



INVESTMENT SERVICES

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Re-Inflating the Economy

The Federal Reserve seems to be committed to use whatever means necessary to re-inflate the depreciating US economy and financial system. This culminated in the Federal Reserve Open Market Committee's (FOMC) March 18th meeting announcement in which the Committee indicated it would inject \$1 trillion into the economy by purchasing an additional \$750 billion in mortgage backed securities, \$100 billion more in agency debentures, and \$300 billion of two- to-thirty year Treasuries (which is approximately 30% of the anticipated new Treasury issuance over the next year). These actions pushed the Fed further into the strategy of quantitative easing, or engaging in an easing of monetary conditions without further lowering the targeted Fed funds rate. With Fed funds at a range of zero to 0.25%, there exists little else for the central bank to do other than these type of asset purchases.

The Fed's announcement that it would start buying such a large amount of Treasuries during the same time frame that the Obama administration is announcing historically large federal budget deficits verifies our previous suspicions that the central bank will be "monetizing" the national debt, or converting it into cash. These actions are the quickest way to expand the money supply and, by extension, increase the likelihood of inflation. This is not lost on the current members of the FOMC. In fact, as unusual as it sounds for a central bank, this is precisely its objective. The decelerating level of inflation has become concerning to the Fed as indicated in its most recent post-meeting statement that "the committee sees some risk that inflation could persist for a time below rates that best foster economic growth".

The risk of inflation is not considered a significant threat (in the near-term), as the increase in money supply brought about by the Fed's recent actions can be thought of as replacing the wealth lost in the housing, credit, and stock markets. Policymakers understand that the long-term inflation outlook is less benign, as this excess money supply must be removed once these depreciated asset classes resume their growth.

The ultimate near-term fear for the Fed, we would think, is a deflationary environment given that the economy's current problems have occurred due to a decline in asset values and a high consumer debt load. A deflationary environment would be particularly troubling in this environment because these asset values would continue to depreciate (as would all other assets) while debt would have to be repaid with more valuable currency. An increase in inflation would, naturally, have the opposite effect in that asset values (including real estate) would increase in value as more money chases the same number of goods while debtors repay their obligations with cheaper currency.

