57 Channels and Nothing On

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Who would have thought that Bruce Springsteen knew about the deflationary headwinds that were blowing back in 1992 before Alan Greenspan, when he wrote the song " 57 Channels and Nothing On"?

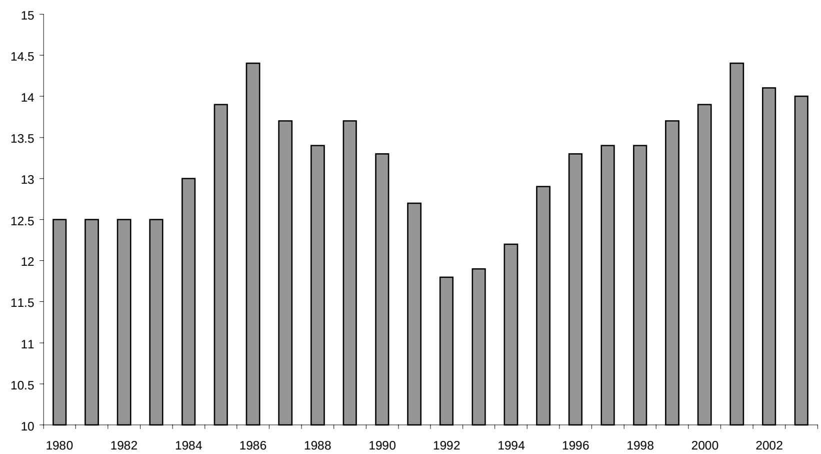
The problem today (as the song says) is supply, not demand. Historically, when referring to recession or depression it was always about demand (and not enough of it). Strangely enough, when looking back over the past three years, whether you call this period a slowdown, a post-bubble era, or a recession, the unique situation that challenges us, is not the demand of the consumer, but the supply of the manufacturer. In essence, the world is awash with goods. Whether you are talking about fibre optics, computers, cars or candy bars there is just too much of it around. To fight this supply dilemma, the U.S. Federal Reserve has tried, and is still trying, to face this challenge with liquidity. Never before in the history of Federal Reserve monetary policy has it fought such a tough battle. Federal funds, reaching historical lows of 1 percent, are trying to keep that consumer with a full stomach of SUVs, houses and cable channels afloat. Yes, it is working, but just barely. At the end of the day, the consumer just can't keep up. There are just too many goods coming off those conveyer belts.

This, in essence, is the problem. Greenspan and company are actually causing further problems by allowing goods to be produced too cheaply. They should be raising rates aggressively. Yes, raising them!

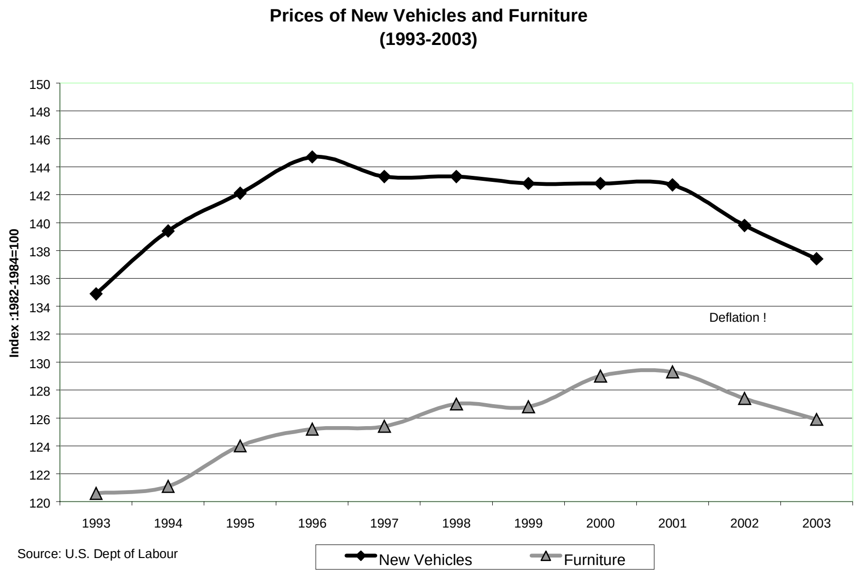
Before we get nasty e-mails about this theory, let's take a step back. In today's economy, if you are a manufacturer, you simply have no pricing power (with some exceptions, such as natural gas producers and mutual fund companies' MERs). It is nearly impossible to pass along price increases. Every time we consider a prospective company for investment, we always end up speaking to management. No matter what they produce, there is just one word they all use after we ask about passing along price increases. That word is *China*. They are all so frightened about China (or Asia). The prospects of a weak Yuan have the CEOs and CFOs waking up in a cold sweat every night.

