

Crash or No Crash - The all important – “inflation or deflation” question

This question is important because, in order to adopt the correct investment strategies we need to try to anticipate if Stock Markets will:

1. Crash and Burn – A Crash is a Crash – you have lost money;
2. Trade Sideways – read negative “Real” returns – easier to know you have lost money as you know that if the DOW & S&P are at the same level in 2011 as they were in 2000 you have obviously lost after adjusting for inflation, whatever that may be;
3. Go up in “Nominal” terms but not in “Real” terms – harder to evaluate if you have or have not lost money, since the markets have gone up dramatically and yet, their rise may not have exceeded the real adjusted www.shadowstats.com inflation rate. This is what happened in Zimbabwe, where share prices rose to Trillions of Zim Dollars in a few years, but declined when measured in Dollar, Euros, Gold etc; or
4. Go up in “Real” terms – can only happen if Fiat currency party comes to an end and the Global Economy is Healthy.

Essentially, I think it is safe to say that the Global Economy is not healthy and that a lot has to happen before all is in order – i.e. it will not return to “Good Health” in the foreseeable future – Read reports:

- From Here to Final Destination; and
- Investment Backdrop.

Therefore, we need to evaluate only the first three. These will depend on two factors, namely:

- The extent to which Sovereign, State, Corporate and Private austerity measures impact on the Global Economy; and
- Whether, based on actual and not manipulated statistics, we have:
 - Deflation – prices of all things including food, fuel etc come down;
 - Inflation – prices of all things go up between 1% - 15% per annum;
 - Hyperinflation – prices go up monthly, weekly or daily; or
 - Stagflation – Inflation or Hyperinflation with negative GDP.

Before we commence with our analysis, I think some perspective is useful. It is a fact that all countries manipulate their inflation statistics to the downside, which means they manipulate their GDP growth (after inflation) to the upside. Looking at www.shadowstats.com, we find that Official US inflation rates are say 2% whereas the correct rate is probably closer to 8%-10% per annum. Similarly, average GDP growth in the US has actually been negative (-2.5%) and not positive (2.5%) for the past decade and unemployment at 22% is double what the official figures report. Therefore, looking at the past decade, the US has had Stagflation - Negative “Real” GDP Growth with considerable Inflation.

It is a given that severe cutbacks (austerity measures) on all levels will have a negative impact on economic growth. The question is: - Will this cause markets to crash or will the constant liquidity injections keep markets up.

Potential Scenarios are as follows:

1. Cutbacks will cause GDP growth to slow and markets to crash and burn;
2. Higher inflation will cause markets to trade sideways;
3. Hyperinflation will cause markets to rise in nominal terms; and
4. Higher inflation will cause yields to rise in time and that will cause a Bond market collapse, which will precipitate a Banking collapse, which will result in an equity market crash.

So how do we figure out which is the most likely scenario.

Current trends that we know about that are relevant and escalating/accelerating:

- Increasing awareness by individuals that the global economy is in trouble, coupled with increasing dissatisfaction by the electorate that those in office are “not doing their job”;
- Growing concern about increasingly worthless Fiat money and greater awareness that Gold is an alternative currency. Early media coverage in the papers and on business channel talk shows confirms this. Bad for \$;
- High and rising US unemployment – 22% using www.shadowstats.com 's 1980's US formulae, which means ever fewer people are spending money that will exacerbate any slowdown in economic growth. Mediterranean countries are now at 22% official – unofficially higher;
- In the face of Global Economic Uncertainty, individuals are maxed out on debt and are increasing savings/reducing debt, all of which adds up to “Business slowdown”, which equals lower spending, higher unemployment, lower tax revenues and negative economic growth;
- Ever increasing amount of people cannot make ends meet due to under compensation for rising living costs, thanks to artificially depressed inflation statistics. This, coupled with high unemployment has led to global food riots and anti Bank/Government protests, which will, in turn, probably lead to higher crime, greater security concerns and/or anarchy;
- Globally, Banks are reluctant to lend and are hoarding cash to boost their reserves – inter alia as a buffer against further economic setbacks – which is contributing to slower economic growth;
- Globally, companies are cutting back, hoarding cash, avoiding capital expenditure and reluctant to embrace long term expansion projects, due to the global uncertainties, which implies slower economic growth etc;
- Escalating pressure from the public, national and international arena on local and national authorities to adopt austerity measures, which equals lower spending, higher unemployment and lower tax revenues;
- Greater inclination to monetize debt to cover escalating budget shortfalls exacerbated by lower tax revenues, especially in the USA, as they have to monetize or admit bankruptcy (UK close behind). Governments have to choose between frugality, which could lead to unrest, anarchy and bankruptcy or profligacy/monetization which will lead to hyperinflation, currency debasement, international censure etc;
- Prices of what we own seem to be decreasing due to lack of demand and prices of what we use seem to be increasing due to speculation spurred

