Qwest Investment Management

Weekly Trend Watch

January 22, 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.

Inflation AND deflation?

There is considerable academic debate about whether inflation will erupt under the current global fiscal and monetary policies. In reality, the discussion should be about the kind of inflationary pressure that we may face.

Inflation bulls argue that all the U.S. government spending and money printing will result in a weakening U.S. currency and therefore asset inflation. By contrast, the deflationists argue that with a weak U.S. economy, wages are not likely to rise and downward pressure on prices will continue. Both arguments could be right. Steve Randy Waldman explains the difference (our emplasis) (see http://www.interfluidity.com:80/v2/213.html):

> Whether an economy generates asset price inflation or consumer price inflation depends on the details of to whom cash flows. In particular, **cash flows to the relatively wealthy lead to asset price inflation, while cash-flows to the relatively poor lead to consumer price inflation.**
>
> Why? In Keynesian terms, poorer people have a higher marginal propensity to consume. The relatively poor include people who are cash-flow constrained - that is they cannot purchase what they wish to purchase for lack of green, so their marginal dollar gets immediately applied to the shopping list. Also, poorer people may be different, there may be a correlation between poverty and disorganization, lack of impulse control, inability to defer gratification etc. Think of Greg Mankiw's Spenders/Savers model (http://www.economics.harvard.edu/files/faculty/40_aea1.pdf)

What kind of inflation?

The deflationists are right in that consumer price inflation is likely to be restrained in the current environment. On the other hand, much of the stimulus has flowed to the banking system and Wall Street, a relatively wealthier segment of society. This is likely to result in asset inflation, which shows in the commodity prices.

The proof is in the pudding. The accompanying chart shows the price of gold, which is substantially higher than where it was at the height of the Lehman Brothers crisis. Gold has risen, despite the fact that in 2009 we witnessed the greatest global deflationary episode since the Great Depression. Is this due to inflation or deflation fears or both?

It is market reactions like this 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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