# "Banks Set to Cut $1 Trillion From Balance Sheets"

-Financial Times, March 25, 2012

With gasoline prices breaching $4.00 per gallon in some markets, what I am about to say might sound a little crazy, but hear me out:

***Inflation will not be a major concern for years.***

This is not an academic argument or a matter of politics or ideology; it is perhaps the single most important factor in the investment returns you enjoy in the years ahead. The portfolio you build for an inflationary environment is a very different portfolio than the one you build for an environment of flat or falling prices.

With that said, how can I be so certain that inflation will not be a major concern? Is it not true that the Federal Reserve and European Central Bank are flooding their respective economies with cheap credit and printed money?

Well, they are certainly trying. But contrary to popular belief, it is not the amount of money *created* that causes inflation; it's the amount of money that actually enters the financial system. And right now, the world's major banks are not particularly interested in getting it there. In fact, their attempts to shrink their balance sheets have had precisely the opposite effect, actually removing liquidity from the system and starving the real economy of credit. And as the headline above makes abundantly clear, they are not finished yet.

Housing continues to be a drag on money creation as well. Even though the housing market is showing signs of life in some markets, American homeowners are far more interested these days in paying down their mortgages than extracting equity with new debt. This is good news for the long-term health of the country, of course. But it means for the foreseeable future, housing will not be a source of liquidity.

And finally, demographics will play a major role in the moderation of inflation. America's Baby Boomers, who were such a powerful force during the boom years, are now far more interested in saving than spending. As they pay down their debts and pad their savings, they remove would-be spending from the economy. Again, this is a normal part of the economic cycle, and it is important for the long-term health of the country. But it also means that consumer demand will be modest and inflation tame.

Someday, we will have real inflation again; to everything there is a season. But it might take a lot longer than you think. Japan, for example, has struggled with on again / off again deflation for much of the past two decades.

Japan had a unique and deadly cocktail of high debt, aging demographics, and bad policy that led to its 20-year stagnation, and the United States is certainly not Japan. Still, my point stands: even in a modern economy, high inflation

is not the inevitable outcome of loose monetary policy. And given the continued deleveraging of the private sector, inflation in the United States and Europe is likely to be mild at worst.

For investors, this means that a portfolio that focuses on quality, safety, and income will be the proper course of action.

Sincerely,

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