up its strategic reserve in order to stabilize prices, but this is also mostly heavy crude. These actions would work for a while, giving some countries a chance to regroup and bring production back up to expected levels. The question is whether this would be enough, but that cannot be known except in the fullness of time.

Other Economic Challenges

There are also some other issues that the global recovery must deal with if it is to continue along its present path. For example, the Irish elections were just held, with two opposition parties gathering enough votes to dominate Parliament and form a coalition government. The leadership of these parties ran on a platform favoring some sort of restructuring of Ireland's massive debt. This would be a big change from the perpetual bailouts of the previous administration, and it is not clear what the consequences will be for the EU. However, if the debt is partially repudiated, as some suspect might happen, then we will have another European crisis on our hands forthwith. Another problem area inside the EU is the pending sale of many billions of Euros in debt issues by Portugal and Spain in the next

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Recovery to Weaken (Continued)

year or so.[7] It is not yet certain that these sales will go well, although the ECB has been very accommodating with its quantitative easing program, and the EU is quite capable of yet another bailout package. The difference this time is that Germany is now a wild card, since voters in regional elections have been making their displeasure with current policies clear, and general elections are around the corner.

In the U.S., the budget debate is approaching its climactic turning point. The essentially phony issue of renewing the debt ceiling has been used as a political debating point to force consideration of the state of our finances, which is so bad over the long term as to defy partisan bickering, one would think. But one would be quite wrong - there is no apparent limit to the potential for partisan bickering in Congress or the White House over spending. What's ridiculous here is that the argument is over about $100 billion at most, which is a paltry 2.7% of the proposed $3.70 trillion budget. No one is even talking about dealing with entitlements, which is where the real problem lies. Anyway, the reason the debt ceiling is a phony issue is that neither side will admit that the real number is much higher than what is being discussed. The actual number for the national debt, when you count all of the off-balance sheet items like Fannie, Freddie and Sallie Mae, is a whopping $20.71 trillion, up $3.27 trillion in just one year.[8] This is far above the paltry $14.1 trillion being considered as a "ceiling." The dishonesty of this debate is disturbing, and one wonders if there are enough adults in our federal government to make a quorum in the Congress. The bond markets are watching closely for portents, and someday in the future, if Congress and the White House don't act decisively, the bond markets will demonstrate who the real boss is. I hope this doesn't happen because it won't be pretty, but maybe we must have a crisis in order for our dysfunctional system to work. At least this time the debate is centered on where to make cuts, however token they are, instead of how much to increase spending.

Other issues facing the US include the critical decision about whether to follow up the QE2 round of quantitative easing with an extended QE2 or new QE3 round. The probable trajectory and meaning of recent inflation data are also at issue, as are the challenges arising from the commencement of another down-leg in the housing market, and continued high unemployment. The Fed faces the extended QE decision in June or perhaps later in the year, depending on circumstances and the flow of data. The decision will probably hinge on the relative health of the economy, the rate of inflation as measured by the Fed (i.e., core CPI), and the direction of the markets. The CPI inflation data have risen dramatically from low levels over the last four months, to a current YOY reading of 1.6%. Inflation expectations over the next five years as reflected by the Treasury bond "break-evens" against TIPS are still quite modest at 2.06%, but this measure was at 1.13% in August.[9] The most recent peak in inflation expectations was 2.72% in July of 2008 when oil peaked at $147.20/BO. One concern expressed by a number of observers is that the Fed remains focused on core inflation (CPI minus food and energy costs), while headline CPI is rising much faster. This view of inflation on the part of the Fed is in sharp contrast to the European Central Bank (ECB) and the Bank of England (BOE), both of which track headline CPI instead.