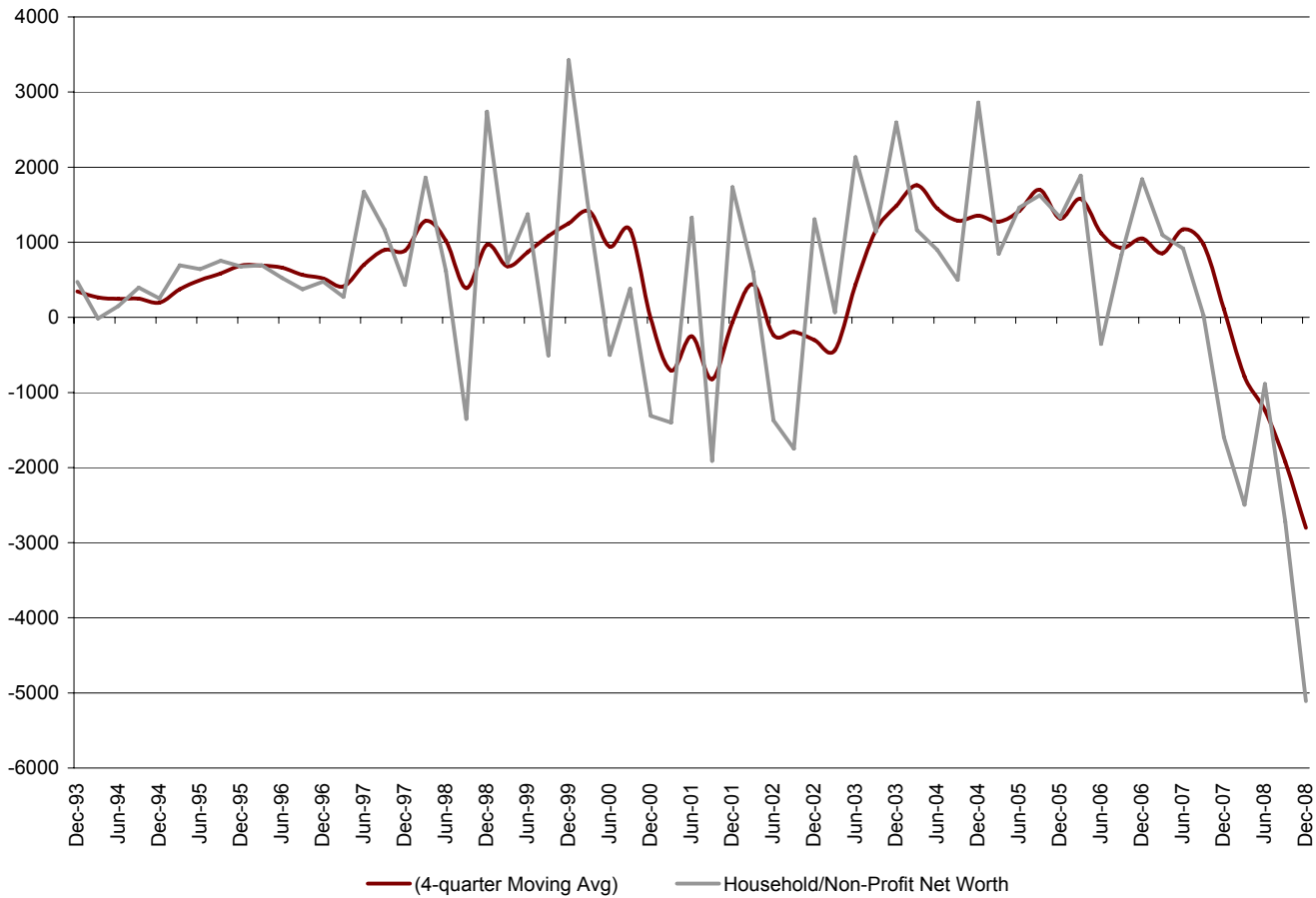
Although the economy may not yet have achieved a deflationary environment (a decline in the general price level), it is clearly experiencing a disinflationary one (a decline in the level of inflation). The inflation rate as measured by the core consumer price index has fallen from a cycle peak of 2.5% (on a year-over-year basis) in January 2008 to 1.8% last month. The Fed's preferred inflation measure, the personal consumption expenditures deflator has demonstrated an even more rapid descent as it has fallen from 2.4% last August to 1.6%, also on a year-over-year basis.

The negative impact that deflation would have on the economy would best be demonstrated by the status of the all-important consumer sector which represents approximately 70% of the country's gross domestic product. Debt increased from 12.3% of disposable income to 14.3% during the period from 2000 through 2007, reflecting an increasing burden. Even more sobering is the impact that the recent asset deflation has had on household balance sheets. Household net worth has fallen for five consecutive quarters, the first such occurrence since the data has been compiled starting in 1951. In fact, the previous longest string of negative household net worth growth was two quarters. Given the fact that the housing values continued to decline during the first quarter of 2009 and the Standard and Poors 500 Index slid another 8.5%, it is a near certainty that the nation experienced a sixth consecutive quarter of declining household wealth.

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HOUSEHOLD NET WORTH CHANGE (in \$ Billions)



An increase in the money supply is also not as concerning to the Fed due to the reduction in the money multiplier (the expansion of the money supply due to the extension of credit) due to such a dramatic contraction in credit supply as well as a decline in money velocity (the number of times a single dollar is spent during a specific period) due to the decline in final demand. This provides the central bank with greater leeway to continue to increase the money supply and achieve what we feel is its ultimate objective; re-inflating the economy.

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