

# Chapter 1

## The Current Economic Storm

It has been said that when your neighbor is out of a job it's a recession. But when you are out of a job, it's a depression. In the United States, the mood of individuals in this current economic environment has surely changed. Unemployment is rising, spending is declining, and asset values have burst from a seemingly high level. But this mood may not only be isolated in the United States, as many other countries around the world are struggling with their own sovereign debt and internal financial issues as the current storm spreads globally.

If the economy is doing as well as portrayed in the media then why are housing prices continuing to decline and the price of goods falling? My answer is simple. Don't believe everything you hear or read. The real truth about the economy is reflected in your budget and spending habits.

## Is It Deflation or Depression?

Deflation is when aggregate demand is less than supply of goods and services, thus general price levels drop. It's not that we don't have a surplus of goods and services; rather, we are experiencing a collapse of aggregate demand. We are entering a new but old economic era where the U.S. economy has been before. We are not only experiencing another major decline in the stock market similar to the Great Depression, but we are also reliving the large amounts of fraud embedded in our financial environment that accompanied that time period. In my opinion, contrary to what our leaders are boasting, it is not over yet and we are in the early stages of a Great Deflationary Depression. This just may be the beginning of a multi-year period of slow or negative economic growth not seen since the Great Depression.

A depression is a sustained, long downturn in an economy or a long-lasting recession. Recessions can be considered healthy for an economy. For instance, if growth starts to accelerate and signs of inflation seep into an economy as seen by too much demand for the amount of goods or services available, then a cooling-off period may materialize to slow down the demand and keep prices within a reasonable growth rate. The U.S. Federal Reserve has power to raise interest rates, which slows down the economy by increasing the cost of borrowing money, thus taking dollars out of the money supply as a goal of slowing demand. The opposite is true of a recession. The Federal Reserve will lower interest rates in an attempt to inflate the economy, thereby decreasing the cost of borrowing money and increasing the amount of money supply as a goal of inflating the economy.

Unfortunately, this is not an exact science and the Federal Reserve can get it wrong. Between 2001 and 2006, the Federal Reserve had a policy to keep money flowing, which caused a huge bubble in real estate and financial paper assets. In its final stage in 2008, commodity prices rallied to extreme levels in a parabolic manner

that eventually had to crash. By the end of 2008, most asset classes crashed at the same time. Equities, real estate, oil, grains, metals (precious and non-precious) and basic material prices fell in tandem with each other as the over-leverage in the financial system began to fall apart.

As the cost of money was so low, speculators borrowed as much as the system would allow and purchased as many assets as they could get their hands on. Speculators are investors such as individuals, hedge funds, pension plans and other similar entities that attempt to profit on price movements as markets rise and fall. A major problem inherent within the financial system was that speculators were able to purchase most asset classes with minimal actual investment dollars as leverage was the name of the game. A speculator could buy a house with little money down or buy futures contracts on crude oil for speculation with approximately five percent down. The problem was that if and when prices declined, the speculators would have to put up more money or sell out the asset to cut their losses. In reality, as prices collapsed, the global speculators had one huge margin call.

To meet the margin call, speculators turned to their usual resources: banks. Unfortunately, bankers had also become speculators along with nonbank speculators for the opportunity to enhance returns to compete with the nonbank investment firms. This created a domino reaction that started as the first speculator couldn't meet his or her margin call. The massive selling of the underlying assets encouraged other margin call speculators to unload their assets after realizing what was happening. The global assets started to implode and prices started to drop at an accelerated rate.

Now, realize that it took from 1983 to 2007 to create this massive bubble of asset appreciation. History has shown that a multi-decade bubble of such magnitude does not clean itself out in two years. I believe that it will take at least half the time of the building of the bubble to correct itself before prices of goods and services can be realigned for the next growth cycle. Therefore, I believe the next growth cycle will begin in 2020. Until then, our economy will

experience a multiyear deflationary cycle that could see assets fall as far as 90 percent from their peaks in 2007–2008. Do you find that hard to believe? Well, in the Roaring Twenties, most believed that such a fall could not happen, but it did. In my opinion, a depression started in 2008 and we are only two years into my expected cycle of 12 years.