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This brings up the whole question of whether the Fed is properly measuring inflation, as discussed elsewhere in this newsletter. It is unsettling to realize that CPI measurement was drastically altered in its methodology in a series of adjustments in the 1980s and 1990s. While this was supposedly designed to correct some errors, its effects have been to cut Cost of Living Adjustments (COLAs) for Social Security payouts by many billions of dollars over the last 30 years. This is probably not an accident. The result is that when you look at a comparison of CPI with other measures of inflation you can observe huge divergences in the data. The people at www.shadowstats.com have calculated CPI under the old pre-1982 methodology, which gave a CPI reading of 8.51% on 11/17/2010, vs. the official reading of 1.17% on that date. A separate measure has been put together by researchers at MIT under a study called the "Billion Prices Project," which looks at the prices of 5 million items on sale online in 70 countries.[10] Their BPP Index gives a current reading that is up 2.81% YOY, far above the 1.6% increase seen in CPI data.

It is difficult to establish which of these readings is most correct, but it is not hard to believe that the government is systematically under-reporting inflation since the change in methodology. To the extent that this is true, the Fed may be committing a policy error by keeping money too loose for too long. This is in fact what allowed them to inflate two separate asset bubbles in recent years. The deflation of the first bubble was accompanied by the Tech Wreck; the deflation of the second was accompanied by the Great Recession. It is no secret that the Fed's ultra-loose monetary policy may be feeding inflation in food prices and energy all over the world through the unintended consequences of feed-back loops like international money flows (see previous two editions of this newsletter). China's ultra-loose monetary policy is probably doing the same thing. The federal deficit is also a factor, as we discuss in the Special Topic presented on page 6.

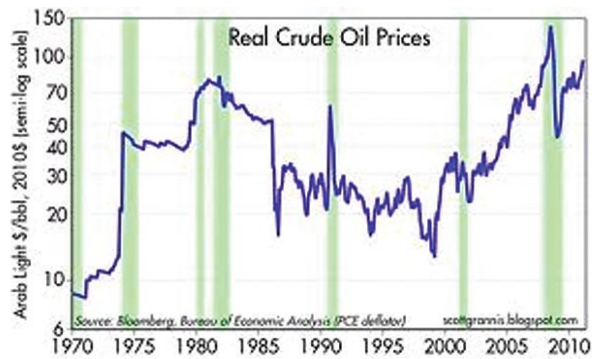
Market Summary:

Markets Pause for Fuel Check

By Dheenu V. Sivalingam and Kevin M. Wilson

The developing situation in Libya, combined with unrest in other Middle Eastern and North African states, continues to dominate media and market narratives. Even though we have no informational or analytical advantage in tracking these events, we continue to anticipate that increased market volatility across multiple asset classes will yield greater risks than opportunities for equities. Volatility is the rate and magnitude of change in share prices. Market volatility as measured by the "VIX" opened on 02/22/11 at 16.43 and two days later touched a high of 23.22; this is a 41% jump, which we have not seen in the market lately. Looking at the domestic macro view, the revised Q4-10 GDP released by the Bureau of Economic Analysis on 02/25/11 showed a 2.8% rate of growth versus consensus expectations of 3.3% and an initially estimated 3.2%. With higher import commodity prices factored in these data do not represent a remarkable revision, although gains in consumer spending were partially offset by contracting state and local government spending. This is a trend that is likely to accelerate in the coming quarters as local austerity measures take hold. GDP price chain figures showed a 0.4% expansion in the revised data, driven largely by higher oil cost inputs (which should be taken note of in light of current crude pricing dynamics).

Risk management is a vital part of portfolio management. One way to handle risk management is to focus on finding precise entry and exit points for individual securities in order to operate in a disciplined fashion. We tend to pay a lot of attention to short-term factors in the U.S. Equity markets. We are currently watching different trend lines on weekly charts that roughly define the geometry of this market. Recently, the market rose to challenge the top of the present long-term trend channel established in June 2009. As often happens at these turning points, the market found some sellers at this higher level, was thus unable to trade through resistance, and pulled back down into the channel. As it seems likely that many longs had initiated positions after the first of the year, so-called "weak-hand longs" (or "Johnnie-Come-Lately's") may have dominated the selling. Such newly held positions are always fuel for the fire on any significant dip. Though we are aggressively looking for a good point to add to long positions ourselves in the various portfolio strategies, we are wary of taking on too much exposure too quickly, in what could be a more protracted pullback.



