

Current Economic Outlook

Tuesday, July 14, 2009

The world economy is at a tipping point. Wealth is being drained from our nation to developing nations because we have violated the fundamental principles of wealth. The fruit of our fiscal and monetary policy will be a prolonged recession combined with inflation. To build wealth in this new environment, an individual must dramatically change their investment portfolio.

Principles of Wealth Creation and Destruction.

First, let me state the principles of wealth. These principles, like the laws of physics or the laws of mathematics, have natural consequences. Here are the economic laws of wealth:

1. Wealth is created through savings, investment, and production.
2. Wealth is destroyed by borrowing for wasteful purposes and spending on goods and services that do not produce a long-term benefit.
3. Living standards rise where wealth is created - through savings, wise investments and production.
4. Standards of living decline where funds are spent foolishly and debt is accumulated for frivolous purposes.

As a nation and as individuals, we have for many decades been a nation of frivolous spenders. As individuals, we have had a savings rate near zero. As a nation, we are:

- 23rd in reserves of foreign exchange and gold¹ (government savings), just behind Nigeria.
- Ranked 1st as a debtor nation² (or should we say – last) with over \$12 trillion in debt.

Postponing the Consequences.

The United States has been able to postpone the consequences of the laws of wealth through several means:

1. The amassing of trillions of dollars in U.S. budget and trade deficits.
2. The simultaneous willingness of Asian central banks to purchase our debts (China alone holds more than half our debt.).
3. Our status as the world's "Reserve Currency."
4. The manipulation of our currency by the Federal Reserve.

¹ <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2188rank.html>

² <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2079rank.html>

Like many laws of nature, you can postpone consequences for a period of time, but eventually the laws of nature take effect. And the longer you postpone the consequences through manipulation, the steeper the fall. The Fed has managed this postponement by forcing interest rates down every time it appeared our economy might slow. Interest rates are the “price of money.” When the price of money was unnaturally low, businesses and consumers were given an incorrect signal – that loans were cheap and risks of default were low. As a result, our nation and our nation’s people borrowed – for bigger houses, newer cars, and more toys. We violated the laws of wealth.

These unnaturally low interest rates the Fed created resulted in bubbles; a housing bubble and a debt bubble. But the natural laws of wealth have begun to respond, and the air is starting to leak out of these bubbles. Rather than let nature take its course, however, the Fed has gone to extreme measures to prevent our nation from entering a depression – the natural consequences. One method they have used is to print money. In less than 12 months, they have increased the money supply by over 100%³. Such an increase is off the charts. It has never been done before to this scale.

Congress has also done its part to keep air in the bubbles, by borrowing unprecedented amounts of money for TARP (Troubled Asset Relief Program), the stimulus program, and to purchase banks, auto companies, etc. The government is purchasing bad assets with borrowed money. In short, the government’s cure for the consequences of our profligate spending and borrowing is to go on a massive spending spree with massive amounts of borrowed money. It’s like a drug addict who tries to solve the problems resulting from his addiction by going on a drug binge. This will not end well.

Investors on the Sidelines.

So long as the government continues to do various things to stimulate the economy, rescue selected businesses, and threaten to increase regulation of certain industries, investors will stay on the sidelines and our economy will stumble along. Wise investors recognize that we have become a political economy – as government involvement creates significant distortions that make it difficult or impossible to analyze a business or industry for potential investment. Just as FDR’s New Deal - with its intrusion into the marketplace - prolonged and deepened the Great Depression, the current efforts of our government will magnify the severity of the current downturn and slow the ultimate recovery. Although we might see an uptick in economic activity resulting from the stimulus, expect any such good news to be short lived. The massive addition of government debt will result in increased interest rates, which will stall any economic growth. Inflation will rear its ugly head and we will stagger under the mountain of debt we have incurred.

³ <http://research.stlouisfed.org/publications/mt/page5.pdf>

Inflation.

We are looking at the real possibility of a prolonged recession with the added kicker of inflation. Why inflation? How can we have inflation during a recession?

1. First, as mentioned above, our government has been on a borrowing binge. In order to pay for all these bailouts and stimulus funds, the government must issue bonds. There is only so much appetite by investors for more U.S. bonds. It's a simple matter of supply and demand. The supply of new government bonds is about to get massive. The demand by investors for more bonds is not likely to match the supply, so the bonds will sell for less (i.e., the interest rate the government must pay will increase). Stated another way, the interest rate on the bonds will "inflate". This will impact interest rates across the board. The price of borrowing will increase for one and all.
2. As mentioned previously, the Fed has doubled the money supply within the last twelve months. Twice as much currency is in circulation than there was just last year! If you have two dollars chasing a hamburger today, when only one dollar was chasing it yesterday, you're going to start to see that hamburger sell for more money. The price of the hamburger will "inflate".
3. Have you noticed that during the depth of this recession oil prices have risen from \$37 to over \$60? How can that be? Oil prices have always fallen during a U.S. recession. The answer is twofold and it has to do with the supply and demand of energy:
 - a. The United States no longer dwarfs other nations as an economic powerhouse. The economies of China, India, Brazil and a number of other nations are quickly catching up and are consuming substantial quantities of oil as they grow. Just this year China surpassed the United States in the number of cars manufactured. And while the U.S. is suffering with a declining GDP, China is still growing this year at a 9% clip. The bottom line: other nations are consuming increasing quantities of oil.
 - b. There is a finite amount of oil in the ground. We may have pumped all the oil that is easy and inexpensive to reach. From this point each barrel of oil becomes more expensive to recover from the ground. That limits the amount that can be pumped in any given day, month or year. With this constriction in supply and a world of nations having a growth spurt, the price of our energy will increase, or "inflate."
4. The price of oil affects virtually everything in our economy. Our food prices are heavily dependent upon oil – to plant, harvest and transport the food to the grocery store. Oil is a key component in virtually every manufactured item we make and use. As the price of oil inflates, the price of everything in our world will inflate.