As deflation begins, the buying power of your dollar in the United States will get stronger regardless of the value of the dollar versus other world currencies. You will be able to buy more goods and services as deflation cuts prices to stimulate movement. You want to be in a position to take advantage of the low-priced asset environment to come.

Currently, I hear advisors hawking gold and other hard assets. I believe that this couldn't be farther from the truth. These people have been trained to believe that as the Federal Reserve keeps pumping money into the financial system, it will cause an inflationary environment. Based on my calculations, the amount of money being pumped into the U.S. financial system is still less than the value of the assets that were highly leveraged—whose values have been destroyed by the bubble bursting in such assets as real estate and the stock market values up to now. But on top of this, our leaders are actually prolonging the length and deepness of the depression. They are preaching that in order to get out of the deepest recession since the Great Depression, we must go further into debt. How can the debt problem that was caused by a spending free-for-all be corrected if people are being told that going into more debt will solve the problem? This is absurd and will never work. Japan tried this method and it got them to the same place we are headed for here in the United States, a prolonged deep recession that I describe as a deflationary depression.

## The Government Cannot Save this Sinking Ship

History has shown that when governments get involved with capitalistic societies, the rules begin to change. For example in 1920, the U.S.

economy was about to go into a deep recession. The government at that time had the ability to choose to intervene or let the natural order of capitalism take place. The choice was made not to interfere with capitalism and as companies failed, the economy began to flourish. The result of the no-action policy was rewarded with healthy economic growth all during the Roaring Twenties until the crash of 1929.

After the crash of 1929, which was caused by too much speculation, the government decided that it needed to do something drastic to start policies that they believed would get the economy back on track. However, government intervention had the opposite effect. Programs were designed to encourage people to rely on the government instead of on themselves. Many were looking for hand-outs, as we may be experiencing today.

At the same time, the agricultural economy was starting to deteriorate as climate change reduced crop production during the dust bowl period which resulted in more people out of work.

Finally, during the 1930s, the newly born Federal Reserve developed policies that were more restrictive than expansive due to lack of experience by the Fed officials as to how to handle the economic environment. A restrictive policy resulted in a continuation of the depression which ended up being one of the worst economic depressions known as the Great Depression.

As for today, I see history repeating itself. Starting in 2004 through the peak in 2007, the real estate housing market began to teeter after a wild increase of housing prices for many years. The later years were the most exciting as housing prices ran up into 2006. However, warning signs were beginning to show up in the cracks and the government, instead of allowing prices to moderate, developed plans to get almost everyone into the housing game. We recently found out through congressional hearings that banks and other financial institutions were encouraged to continue lending money to people that would have never qualified for mortgages, just to keep the game going. On top of that program, Wall Street firms

were packaging these low-quality loans as investments to pension funds and individual investors alike, not only here but also abroad.

Inevitably by late 2007, the bottom was beginning to fall out and housing prices began to collapse as mortgage defaults and sales began hitting the markets at a rate faster than the markets could absorb. At first, our leaders said that the housing financial problem would be contained and would not spread to the rest of the economy. Unfortunately, in my opinion and that of others I clearly respect, the housing market is the backbone of any economy. Housing supports many professions and manufacturing companies and without a strong housing market, these industries will begin to feel the effects, resulting in layoffs and increased unemployment.

The cycle then begins. Housing starts and sales of existing homes begin to fall. Then, mortgage defaults start to rise, putting more houses on the market competing with new homes that were being built at a rapid speculative rate. Continuing along this cycle, as the values of the homes that were financed to the maximum levels fall below their respective mortgage balances, homeowners start walking away from their homes, thereby leaving the value of their neighbors' homes to decline. The final result ends up being high unemployment.

The Federal Reserve then steps in and drops interest rates to practically zero for banks to borrow so that they can lend to prospective homebuyers. But this is the part of the equation that no one, in my opinion, expected: The demand for mortgages and loans dropped to extremely low levels. The psychology of the consumer began to change. People stopped buying homes and even started to slow down buying durable goods on credit. The loans on the books of many banks and financial institutions began to crumble. The Federal Reserve had already dropped interest rates to historically low levels, so the next plan was for the Federal Reserve to buy up the nonperforming loans from the banks and financial institutions in hope of flooding the markets with capital. Unfortunately, this program didn't seem to help create demand. In fact, many economists and economic advisors thought it would be inflationary.