In perspective, the pullback at the end of February has not yet been very significant, as it has only brought the market back down to touch the present upward trend line which was established last September. This type of accelerated trend line within a channel often fails to contain prices, so we will not be too surprised if it is broken in the coming weeks. If so, we will look to the much longer term (March 2009 – present) upward trend channel as the next reasonable stopping point for prices, being aware that this is potentially about 100 points on the S&P 500 Index under current levels. Our thinking on this market is still very much shaped by short-term price action, money flows into specific sectors and market-leading stocks, and our gauge of market sentiment, and this type of technical analysis provides a valuable perspective. In the short term, it seems most likely that buyers will step in, in an attempt to maintain the "buy every dip" pattern, but we will treat the next rally with a high degree of skepticism. If we see any weakness in that rally (most likely, on a 2-5 day timeframe), we will reduce long positions in expectation of finding a spot to buy them back after another leg down.

CHART 4: OIL PRICES IN REAL TERMS BREAKS NORTH OF $40/BBL

At this point, there are many crosscurrents in this market and we do not want to be too reactive, except perhaps on the defensive side. The market's very high valuation in historical terms, weak fundamentals for an increasing number of stocks, and poor technical indicators in recent weeks are all indicative of a topping situation that can only be fixed with a correction. The possibility that bad economic news from Europe, Africa or the Middle East could be forthcoming soon may suggest that although it is tempting to buy the dips, discretion may be the better part of valor. Of course at some point the dip will be just the right depth for buying. We would feel much better if the dip were to reach a depth of 15% than if it stops at 5%, since risk will not have been sufficiently bled off at the shallower level. It may be important to note that the oil

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Markets Pause for Fuel Check (Continued)

price increases of late may have a cumulative negative effect on future market returns if they exceed certain limits. For example, an 80% increase in oil prices within a 12-month period has been generally associated with extremely negative returns in the ensuing months.[11] Right now the YOY increase in oil prices is only about 24%, but last April 26, on the verge of a 17% market correction, the YOY oil price had increased by 65%; not enough to follow the empirical rule used here, but still pretty steep. More convincingly, the YOY increase in oil prices on July 11, 2008 was a whopping 96%; the stock market lost 57% over the next eight months.

On the other hand, over the last year there has been an 86% correlation between the S&P 500 Index and the market activities (bond purchases) of the Federal Reserve.[12] So as long as the market thinks that the "Bernanke Put" is in place, they may continue to rally. We will be more aggressive in adding some exposure around 1,275 on the S&P 500 Index, and even more so at around 1,229 based on the assumed continuation of the overall bullish trend in the market. However we still feel that the pivotal risk point for making additions is nearly another 150 points below, at about 1,120. Thus, realistically we will have to give the bears a chance and see what they can put together here, remembering that, ultimately, we want to buy weakness in equities at much more attractive entry points.

Wealth Management Planning Note:

Inflation and Retirement Planning

By Patrick J. Pfahl

We have not had to think too much about inflation for the past 30 years, but it would be a mistake to ignore the fact that high inflation is increasingly probable within the next two years. It may already be taking up residence in the guest house (i.e., China). The ramifications are obvious - you and the people you care about cannot sit in fixed income investments that pay nothing and think it's going to be ok. There are always options and opportunities; I will provide a little history here, and hopefully some ideas that may help.

Recently I came across a new word: "Biflation," and instantly I understood - it is when the things we need are going up in price (gas, food, medicine, education) while the things we own are going down in value (house, car, portfolio). It sometimes takes years for a new word to find its way into the formal dictionary - this one may move quickly, it already has a Wikipedia page. Today's stated inflation rate (or CPI) is 1.5%, but it does not really feel that way - perhaps it is the Biflation effect which is not reflected in current methods of computing inflation.

bi·fla·tion noun \bi-'flā-shən

1 : concurrent act of inflating and deflating:

2: a continuing rise in the general price level usually attributed to an increase in the volume of money and credit relative to available goods and services with a simultaneous decrease in the general value of owned items.

