# And Now What?

It was only nine months ago that many were complaining about there being too much liquidity and not enough volatility. Now they complain of the opposite, not enough liquidity and too much volatility.

What has happened? Bankers and investors pushed leverage to its limits in the untrammeled pursuit of short term performance. Transparency and common sense were cast aside as marginal after-thoughts of old fashioned conservative thinking. Last time we had a bubble, a decade ago, we indulged in wild-eyed "new economy" speculation. This time it was financial engineering. Both periods thrived on a credulous acceptance of the un-understandable, the intransparent, the opaque.

The U.S. recently needed to prevent Bear Stearns from collapsing because of the danger of systemic counterparty risk. The world of derivatives had acquired a jungle like darkness and density that threatened to engulf the whole banking system. No one wanted to enter that uncharted wilderness.

Where does this leave us now? There will be greater emphasis on transparency and risk control. Financial types will have less of a swashbuckling and arrogant air about them. We shall undergo a period of sobering reassessment as we try to come to terms with the spendthrift ways of our recent past. Governments will try very hard, particularly in the U.S., to counteract the recessionary implications of economies that are deleveraging. Lip service will be paid to fighting inflation, but the real priority will be the avoidance of higher unemployment.

Heavily-indebted economies can hardly accept the risk of serious recession. Modest inflation will be regarded as much the lesser evil. Inflation will hover over us as we continue to print money to create liquidity in the financial system. Inflationary pressures from the continuing high demand and relative scarcity of commodities will continue to weigh upon us. Developing countries will no longer act as a source of ever lower production costs. They will increasingly export their own inflationary trends to our more developed economies.

Going forward we can expect a period of very modest economic growth with an inflationary bias. We shall in all likelihood avoid the low growth, high inflation excesses of the seventies, but we must be prepared to face stagflationary tendencies that will likely be with us for some time to come. Such an environment will likely be very difficult for government bonds, relatively challenging for equities, but favorable for corporate credit. Let us not forget that inflation helps borrowers repay their obligations with less valuable currency.

March 28, 2008