

LEADING INDICATORS



Dale Dehmer

The State of Our Economy

[by Tony Hallada]

In the Summer 2008 edition of *EFFECT*, I described the Greenspan Put (lowering interest rates and increasing money supply) and discussed how Federal Reserve Chairman Alan Greenspan's actions had resulted in unprecedented economic growth and expansion during his tenure. I also suggested that our

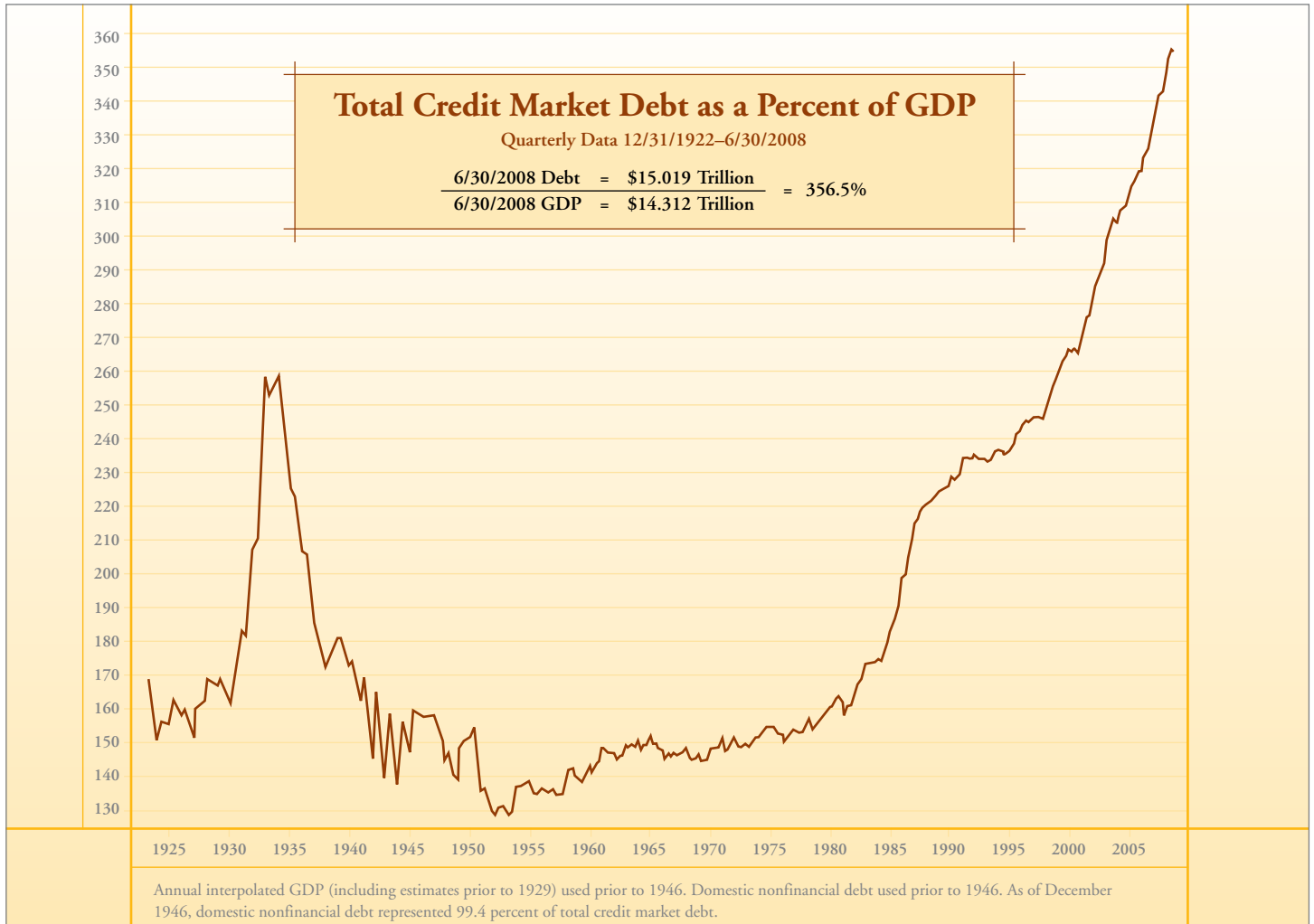
economy would have been better served had Greenspan not utilized monetary stimulus to the degree that he did.