In Great Britain, the stated CPI is 1.2%, but they also have another measure called "Pensioners CPI" - and you may have guessed this - it is much higher. The current pensioners' inflation rate is an astonishing 8.6%. Consider the fact that in the U.S. the price for gas has jumped 11%, fresh produce is up 17%, and meat and fish are also pushing 15% higher from this time last year. Real estate taxes (I wrote about that last issue) have been rising at a national clip of 10% per year for the past decade and the AARP tells us that the price of common medications has risen 8.3% since last year, ouch. Measuring the change in consumer prices is not a new phenomenon; the Bureau of Labor and Statistics has tracked a "fixed basket of goods and services" since 1919 and published it on a monthly basis. People have relied on the CPI for decades, and in fact after WWII businesses began using it to track "cost of living" changes for laborers (union members). In 1975 Congress began indexing Social Security (for retirees) to the CPI (previously it took a Congressional vote to increase Social Security payments).

Since the government cannot control inflation, it has taken control of the calculator.

The 70's were troublesome inflationary years for the country; inflation averaged 8.6% yearly for the entire decade (perspective: $100 in 1970 would only buy $41 worth of goods in 1980). This troublesome decade was followed by many more years of lower but still harmful inflation, but significant changes in the CPI formula were made, which has ultimately resulted in a lowering of the ongoing calculated rate. In 1984 a "new" CPI was introduced by Michael Boskin and Allen Greenspan that involved three significant changes to the calculations, including:

1) Calculated Equivalencies vs like-for-like comparisons: The most common example used is the hamburger for steak analogy. The new calculation assumes that you will stop eating steak and substitute hamburger rather than pay for the increase in steak prices.

2) Geometric Weighting: items rising in price are given a lower "weight" than things decreasing in price. The logic here was that people will stockpile lower cost items.

3) Owners' Equivalent Rent (41% of CPI calculation): vs actual changes in housing

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Inflation and Retirement Planning (Continued)

values/cost. Some say this understates values and distorts inflation especially during rapidly changing housing markets like those today.

The stated intent of the change was to move the CPI from being a measure of the cost of living to a measure needed to maintain a constant standard of living. Critics of the changes made to the CPI calculator insist that the authorities may have violated the trust in the system built up over decades, and that by modifying the calculations they have "played" the populace. According to John Williams who hosts the web site shadowstats.com, if we were utilizing the same calculators from the pre-1984 change today the current inflation rate would be 8.51%.

How you can prepare and adjust for inflation pressures when they arrive.

Here are seven ways for you to deal with the potential inflationary period ahead:

1) Save more money: the inflation assumption used in developing a financial plan needs to be high enough to provide an accurate answer to the famous "what's your number" (how much is enough) question.

2) Reduce your retirement years: Currently 14% of 65 year olds are working and the number is increasing. In the latest census 34% of pre-retirees stated they planned to delay retirement past age 67. Part time work in retirement is becoming very common; in fact this phenomenon is also forcing another new concept called the "Unretirement Index" which is now actually being tracked by Sun Life and other insurers.

bi·fla·tion noun \bi-ˈflā-shən
1 : concurrent act of inflating and deflating:
2: a continuing rise in the general price level usually attributed to an increase in the volume of money and credit relative to available goods and services with a simultaneous decrease in the general value of owned items.

4) Reduce your expected needs (behavior changes): conservation and producing or growing your own goods will stretch your savings much farther and easier than "saving more". This includes things like driving a Prius and growing a garden.

5) Adjust your investment portfolio: for changing inflationary conditions. The National Bureau of Economic Research data indicates that retirees had NOT adjusted their portfolios to reflect inflationary pressures through the 70's - and many were devastated. Traditionally hard assets (investments with intrinsic value such as oil, natural gas, gold, farmland, metals, diamonds and commercial real estate) have provided inflationary protection.

6) Use Reverse Mortgages: These annuity type products are complicated and expensive but are expected to be a growing option for retirees who on average have less than $50,000 saved for retirement and have 85% of total net worth tied up in their home.

