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Over-Stimulated
Investment Update – November 2009

Never count the United States out. History has never seen a nation rise to such dizzying levels of aggregate wealth as quickly as our great nation has, and as beneficiaries of this trend, we have one ideal to thank – freedom. It has been through our freedom to pursue opportunities – businesses being developed, dismantled and redeveloped – that so few have had so much on such a grand scale. In that sense, the United States has been the single-greatest incubator of new businesses and emerging technologies since the dawn of man. However, even though our long-term record remains intact, we have had many patchy moments along the way which always cause the short-sighted to call these sentiments, and the future of our great nation, into question.

We're in one of those patchy moments now. Over the past 80 years, two manipulations have worked to help us through these stretches of discomfort or periods of outright despair – lowering taxes and enticing us to borrow. Both manipulations put more money in the hands of spenders, and for those of you keeping track, this is the essence of "stimulus", the most overused word coming out of Washington over the past 18 months. Whether it has come in the form of bailouts, Cash for Clunkers, first-time home-buyer incentives or good-old-fashioned cheap credit, our "friends" on Capital Hill are determined to stimulate us.

This time, however, Americans in general and the banks specifically aren't cooperating with Washington. In order for stimulus to work, money must be spent, and the Federal Reserve's (the Fed's) favorite tool for achieving this end comes from enticing us to borrow with lower interest rates. Americans have shown an unwillingness to take on more debt, but let's leave that out of this debate for now. Even if we did want to borrow, banks must be willing to lend, which brings us to the problem du jour… the Fed has delivered the cash to the banking system, but banks are unwilling or unable to lend it. This is in stark contrast to most of the last 50 years in which banks have lent almost everything they could in order to maximize their profits.

Take 2007 as our most recent example of the good-old-days. In any given month in 2007 for example, banks had $41 billion in reserves and had reserve requirements (the amount of depositors' cash they had to keep in reserve to stay in the good graces of the Fed) of $40 billion. This extra $1 billion was basically money looking for a borrower. However, banks today have $620 billion in reserves and have reserve requirements of only $62 billion… 10 times the amount required! That represents over a half-trillion dollars which could be borrowed, spent and could otherwise be out in the system that is instead sitting on the sidelines. That's an awful lot of "stimulus" which has not made it into the marketplace, and it also has the potential to be an inflationary bomb.

Here's why. Technically, that money isn't circulating in our economy, so it's not having an inflationary pressure. If banks do begin to lend that money, it will represent a doubling of the monetary base since 2007, which would almost certainly mean a devaluation of the dollar and inflationary pressure. Money in many ways is like any other commodity – if the supply increases with everything else held constant, the value tends to drop. Since there isn't commensurate economic growth to require that much money be in the system, more money in the system means each dollar is worth a little bit less (i.e. inflation). If the Fed pulls money out of the system to curb the pressure of inflation, and thus drives interest rates up (very likely), it will have a depressing effect on the economy as consumers will be even less likely to borrow and spend.

In the end, we have a high probability of either having good economic growth and a dollar wrecked by inflation or bad economic growth and a stable dollar... neither is good for the United States. Before we

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all sound the alarm bells though, running madly with arms flailing down our suburban streets at this uninspiring thought, be reminded of this – the depression of the 30's was followed by the industrial boom of the 40's and 50's, the inflation-ridden 70's were followed by the technology-driven 80's and 90's, and the roller-coaster economy of the 2000's will certainly be followed by better years to come. After all, you can never count the United States out.

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