My opinion is that the Federal Reserve could not replace enough lost money back into the system. All they did was remove toxic nonperforming assets from the banks and financial institutions and put them on the Federal Reserve balance sheet. Future generations will most likely foot the bill for this program.

I conclude that the government cannot stimulate demand for credit in a deflating, over-leveraged society. They cannot change the attitude that took an about-face when it went from "I want it now" to "I need to conserve" thinking. Credit demand will continue to slow for years to come as households, small businesses, and even major publicly traded corporations realign their balance sheets and hoard cash. These are truly signs of a deflationary depression.

## Protecting What You Have

Batten down the hatches and preserve your money now. If you own fully invested stock market vehicles such as mutual funds, you might want to think about getting out now. In my opinion, if you have excess money in bank accounts above Federal Deposit Insurance Corporation (FDIC) protection levels, invest that money in short-term U.S. Treasuries in such time periods as 3-month Treasury bills to 2-year Treasury notes. Be aware that it is not the time to think about or hope for return on your money. You should be concerned about the return of your money when you will need it the most. Even if the banking system defaults, you can still go to the U.S. Treasury and redeem your bills, notes, and bonds. Back in the earlier stages of the Great Depression, there were such days as a bank holiday. These bank holidays were designed to cool the public down from panic about getting access to their money.

Today, we have the FDIC, which is an agency of the U.S. Government designed to guarantee deposits up to certain amounts per account per customer at its member banks. The guarantee fund used by the FDIC gets its fund from assessments from the very banks it protects. Unfortunately, that fund ran out of money and

assessed the banks in 2010 for years to come just to put money back in the FDIC pot. The funds are again running out of money due to the continual failures of banks. The FDIC's own reports indicate that they expect over 400 banks to fail by 2012. Furthermore, there is an available credit line from the U.S. Treasury to the FDIC, but if tapped into then the U.S. Treasury would have to issue more bonds (debt), because by my calculations, they don't have the resources on hand to cover the credit line as tax receipts have been declining and government policies have been spending.

Today, our government is financing its operations by issuing U.S. government securities such as Treasury bills, notes, and bonds. But buyers of large amounts of these U.S. Treasuries are foreign central banks such as China and our own Federal Reserve! Sounds like a Ponzi scheme to me. The U.S. Treasury is issuing securities and our Federal Reserve is buying them. Not only is the Federal Reserve buying the debt that the United States is issuing, but they are also buying toxic debt from the banks to put cash in the banking system. I will go into more detail about this later in this book, but be aware that I question the validity of the Federal Reserve as an agency of the U.S. Government as it is stated in their own brochure; in my opinion, it seems that it stands on its own as a separate entity.

Deflation is here and getting worse. Keep liquid and safe with your money and preserve it for future financial purchases at lower prices over the coming depression. You may see bargains that you can only imagine right now.

## Profiting from the Coming Deflationary Depression

There are several ways to profit in a recession. The first way is to realize that cash is king. Bargains will appear whether in goods at stores dropping in price so inventory can move, or real asset prices such as real estate, precious metals, and other tangible assets as investments get liquidated at obscene prices. Services such as home repair, auto repair, and personal care, among others, may see their

prices drop. So being patient as the deflation cycle develops will give you tremendous opportunity to take advantage of a lower cost environment.

I also believe that the equity markets will also deflate with the deflation cycle. Investors will not only liquidate to raise capital, but the future company earnings, which stock prices are supposed to reflect, may decline to lower levels, thereby dragging down stock prices.

In the 1929 stock market crash and subsequent years as the markets moved lower, there were aggressive investors who sold stocks short. Shorting stocks means that you borrow the stock from another investor and sell it to a buyer. Your bet is that the stock will move lower and you will be able to buy it back in the future at the lower price and redeliver it to the investor you borrowed it from. This is one way of profiting in a potential declining market.

