Is It Hype or Hyperinflation? At RSW, It's Just Deflation!

For the last several months many individuals have been concerned that hyperinflation is around the corner. As you know, we at RSW have taken the other side of the argument; deflation. Although some of the deflationary forces have marginally lessened, many of these powerful factors still remain. For example, spending power continues to be zapped from consumers, while they are already in a weakened financial condition. Some of these culprits are outlined below:

- Does anyone seriously believe that mortgage rates rising from 4 ¾% to 5 ¾% won't further delay a housing recovery?
- Gasoline prices are on the move: up 62% from the lows (yet another burden on the consumer)
- Continued rising rate of unemployment
- Falling capacity utilization
- Falling wages
- Rising interest rates (more on this below)

Is the banking system really healed?

A few short months ago the key to a healthy economy and the banking system was the prospect of getting the toxic assets off of the collective banking system's balance sheet. Oh wait, these assets are still there! Is it possible that they're just not saleable?

Then there is the infamous stress test. (Banks would undergo stress tests to check whether they could hold up if the economy continues to deteriorate). One of variables of this test was an unemployment rate of 8.9%. Someone should alert the "stress testers" that we are well on our way to 10%. Begging the question, are we to believe that the other variables were conservative enough? Further, was this test designed to disguise the stress in the banking system or was it designed to keep the markets from getting stressed about their financial condition?

Rising interest rates: Is this a sustainable march to higher yields?

As we stated in our 2009 outlook : "Should the financial and economic outlook improve, a renewed appetite for risk could send 10-year Treasury rates back toward a range of 3 ½% to 4%". In addition, there is one important element that has also contributed to the recent rise in interest rates, namely Treasury new-issue supply. For example, today $19 billion of 10-year bonds were auctioned followed by an auction of $11 billion of 30-year bonds tomorrow. As we have witnessed, overwhelming supply tends to disturb current market rates. While Municipal bonds largely ignored most of the rise in Treasury rates, they too have succumbed to the upward pressure of Treasury yields.

Bottom line: We would categorize this increase in rates as a cyclical one and one that should be short-lived. Higher interest rates, if only for a brief period of time, should only serve to compound the problems (highlighted above) of the already fragile U.S. financial system and economy.

Sincerely,

Robert S. Waas
Managing Member