Inflation may not happen next month or next year, but within two to five years we will see significant inflation and it will be extremely hard for the Fed to tame. They believe they have the wisdom and insight necessary to thread our economy between the extremes of deflation and inflation. But they have no control over the price of oil or commodities. And the Fed will get no help at all from our government leaders who appear completely blind to the upcoming rise in oil and commodity prices – as evidenced by their desire to implement Cap-and-Trade legislation. Cap-and-Trade will further destroy wealth, while it inflates the price of our energy.

How does this new dynamic of inflation, as well as the continued destruction of our nation's wealth by our leaders affect the various types of investments we might choose?

Our Currency – the U.S. Dollar.

Our currency is critical to the value of our portfolios – because our investments are denominated in dollars. Over the past decade the value of the dollar as compared to other currencies has declined at a steady rate. Why? During this same period our nation continued to function in such a way as to destroy wealth – as defined at the beginning of this Outlook. When the world economies began to swoon in 2008, however, everyone rushed to the dollar and it spiked in value against most currencies. This spike was short lived, and we again see the continual slide of the dollar against world currencies. As the world's nations have witnessed the reckless spending of our government during the past year they have been increasingly vocal about replacing the U.S. Currency with something that will not depreciate so quickly. Expect no end to the decline in our currency, which is no longer backed by gold or any other money of value, but is backed by the “good faith and credit” of the United States, the greatest debtor nation in the world.

Real Estate.

This new reality of falling home prices is still very difficult for Americans to grasp. The real estate bubble has deflated home prices so quickly we have come to believe that they can't possibly decline any further. But the fact is; the Fed cannot force interest rates any lower. The Fed Fund Rate is near zero. Even in the depth of this recession interest rates have bounced up in 2009. As interest rates rise (see our earlier discussion on inflation), home sales will slow and prices will continue to deteriorate. Inflation and the crowding out effect of government bond issues will push interest rates into the stratosphere.

U.S. Stocks.

Inflation is murder on the value of equities. It is very difficult for businesses to pass on the inflated price of their raw materials to consumers by way of higher prices – especially in a recessionary period with high unemployment. Inflation and a declining dollar will have a

devastating effect on the intrinsic value of stocks. Only a select few equities, those associated with energy, commodities and/or substantial exports will thrive.

U.S. Bonds.

When the financial crisis became evident and the world economies began to sink, investors rushed to U.S. Government Bonds as a safe haven. This has created a bubble in government bonds. As discussed before, our government will be issuing unprecedented quantities of bonds to finance their spending binge. Our bond bubble will deflate as investors witness the explosion of new debt issues and the resulting decline in the value of their bonds. Investors will look for an asset with real intrinsic value in which to store their wealth.

Gold.

There is no longer a currency in the world backed by gold. All money in every currency is now fiat. The world's currencies are backed only by each country's ability and willingness to tax its citizens and issue debt. All of the world's central banks are simultaneously inflating their currencies. They're forced to – to prevent they're currency too quickly against the currency of the U.S. – otherwise their exports will become too expensive in the U.S. Everyone is trying to keep the U.S. spending machine going.

Governments of the world are quietly accumulating gold, namely China and Russia, as a hedge against the possible melt-down of the U.S. Dollar. Gold throughout history has been chosen as a reliable store of value because it is rare (i.e., it cannot be duplicated like the currency can be printed), it cannot be destroyed, and it can be divided, moved and exchanged.

When inflation spikes, gold spikes twice. Gold will be an important part of a healthy investment portfolio going forward.

Commodities.

Commodities are “real assets.” They include food items, metals and energy (e.g., oil, gas). Two factors have pushed up the price of commodities in the last decade: First, the continual debasement of the dollar by the Fed, and second, the increasing demand for the limited supply of raw materials by the growing economies of the world (e.g., China, India, etc.). Although the value of commodities fell substantially during the financial collapse in 2008, expect the upward trend to continue in the future for the same reasons – Fed action and increased demand from growing economies. These growing economies have demonstrated during this U.S. recession that they can continue to grow without us. So demand for the world's resources will continue to increase – and the price for those commodities will continue to climb.

Summary.



We are in the midst of a fundamental change in the world's economies. We will see the wholesale shift in standards of living from debtor nations to nations of wealth. The U.S. is a debtor nation. It is the world's biggest debtor nation. We are beginning to reap the consequences of the destruction of our wealth.

We will witness the Federal Reserve and our government leaders continue to "manage the economy". But their efforts will be fruitless as the weight of the laws of wealth, like the law of gravity, take hold. The result of their effort, the unintended consequence, will be inflation – substantial inflation – which will eat away at the purchasing power of the poor of our nation and of those on fixed incomes.

Commodities, and businesses which mine and harvest commodities, will see the value of their goods become increasingly precious. Historic stores of wealth, such as gold, will become precious as well.

This future is not comforting. It will in fact be painful for many. But with the foresight we have, we will position our portfolios in such a way as to not only weather the storm, but thrive in its midst.

Clayton R. Smith