Qwest Investment Management

Weekly Trend Watch

January 15, 2010

Inflation/Deflation Timer - Current Indication:

Inflation

The Inflation-Deflation Timer is a trend-following model, and this class of model is incapable of calling tops or bottoms, and therefore its value is in the ability to spot trends. The trends we are looking for are: inflation, deflation and neutral.

This is an ongoing monitor of the Inflation-Deflation Timer model, for more information on the model, see http://www.qwestfunds.com/publications/newsletters_pdf/newsletter_november_2009.pdf

Cam Hui, Board of Advisors, Qwest Investment Management Corp.

Qwest Commentary

Still bullish on inflation

The Inflation-Deflation Timer model remains at an "inflation" reading and has been at this reading since July 2009.

Asset inflation, here we come!

The long term trajectory of central bank policy remains asset inflation friendly. The deputy governor of the Bank of Canada stated on January 11, 2010 that the Bank of Canada won't raise interest rates to cool housing (http://www.theglobeandmail.com/report-on-business/bank-of-canada-wont-raise-interest-rates-to-cool-housing/article1427298/):

"Some observers - those who see a housing bubble forming - have said that since low interest rates have stimulated housing market activity, the Bank should now raise interest rates to dampen that activity," deputy governor Timothy Lane wrote in a speech delivered by an adviser on his behalf in Edmonton. "But that poses a problem."

[..]

Those who fear a bubble worry that many people are taking advantage of cheap money to buy homes they wouldn't be able to afford once rates rise, leading ultimately to a crash in prices.

Mr. Lane said the bank understands the concern, but it uses its lending rate to keep inflation in check for the whole economy and the housing market is "only one of several factors" that influence inflation.

[..]

Instead, he said, the government could increase capital requirements for lending institutions, adjust loan-to-value ratios and change the terms and conditions required to obtain mandatory mortgage insurance.

[H]e said. "Ultimately, it is the Minister of Finance who is responsible for the sound stewardship of the financial system."

Lane's remarks are reminiscent of Ben Bernanke's speech at the American Economic Association in which he absolved the Fed's role in the last bubble (http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm). This has prompted comments such this one, the Fed missed this bubble, will it see a new one (http://www.nytimes.com/2010/01/06/business/economy/06leonhardt.html)?

Central bankers seem stuck with the concept of inflation as it existed in the 1970's, where a vicious feedback loop created a self-reinforcing cycle of inflation. In my previous post I ask, what kind of inflation? We believe that this next round of inflation is likely to show up as asset inflation, which primarily manifests itself in higher commodity prices.

Long term commodity bulls

If the role of central bankers is to take away the punch bowl just as the party gets going, the Bank of Canada has now abdicated that responsibility to the party's host (the government). Even worse, Bernanke's response has been "what party?"

This willful blindness to the asset inflation problem by central bankers creates a commodity friendly backdrop. It's this attitude that makes us long-term commodity bulls.

DEFINITIONS (as defined in the American Heritage Dictionary)

Inflation
A persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money, caused by an increase in available currency and credit beyond the proportion of available goods and services.

Deflation
A persistent decrease in the level of consumer prices or a persistent increase in the purchasing power of money because of a reduction in available currency and credit.

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