But it's not just China. The Fed, during the past year, has considered the prospect of deflation and its potential of spreading to North America. Well, it might not be here yet, but it looks like it is coming soon. It started with Japan, jumped to China and other parts of Asia, and now it's rearing its ugly head in Germany and Switzerland. Basically, what Greenspan and the Fed are wondering out loud is actually happening today. The question is: What can the Fed do? Or better yet: What choices does it have? We know that interest rates can only fall another 100 basis points. What else can they do? Devalue the U.S. dollar? The problem is that the U.S. depends on foreigners to buy their currency to the tune of $1.5 billion per day. Over time, a weaker U.S. dollar would help the U.S. manufacturer. This would create more demand for U.S. goods, but as mentioned before, that is not the problem. If this doesn't work, there is not much else they can do. Well, maybe there is one thing. Although it goes against classic

U.S. Household Debt Service Burden
(Ratio of Debt Payments to Disposable Personal Income)



Source: Federal Reserve



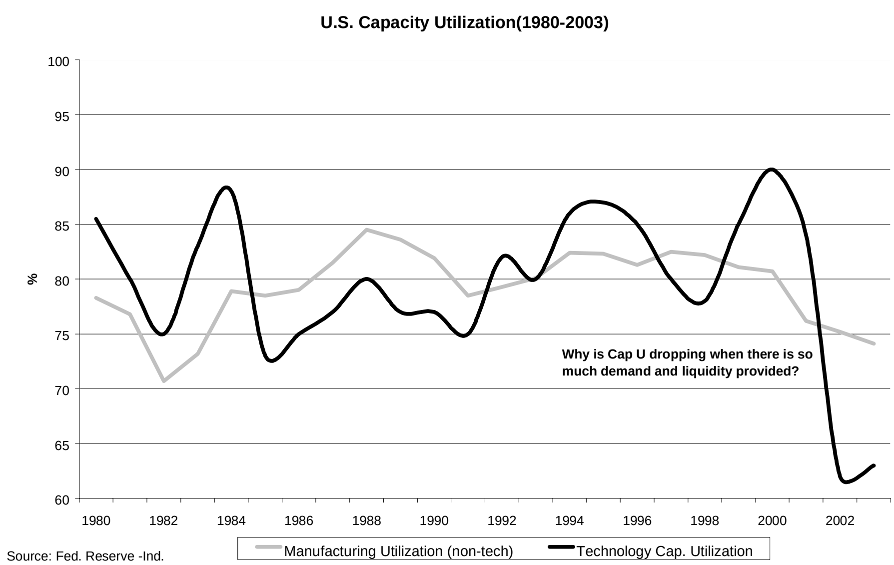
monetary policy theory, raising interest rates might be the answer. As mentioned before, this is a supply problem, not a demand issue.

Although it will hurt, the Federal Reserve needs to raise rates aggressively. What the Fed is doing now is creating another bubble. It is like the patient given an injection of morphine before he or she can feel the pain. Debt levels are at all time highs. These levels will go higher due to the *free money* that the central bank is giving out. In essence, Greenspan is creating a debt bubble for the average consumer, which is a very scary situation.

But this is not the biggest problem. As we keep saying, it's the supply side, not the demand side. There is just too much capacity in the system. There are too many inefficient companies with bad business plans that are surviving and supplying. How are they surviving? They survive using cheap money via loans through the public or private market. With the prospect of deflation, everyone is chasing yield. Investors are funding the lender directly or indirectly with cheap money.

Just look at the income trust market as a gauge. Some of these companies should never have been given a chance to enter this market. Some have already collapsed their distributions. Only when rational risk-adjusted capital is provided will the strong and viable companies of the world have more control over supply. Forced consolidation and more expensive capital will allow the cream of the crop to survive and thrive. These companies will have some (and I stress *some*) pricing power. Supply will be tempered, and a bit of equilibrium will be restored. Remember, the constant threat of technology will always put pressure on the manufacturer to cut costs, and thereby, cut prices.

To further the point, the allocation of capital is still moving to sectors that have large overcapacity and not to industries that truly need it. For example, let's look at the outdated electrical power grid. If projects like these are not supported, expanded and updated, our advances in technology that we hold dear will pay the price because we won't have the electrical capacity we need to develop them. As a result, we (the capital providers) will not be building the infrastructure for long-term and sustainable economic growth.



In the end, the way things are going, over the next few years, as the song states, we might have nothing to watch on those 57 channels, but it sure will be nice to watch it on a giant plasma screen TV for a fraction of the cost of today's prices. After all, there are some benefits to deflation.

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