Fortunately, today's investors can choose from derivatives such as options, futures, and exchange traded funds (ETFs) to profit in a declining stock market. If you choose options, put buying would be the position of profiting as the market moves lower. The only problem is that if the market doesn't move lower then you will lose money on that bet. The fortunate part is that with put buying, you can only lose as much as you invested. It's a bit more complicated than what I have explained here and I do recommend that you seek out professional help before taking any of this advice.

Also, as a derivative, one can sell a stock index futures contract to buy back at a later date. There are futures contracts on the major stock market indexes such as the Dow Jones Industrial Average, the S&P 500, the NASDAQ, and the Russell 2000 indexes. Again, I caution you that these vehicles are risky and you should consult a professional advisor if you choose to use these vehicles to make a bet on the future of the market.

Finally, there are ETFs that you can buy like a stock where the value has the potential to increase as the markets decline. These vehicles are getting more popular especially because of their liquidity and

ease of trading. Another plus is that ETFs can be used as vehicles in an IRA account or other similar plans that have restrictions on the availability to invest in other derivatives such as options and futures.

Somewhere in this cycle will be a great opportunity to purchase stock of major corporations at rock-bottom prices. The Great Depression–type levels or the levels of the Japanese stock prices that declined for the past decade will be seen here in the U.S. markets in the future. Throughout this book, you will read about points and time levels where great opportunities may show themselves for entry into the equity markets, but for now think in terms of deflation. This means lower prices ahead for mostly every sector of the economy as liquidation continues to take place until we run out of sellers.

## Preparing for the Next Hyperinflation Cycle

Eventually, once the deflationary depression cycle runs its course, we will need to prepare to invest in the coming hyperinflationary cycle. I do warn that this cycle is many years away as the current deflationary cycle needs to bottom first. Of course, when we reach that bottom, the government and the economic advisors may not see it and keep policies of money expansion on too long.

If the money expansion policies are not curtailed in time then the probability of the hyperinflation exists. We anticipate that hyperinflation will be the result of loose government policies held too long, and our current target for the peak in hyperinflation is around the year 2020. In later chapters in the book, we will note our expected target for the peak in gold, which is known as a safe haven for hyperinflationary parts of the economic cycle.

## Summary

Almost every major depression in the history of the United States has been greeted with a substantial decline in the money supply.

This decline is also often accompanied by a collapse of the banking system in some shape or form. During major depressions, money and banking center difficulties are among the major causes of the declining economic climate.

For thousands of years through the ups and downs of economic cycles, people have always had trouble with money. They complain about inflation and blame it on an excess increase in the money supply. Or, they have trouble in recessions with unemployment moving higher, factories sitting idle, and falling prices of consumer goods and services and then complain that the money supply is declining and not growing rapidly enough. The point is that there is seldom that exact point where demand equals supply, as we learn in Economics 101, where there is in theory just the right amount of money in circulation. A multitude of policies have been tested and tried to control the money supply for hundreds of years, yet none have gotten it exactly correct.

Throughout the history of expansion and contraction of our economy, it is clear that money is the most important element to all of us. Our current system, after centuries of experiments, has created sophisticated measures to control the money supply in the interest of the public. But, through it all, this only raises new questions about how these new measures of power should be used.

Consumer and corporate expenditures for goods and services, particularly investment expenditures, are greatly influenced by the money supply. The management of the money supply affects four of the major objectives of economic policy: full employment, price stability, growth, and balance of payments equilibrium, which is very difficult to get exactly right.

As the goal of the current Federal Reserve System is to influence expenditures for goods and services through its control over the money supply, its policies cause economic depressions, deflation, hyperinflation, and market bubbles, although indirectly. Such changes in the money supply also influence the behavior of banks and other lending agencies where they may take on too much risk or curtail risk

when the environment is uncertain. As a result of all of these variables, changes in interest rates and the availability of credit strongly influence expenditures for business investment, construction of houses, and other types of spending. But the underlying measure is the psychology of the consuming public. If they become scared and stop spending, as we are beginning to experience in this current cycle, then no policy of the Federal Reserve or U.S. government or bank lending capability will stop a deflationary cycle.

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