7) Use Leverage: perhaps not a viable option for inflation at 4% but if inflation edges back up in the 8% range this may be a very good option if your credit is good and you have access to relatively cheap money.

At Blue Water we are planning for and adjusting our strategies to maximize returns in the changing economic and market environment. We are also carrying out critical conversations with our clients about making adjustments to their planning assumptions and investments on an ongoing basis. We invite you to set aside some time to speak with us soon.

Special Topic:
Inflation and the Price of Eggs

By Kevin M. Wilson

When people in the U.S. worry about high inflation, they usually recall the bad old days of the 1970s and early 1980s, when inflation averaged over 8% annually, oil prices soared, and bond investors lost money every year. Inflation is indeed an insidious enemy, because it slowly attacks the standard of living of the middle class and the poor. For example, its acceleration in the episode just mentioned, plus its impact in the period since, calculates out to a requirement that wages would have to have risen by a factor of 4 since then to break even. I remember what I made in my first professional job as a geologist during the oil boom in 1979, and 4 times that is about right. I've been fortunate in staying ahead of that pace, but millions of Americans have not. Real wages have stagnated over the last 35 years, and household income has barely beaten inflation since 1975; the gains were mainly due to women entering the work force. The median income for men was actually higher in real dollar terms in 1973 than it was in 2009.[13]

When people in Europe worry about high inflation, many recall what happened in the 1920s, when Germany, Austria and Hungary were subjected to catastrophic hyperinflation in the aftermath of World War I. **In late 1919, the exchange rate for the German mark was 43 to the British pound sterling (equivalent to about $5.20 in U.S. currency).[14] In November 1923, just four years later, the exchange rate was 18 trillion marks per pound! What would have bought 500,000,000,000 eggs in 1918 bought just**

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Inflation and the Price of Eggs (Continued)

one egg in 1923, assuming any were available with millions of people starving. (As a point of reference, note that a free-range egg costs $0.23 in the U.S. right now). The trouble started when the costs of running the war in 1917 and 1918 were covered by increasing the supply of money. Then extremely punitive war reparations were demanded by the Allies after they defeated Germany. Germany didn't have the money, but they did have lots of printing presses, so they met the demands by printing more money. This started an inflationary spiral as workers demanded higher wages to keep up with the inflation caused by depreciating currencies. The inflation had such a debilitating impact on society that Hitler was able to exploit the situation and rise to power. The rest is history.

More recently (2008), Zimbabwe has suffered over 98% inflation per day, and in 1994 Yugoslavia experienced 64% inflation per day.[15] In each case, economically weak dictatorships printed money in huge quantities, destroying their economies. This is relevant today because the developed economies have fallen so in love with government spending programs that they have been "forced" to print money to cover their budget shortfalls. For example, the US federal deficit will reach $1.5 trillion this year, or 9.8% relative to GDP, and the overall debt ratio will reach 100% of GDP by 2013.[16] The U.S. is selling at least $2.3 trillion in debt this fiscal year, and the Federal Reserve will be buying about $900 billion of the total under its quantitative easing program (QE2). The Federal Reserve is now the single biggest owner of U.S. debt issues, holding over $1.1 trillion on its balance sheet.[17] This is about the same as if they had printed that much in new currency in a single year, unless the Fed is somehow able to finesse its exit strategy and circumvent the inflationary impact of its policies. The likelihood of the Fed pulling this off seems very low, so its policies are inherently inflationary in my opinion, which after all was the point of QE2 in the first place. The question is what the consequences will be if the exit strategy fails. However, for now the core inflation rate is still very low and major inflationary impacts have been confined to energy, food, and some manufactured goods, mainly as a result of soaring commodity prices. Meanwhile the service sector, representing about 70% of the economy, is experiencing very stable prices so far.[18]