- on by currency debasement. i.e. US\$ down = US \$ price of commodities up as price cheaper in other currencies = perception of rising commodity prices = speculative boom as return better here than in Cash;
- Commodity prices have been escalating in price for the past decade and are likely to continue rising for another 20 years due to demand from the East (China, India, Russia, Malaysia etc – 3x West's population), which is trebling demand over and above currency debasement = inflationary;
 - We have just completed a decade of persistent negative economic growth (last 10 years average about -2% p.a. see www.shadowstats.com charts), which is likely to continue for a protracted time in a spiral of cutbacks and slowdowns that precipitate further cutbacks and slowdowns.

Note: If the resulting decline in economic growth manifests and escalates, this will almost certainly precipitate the second market crash. This will in turn probably lead to a second round of collapses in the banking sector. However, this time the banks will probably not be bailed out and the result will be massive cascading failures. All this is probably deflationary. Contrarily, the amount of money being printed is floating equity markets and commodity prices higher on a sea of money as was the case in Zimbabwe, where shares rose to Zim\$ Trillions. Therefore, the markets could rise in nominal terms but decline in “Real” terms.

Assuming that continued negative economic growth is a given, based on the above trends, the big question is deflation, inflation, stagflation or hyperinflation:

- Assumption - negative economic growth is a given;
- Add to this deflation and we have depression - Unlikely;
- Add to this inflation and we have stagflation – Most likely;
- Add to this “inflation that is out of control” and we have “stagflation with hyperinflation” – Less likely;

Early indications are that different regions are likely to deal with these threats differently, as they are more or less inclined to take austerity seriously, let us first look at this on a regional basis;

- EU – on balance individuals, private and public sectors are more inclined than not to implement fiscal discipline, austerity measures, higher savings rates, debt reduction etc, that will result in business slowdown, higher unemployment, lower tax revenue, negative GDP, deflation etc. Club Med countries are being compelled to cut back by the bond vigilantes and their Northern EU Backers who are voluntarily adopting same;
- UK –the UK is voluntarily adopting austerity measures;
- USA – individuals are increasingly unhappy with future debt prospects and seem to be inclined towards higher savings and/or debt reduction, while the private business sector is hoarding cash. Indications are that local authorities will be compelled to implement some fiscal discipline, but at national level there seems to be an unwillingness to stop the gravy train. The USA is, at this stage, more inclined to increase spending than to reduce government and, in the face of declining taxes revenue that implies

monetization is inevitable. Richard Russel says US must “Inflate or die”. Therefore, we may have acceptance at individual, private sector and local authority level, coupled with denial at national level; On balance, this is likely to lead to fiscal discipline, austerity, higher savings, debt reduction etc that will result in business slowdown, higher unemployment, lower tax revenue, negative GDP, deflation etc. However, at the same time, it seems there could well be massive monetization, which will mean the Dollar will be undermined. This will, in turn, drive up Dollar Commodity prices;