Small recessions are good for the long-term health of our economy, and Greenspan should have allowed them to take place. By intervening, he allowed excesses to build in our economy that could not be sustained. The result of Greenspan's interventions is an economy that has too much debt due to

cheap money and loose lending standards.

Too many people in our society became complacent, believing that the good times would continue into perpetuity and that our Federal Reserve could continue to prevent economic downturns. Consequently, our economy is moving into a period that is quite different than any we have experienced in recent history. The United States has wit-

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nessed unprecedented growth and inflation (rising prices) over the past 50 years. We are now facing the opposite extreme, a time of deflation (falling prices).

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Deflation

Many of us have never witnessed a period of deflation in our lifetimes, so it is important to have a basic understanding of the concept. In general, deflation is defined as a contraction in the supply of money and credit. Robert R. Prechter, Jr., a longtime market historian and strategist, has done extensive research on the history of deflationary periods in our economy. In his book *Conquer the Crash* (John Wiley and Sons, 2002), he addresses the triggers that result in a deflationary period. Prechter states that in order for credit to expand, both lenders and borrowers need to have the confidence in the borrowers' ability to pay. It is also important that the trend of production continue to expand to make it easier for debtors to pay. Once production contracts, it becomes more difficult to service debt. This in turn puts downward pressure on both the lenders' and borrowers' confidence in the ability to pay.

Are we there yet?

Many of these elements are now in place in our economy. We have a banking system

that is getting much more conservative in its underwriting standards, which is making it more difficult for many to obtain credit. Consumers and business executives are becoming more cautious in their discretionary spending and capital investments. These actions cause a contraction in the velocity of money, which in turn has a downward impact on prices and overall economic activity. Based on Prechter's comments, we will only reverse this trend when the supply of credit falls to a level at which it is acceptably collateralized and confidence in a borrower's ability to repay a loan returns.

The good news?

The good news is that we have already progressed one year into the deflationary event described above. Real estate values have declined approximately 20–30 percent nationwide, stock markets have declined 40–70 percent around the globe, and most assets outside of cash and treasury bonds have lost value in the past 12 months. No one knows when this deflationary event will finish and the trend will return to inflation, but we should not lose focus on the long-term positives for our economy. We are fortunate that we have a global economy that provides the potential for a period of inflation and expansion as the people of Russia, Brazil, India, and China all move toward a higher standard of living. This could result in another period of inflation a few years from now as the demand for raw materials and energy increase with this new global growth trend. Perhaps this time we will remember that a little recession every so often isn't so bad. ●

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Excerpt from *Conquer the Crash* by Robert R. Prechter, Jr.

When the burden becomes too great for the economy to support and the trend reverses, reductions in lending, spending and production cause debtors to earn less money with which to pay off their debts, so defaults rise. Default and fear of default exacerbate the new trend in psychology, which in turn causes creditors to reduce lending further. A downward "spiral" begins, feeding on pessimism just as the previous boom fed on optimism. The resulting cascade of debt liquidation is a deflationary crash. Debts are retired by paying them off, restructured or default. In the first case, no value is lost; in the second, some value is lost; in the third, all value is lost. In desperately trying to raise cash to pay off loans, borrowers bring all kinds of assets to market, including stocks, bonds, commodities and real estate, causing their prices to plummet. The process ends only after the supply of credit falls to a level at which it is collateralized acceptably to the surviving creditors.

