Economic Update

Broadleaf Partners, LLC

Technical, Practical, Theoretical; Observations on Bonds and Inflation

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Long term treasury yields have backed up to around 4%, making a significant move off their lows in the 2's a number of months ago. While there are a number of folks claiming that this back up in yields reflects a change in inflation expectations, I'm not convinced.

From a technical perspective, if inflation were the reason for the back up in yields, one would expect that corporate bond yields would have backed up by a similar amount. But, at least for the corporates I track, yields have stayed steady in recent weeks and in some cases even declined. I tend to believe, therefore, that the back up in government yields reflects a renewed interest in taking risk. Folks feel a bit more comfortable about the state of the economy and as a result, they are no longer willing to buy risk free treasuries at any price. The bubble in treasuries is finally being deflated.

From a practical perspective, I also see little evidence of building inflation pressures. I know of no one who is getting raises and other than the recent spike in gas prices, I see very little evidence that overall price levels are increasing across any type of consumer good be it housing, autos or otherwise. Price competition is relentless, causing venerated companies like P&G to revisit their commitment to the private label business and abandon - at least partially - an exclusive focus on "new and improved".

From a theoretical and political affiliation point of view, there are many reasons to be concerned about future rates of inflation even though the current indicators aren't expressing it in the financial markets or the market for goods and services, be it labor or otherwise. The government has pumped a lot of money into the system with the recent cuts in interest rates and the numerous government bailout programs.

At this point, however, very few banks are taking their huge excess reserves and making new loans. If anything, lending procedures remain very tight, overcompensating for years of being too loose. It is through the lending process that the money supply is generally expanded and too much money ends up chasing too few goods. Even when money was extremely loose a couple of years ago and private equity shops went on a bank enabled buying binge, the overall CPI failed to budge much above 4%, hardly the level we witnessed in the 1970's.

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I do believe that inflation could become a problem at some point down the road, but believe that those who are incessantly worrying about it today do so prematurely and to the detriment of their own personal gains at this particular moment in time. This isn't to suggest that I'm against the reflation trade. To the contrary, I have been a buyer of commodities, materials, energy and industrial stocks in recent months.

As we've said recently, some inflation would actually be a welcomed event, as an additional sign that the economy is on the mend. I'm confident that if greater inflationary risks lie ahead, the Fed will take corrective actions, perhaps as unprecedented in nature as those have been to fight deflationary concerns in the past twelve months.

Inflation, monetarists say, is everywhere and anywhere a monetary phenomenon. While the government is certainly spending a lot these days, other members of the economy still aren't.

I'll become worried when making money becomes easy again.

Kindest Regards,

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