- Japan – has run the monetization route and national debt is now the highest of all, barring that of the USA if unfunded liabilities are taken into account, which they should be. Privately individuals have been saving and reducing debt. As monetization has delivered no real benefits for the past 2 decades, it may be that their Government will adopt a new paradigm – namely austerity;
- Canada and Australia – will probably adopt austerity;
- Far East – will probably implement fiscal discipline, austerity measures, higher savings rates, credit reduction etc, that will result in business slowdown, higher unemployment, lower tax revenue, negative GDP, deflation etc. China has already commenced by de-linking the Yuan from the Dollar, while China, India and Russia are actively campaigning for some sort of new paradigm - ?Gold Standard? International Reserve Currency as they anticipate the impending demise of the Dollar era;
- Africa and South America are small in the global picture, but are likely to be compelled to follow suit by global trends and the absence of credit;
- Middle East, not sure, but are likely to be compelled to follow suit etc.

Note: Countries like the BRIC countries, Indonesia etc, Middle East etc have massive positive trade surpluses, so they can probably spend themselves out of trouble fairly quickly. Therefore, they are unlikely to experience protracted recessions or period of deflation regardless.

Conclusion – the USA which accounts for 30% of the global economy is likely to have high spending at national level compared with probable frugality at individual, private sector and local government level. The remaining 70% of the global economy is likely to opt for frugality at all levels. This means that more than 80% of the global economy is likely to favour frugality over profligacy in the next few years, so we are likely to have a global economic slowdown and US dollar weakness.

So what does this mean for the deflation/inflation debate. I think we are more likely to see deflationary trends bucked by monetization in the USA, the UK and the EU. This does not equate to hyperinflation, despite the fact that the staggering amounts of money created in the past years would imply that this is a huge risk. I also think that the likes of China, India, Russia, the Middle East, Germany and other Northern EU countries will take drastic steps at the first signs

of hyperinflation. This leaves deflation and inflation. I cannot imagine deflation, given the amount of money still out there and the implied continuation of monetization in the USA, UK & EU at the very least, to cover budget shortfalls. This leaves us with moderate inflation coupled with negative economic growth. Based on Shadowstats (US), we have had 10 years of stagflation (as all countries manipulate their stats), as we have had 10 years of negative GDP growth coupled with 10 years of considerable inflation (about 10% pa.). So I vote for continued stagflation for say 5-10 years into 2015/2020.

Bond market yields in the US are converging on Zero, which means they will go up sometime in the next 3-5 years, which will, almost certainly, cause a Bond market collapse. EU and UK bonds are already trending to higher yields. If yields go up globally, a bond market collapse is almost certain and that will lead to a banking collapse, which will, in turn, precipitate an equity market collapse. Now it must be remembered that this could only happen in 3-5 years. But I said equity markets could drift sideways or float higher on a sea of liquidity. Does that mean that equity markets will trade sideways and that the collapse of the equity markets for the next few years will be when it is measured in “Real” and not “Nominal” terms? Again, this would be over time.

I personally believe that this initial period of stagflation will be followed by a period of rising inflation, interest rates and, more important, Bond market yields, which will eventually result in a bond market collapse. This will result in massive Banking collapses followed by a stock market crash. In the event that this scenario plays out, I believe that this crash will take shares to unimaginably low levels. Regardless of whether stock markets crash in nominal or real terms, this will be followed by years of hardship that could make the depression look like a “seriously good times” as the global economy resets. Essentially this is because the abuse of Fiat currencies has allowed the Global Economy to be in much worse shape leading into this stock market crash than it was after the 1929/32 crash. This global crisis will in all probability be accompanied by massive Quantitative Easing, which currency debasement will cause the prices of commodities to rise and drive up inflation. When inflation gets too high, say over 15%, the East will compel the West to adopt painful Fiscal Disciplines, that will be painful in their own right. Essentially, Recessions and Depressions reset the excesses that build up during the preceding growth phase. Since these were papered over during the past 28 years, the imbalance of cumulative excesses is far more extreme than ever before. There has been so much shorting and manipulation in the commodities arena that this rebalancing will extend to this arena – which is inflationary. Only when all these excesses have been eliminated and Fiscally Prudent policies re-instated will the Global Economy return to good health with stock markets offering good future growth prospects. Excellent article worth reading - <http://www.marketoracle.co.uk/Article23789.html>