Bill Gary's

# PRICE PERCEPTIONS

40 YEARS

 Issue #1353 • January 12, 2008

## Recession versus Inflation…

This week, David Rosenberg, Chief Economist at Merrill Lynch, declared the US economy is in recession. This was the first major Wall Street firm to indicate a recession is already underway. Most other major economists still hold out hope a recession can be avoided. Whether or not the US economy enters recession, there appear to be many hurdles to overcome before it returns to the growth of recent years.

Singapore reported their economy *contracted* 3.2% during the fourth quarter of 2007. Japan's stock market experienced the worst New Year meltdown in over fifty years. European economies are sputtering. And, China's central bank continues raising interest rates and bank reserve requirements to cool their economy. These and other economic indicators all point to a global slowdown and/or a global recession.

In a slowing economic environment, most expect prices to stall or decline. During a preceding growth period, production capacity increases to meet expanding demand. As demand slows during an economic downturn, prices generally decline as producers cut profit margins to remain in business. *However, not all prices decline during a recession.*

Since the end of World War II, recessions have basically been a function of money supply. Central banks and politicians want economies to expand. Fiscal stimulus (deficit spending) is accompanied by expanding money supply to spur economic growth. If too much stimulus is applied, price bubbles occur in one sector or another of the economy. During the Nineties, the Federal Reserve expanded money supply excessively and the dot-com stock market bubble occurred. The Fed tightened into the late Nineties to curb excessive speculation and stocks fell sharply in 1998. Fearing a recession, the Fed began pumping out money again. Following 9-11, money supply expanded even more and Congress passed large tax cuts to stimulate the economy and avoid a potential slowdown. This round of economic stimulus led to a housing bubble and the Fed began tightening again until the housing bubble burst last summer.

Now, politicians and the Federal Reserve are once again concerned about recession. The Fed is desperately trying to inject money into the banking system to offset the sub-prime mortgage crisis. President Bush called in the "Plunge Protection Team" last week to discuss methods of injecting money into the economy as fast as possible. The team was created following the 1987 stock market crash and includes Treasury Secretary Paulson, Fed Chairman Bernanke, and exchange regulators. It appears the team will recommend emergency measures such as tax cuts or rebates as well as other fiscal stimulus measures. President Bush said; "In terms of any stimulus package, we're considering all options."

No politician wants to face a recession during an election year. Therefore, it appears likely Congress may approve whatever stimulus package the President proposes. Some expect the President to propose a new stimulus package in his State of the Union Message later this month.

As with past episodes of emergency money printing, much of the new money flows toward positive sectors rather than sectors dragging down the economy. Excessive money printing in the late Nineties moved into stocks other than those of the "dot-com" bubble. Excessive monetary expansion following 9-11 led to a "housing" bubble rather than rebuilding infrastructure. The likely consequences of the current effort will be a "commodity" bubble rather than a resurrection in housing.