Monopoly Money

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Dear Clients and Prospective Clients:

If there is any agreement out there among investors, it surrounds the measures being taken by the Federal Reserve to stabilize the financial system and prevent a 1930's style contraction. These same investors agree that these actions to revive our economy will lead to high levels of inflation. We've rarely seen a future expectation get baked into the stock market as quickly as this topic. People from the political right (who bash Obama) and those from the left (who like Warren Buffett love him) are in agreement. Money could be made by playing the devil's advocate. At Smead Capital Management, we'd like to make the case that this crowd could be wrong. To understand why, we have to take you back to childhood games of Monopoly.

In the winter when we were trapped inside or in the summer when baseball was over, my friends and I played hours of Monopoly. The game is played on a board representing four streets or neighborhoods. Each player starts with $2000 in cash and collects $200 for every time they pass Go. The bank exists for collecting payments for the purchase of properties and buildings. Its second function is paying rewards that can be reaped by landing on certain favorable squares. While one travels around the board, they can use their money to buy properties. If you accumulate two to three properties in the same neighborhood, you can buy houses and ultimately hotels to place on your properties. When an opposing player lands on your property, they pay you rent. The more real estate you own as well as the amount of additions (houses and hotels) to the property, the greater the rent that is paid. The object of the game is to create monopolies and eventually bankrupt your opponents.

To this point the actions of Fed Chairman Ben Bernanke and the Federal Reserve Board have been both systematic (backing money-market funds) and stimulative (dramatically growing the money supply). They sought to and succeeded in driving down interest rates and reestablished normal inter-bank borrowing in the process. Both conservatives and liberals are convinced that the huge increase in the money supply (printing of money) will result in an economic recovery which is followed soon after by very high levels of inflation.

Bernanke's actions are the equivalent of doubling the amount of money held by the bank in the game of Monopoly. If the bank has twice as much money and you pass Go, they give you $200 just like when the bank had less. None of the bank paid rewards change because of the bank having more money. The only way to inflate the game or inflate the economy is to directly put money into the hands of the players. Ironically, to speed up the game as kids, we did just that and gave each player an extra $2,000 or stuffed the center area with thousands of dollars. The more money players had, the faster they bought property and buildings. The faster the Monopolies developed, the faster that everyone but the winner went bankrupt.

The Federal Reserve has increased the money supply immensely, but the institutions and systems for putting the money into the hands of the players are not functioning. Banks are building capital to meet stress tests and working hard to work through existing loans on the books. Non-bank lenders have practically disappeared from lending and securitization is nearly non-existent. Savers sit in CD’s and money-market funds at dismally low interest rates and borrowers cut spending to pay off prior debts and build meaningful savings. They are passing Go and getting the same $200 even though the bank has twice as much money as they did before. Investors have twice as much cash in money market funds as any historical low point in the stock market for forty years. The lower rates are great for getting through the existing debts, but are a big drag on the incomes of conservative fixed-income investors.

Unless the Federal Reserve starts paying $400 for passing Go or people who have learned all the negatives about borrowed money suddenly start borrowing again, the inflation fears are over-blown at best and possibly dead wrong at worst. We will see you at Boardwalk or Park Place if these fears prove incorrect.

Best Wishes,

William Smead

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