

## Excerpt from 3<sup>rd</sup> Qtr Letter to Clients

Lets start with the “new normal” mantra that is being repeated over and over again on TV and in print media. The story goes like this, Americans OVER consumed this decade and that economic growth in this country will NEVER be the same. We are doomed to slow growth as far as the eye can see while we pay off debt. In essence the argument says that America is destined to be in decline forever. I hear this argument from both liberals and conservatives so it is not exclusively a Republican or Democratic argument. As is the case with most arguments there is an element of truth in it. Gross Domestic Product (GDP) growth in this decade has been below average compared to previous decades. This fact was true BEFORE the decline in the stock market last year so the “new normal” has been going on for at least eight years before the media noticed it. Most economists describe GDP as the income statement for the United States; it is the top line revenue for the country which would be similar to what your salary is when you have a job. GDP is like your W2 form you get from your employer. We have been discussing the lack of GDP growth at the office and we have tried to quantify why GDP and the transactions that make up GDP have been weak this decade. From 1947 until last year unit transactions per GDP went up about 3.3% per year. That means that there were 3.3% more units bought each year than the prior year on average. From 1983 until 2008 that number increased at a 3.1% rate which is a slight slow down. Starting in 2000 the increase in the number of transactions per GDP only went up at a 2.07% rate which is quite a drop. When the average consumer buys 38% less stuff than they have in the past it makes you wonder what is causing this. We looked at whether there were less people being born which would affect the number of transactions occurring. The answer is that in the United States our population is still growing at over 1% a year on average which is what it has been growing at since the 40's. If population growth is still going up at over 1% a year then why are we buying fewer goods this decade? We think part of the problem is that as our population ages we buy less stuff because we have most of what we need by age 60. That is a factor but we don't think it explains it all. We think the decline in units going back to the beginning of this decade MIGHT be a reflection of the decline in the middle class and our manufacturing base that was covered up by the boom in housing and financial engineering. We can't be 100% positive on why people are buying less stuff than they use to we can only observe it. What this information tells us is that contrary to popular belief that ALL OF America has been over consuming in this country compared to the past we actually appear to have a huge pent up demand for goods in this country that are NOT related to housing or healthcare. Some segments of our population did not buy as much things as history suggests they should have. Our best guess is that if you were in the bottom 50% of the economic ladder and your job was not linked to healthcare or real estate either through construction or the loaning of money to those groups you had a bad decade. Assuming there is an element of truth in that argument the question becomes when will that pent up demand be released or will this group of underserved Americans just be unable to buy more stuff for the rest of their lives? We think part of the answer is inflation will cause this group to benefit that didn't benefit when we had mild inflation over the last 10 years. We have stated in previous reports we think inflation is coming back and we feel pretty strongly that we still have that right. In the next paragraph we will try and quantify it a little bit.

We have studied how the Consumer price index (CPI) reacted in 1928 to 1934 and how it has reacted since the financial markets melted down last year. It took 44 months for the CPI to go up over 1% from the preceding month during the great Depression. It only took 5 months for that to happen in this market decline. The CPI was dropping before the crash of 1929. Last year the CPI was going up before the markets tanked which is the opposite of 1929. So what does this mean and how does it coincide with people buying less stuff in the above paragraph. We define GDP as the number of transaction units consumed in our country times the price of the unit. The price of the unit is linked to CPI. If we have inflation in the CPI our GDP is going to go up which means the income of the country will go up. If we get a snap back in the units purchased due to the pent up demand mentioned above along with a rising CPI then we could have some VERY STRONG GDP numbers for the next year or two. Very strong. This type of logic flies in the face of the new normal mantra which says GDP growth will be terrible for as far as the eye can see. We don't see it that way because of how inflation boosts GDP. We see 50% of the population wanting to consume but unable to do so this decade and that consumption will get freed up by inflation at the expense of those who did well the last 10 years (inflation and a declining dollar are a tax on the rich and their assets). If you have over 3% inflation while units per GDP go back to its historical ratio of over 3%

we are going to have the opposite of the new normal, very fast growth. We are predicting that come December the CPI will be up over 3% from last December which is going to cause Wall Street to start mumbling about inflation showing up. The financial environment caused by our Governments response to last year's meltdown is just the perfect environment for a huge rally in GDP. Add in the fact that borrowing rates are at basically 2% or less for good companies in the short term debt markets and I don't see how this economy doesn't have a huge rally. The Government wants inflation to help the consumer and the states deal with their debts. If interest rates were at 15% like they were in 1980 I would say the Government would not be able to print money and grow GDP because you can't borrow money at those rates and make a profit. Today high quality companies can borrow at less than 5% for ten years and you can borrow money at those rates and grow your business. Because interest rates are so low, rates can probably go up at least 4% before it will slow down the economy. I know it is not a popular take to say that things might get better for awhile but that's how we see it today. At some point interest rates will go up to slow down the economy and we have a plan to deal with that. For now we are waiting for that to occur before implementing it.