In the U.K., the government debt/GDP ratio will reach 94% in 2011, and in Japan, the government debt/GDP ratio will reach a whopping 204% in 2011. Economic historians Carmen Reinhart and Ken Rogoff have called attention to the fact that when a country's debt exceeds 90% of GDP, the effect is to cut future growth by at least 1% per year on average.[19] This would eventually impact the rise in commodity prices, but perhaps not in time to prevent a huge inflation surge, creating the condition known in the 1970s as "stagflation."[20] Inflation (CPI) has risen to 4% in the U.K., and PPI has reached 5.7% in Germany. In the U.S., the ratio of producer prices at the crude level of production to finished prices moved above 1.30x for only the 4th time in history.[21] Wages were up 0.4% in January, which is at least suggestive that inflation pressures may be increasing.[22] So inflation may be on the way for the developed economies. U.S. CPI has also trended up lately, reaching 1.5% in January, 2011. Some think CPI will jump substantially in the next few months, regardless of the Fed's exit strategy, although even then rates might not be high by historical standards. But the real problem comes when the Fed ends QE2 and must immediately try to offset the effects of very low but rising short-term rates on the velocity of money.[23] They would probably be forced to dump $500 billion or even as much as $1 trillion in bonds onto the markets to hold monetary velocity down. This would cause bond yields to soar and interest rates to rise rapidly for a time, putting additional inflation pressure on the economy.

In addition to inflation pressures in the developed economies, many emerging economies are already experiencing rapidly advancing inflation. For example, India is experiencing CPI over 8%, but that is a decrease from a high near 15% in recent months, brought down by numerous tightening steps by their central bank. **China reports CPI of 4.9%, but internally food and energy have gone up multiples of that. Since China raised its minimum wage by 20% twice in 2010, it is probable that actual inflation rates are much higher.**[24] Inflation is also rising in South Korea, Brazil and Indonesia, as well as in many other countries. Many of these countries applied massive fiscal and monetary stimulus to combat the global financial crisis and Great Recession, but they have not yet fully withdrawn their easy monetary policies. Negative real interest rates are still widespread, including in countries such as South Korea, Indonesia, Singapore, India and China. This means money is still too loose to inhibit inflation in many countries. That will change as countries such as India and China continue to tighten, but there is a long way to go. Economist Milton Friedman demonstrated that "inflation is everywhere a function of money supply," and the danger here is that deficit spending in developed economies and monetary stimulus in emerging economies has boosted money supply to such huge levels that inflation will be difficult to stop.

If we examine the biggest sources of inflationary pressure, it is hard not to conclude that the main culprits are China and the U.S. This is in part because these are the two biggest economies, so their policies have the biggest effects. But there is also the disturbing possibility that both countries have fallen into "policy errors" that may have serious consequences. China is so afraid of high unemployment in the event of lower GDP that they would do almost anything to support growth – as they have already demonstrated with their huge state-sponsored lending expansion and their massive but highly effective fiscal stimulus package over the last two years. The U.S. has relied on a very similar but ineffective fiscal policy and a massive bailout of the financial system, which has expanded the national debt by $6 trillion, or 100% in just three years. But since that wasn't enough, the Federal Reserve has embarked on the biggest expansion of their balance sheet in history, buying about $2.4 trillion in bonds over three years through 2011. Neither country seems ready to dial the risk back because of the fear of slowing down the recovery. But the price may be a global inflation surge not seen since the 1970s.

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We encourage you to share our newsletter with business associates, friends and family. Let them know what we have done for you to preserve and grow your wealth. We would be glad to help your contacts benefit as well. We are not a "stay the course" or a "do nothing" type of firm. We are actively researching, analyzing, and managing risk every day. We do not take our fiduciary responsibilities lightly. We work hard on your behalf to anticipate economic trends and take action accordingly based on our assessment of risk and potential returns. We have made significant investments in our business to make sure we have the best information and people that are capable and intellectually equipped to make important and timely decisions managing your wealth.

Please attend our next "Monthly Market Forum" if you can; we'd love to see you, your relatives, and your friends there. Scheduled meetings will be held at 5 pm - 6:30 pm on March 17, 2011 at The Kitchi Gammi Club, Duluth; and April 21, 2011 and May 19, 2011 at locations TBD. Please RSVP to Blue Water. Business casual attire suggested.

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